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Doing Good and Making Money Go Together

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This paper addresses two key questions:
First, what is "ESG investing" or, as it is often used interchangeably, "sustainable investing".
Second, can ESG strategy be profitable? Indeed, on this second question, ESG investors would want to know if there is a penalty in the form of lower returns if they confine their investments only to companies that meets a desired ESG threshold. Is there a link between ESG compliance and superior corporate financial performance and hence fund performance?

The sustainability of an investment is the extent to which it can remain of value in any plausible situation or circumstances over time. Taking the "E" or Environment into consideration for example, a company with an appalling environmental track record is unlikely a sustainable investment because its value could be damaged by legal action, leading to fines or regulatory sanctions. Similarly in terms of what can go wrong with "S" or Social, a firm that deals with workers unfairly cannot be expected to be sustainable because its value can be impacted by low productivity, labour disputes or even withdrawal of market access into countries or regions with strong labour laws.

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Investors in Malaysia's equity market will no doubt recall the sharp loss in values of glove makers in 2021 and 2022 after a detention order by US authorities was enforced in response to evidence of labour exploitation. (This unfortunate experience turned out to be a blessing as the remedial measures undertaken in response to these charges and the urging of investors have led to vastly improved labour management as reflected by sharply improved ESG scores on the affected companies by ESG raters such as Sustainalytics). And poor governance "G" raises risks of 'agency costs' in the form of management incompetence or negligence or worse, fraudulent acts.

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In a sense, it would be fair to say that an ESG strategy has risk management as a main investment pillar besides the required excess return. Being on the look-out for what might go wrong and encouraging company management to take the necessary mitigating steps protects the downside risks. In becoming better companies in an ESG sense, their shares become more valuable. Intuitively at least, we would argue that sound ESG companies are more likely to generate solid financial returns in addition to the psychological return or satisfaction attainable from exercising good ESG practices.

In terms of capital cost advantage, it is quite easy to see why ESG-good companies have better access to capital than lesser ones. Let's say M is the total sum of money available to be invested in companies. Of this available amount, S is the capital that belongs to Sustainable investments or ESG investors. Companies that pass the ESG tests have access to M, but those that do not, have access only to M-S. Based on this argument, "ESG-bad" companies will have a higher cost of capital than "ESG-good" companies. And, ESG-good companies are likely to face lower risks and probably more stable earnings that lead to higher valuations.

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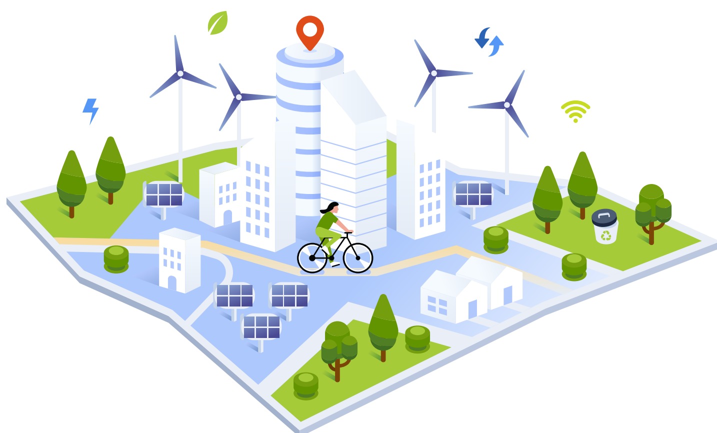
While it can be argued that ESG compliant portfolios if managed well can generate value added returns over the long term, they are not immune to the short-term vicissitudes of their market, political and economic environments – in other words their performances are impacted by vagaries of non-ESG factors. For example, sceptics claim that as recent as 3 years ago, green energy funds have benefitted from the financial impact on oil companies of lower oil prices and that when oil prices rise, as they did shortly after the breakout of the Russia-Ukraine war in 2022, oil companies will outperform renewable energy suppliers.



What we are suggesting is that over long periods of several market cycles, the case can be made that with capital increasingly favouring renewables and good governance and growing number of countries introducing regulations placing a cost on carbon, ESG-good companies will ultimately win the day by rewarding investors well. They can have their cake and eat it too.

Active ESG investors help to transform corporate governance in our portfolio companies, contributing to significant improvements in their financial results and increase in market valuations. Active ESG investors engage with companies in various sectors and regions to improve their governance. Such is the characteristic of "Impact Investing" where the burden on the fund manager extends beyond searching for superior returns to include generating desirable ESG outcomes.

Hence, true ESG investing is anything but "passive". But according to Mobius Capital Partners, ESG investing's dominant instrument today remains largely negative screening, which seems to us a deskbound exercise of excluding companies that fail ESG tests from portfolios. We believe we need to go further. We can turn mediocre ESG companies into tomorrow's leading lights. The full benefit of ESG investing will not be realized until it is combined with an active investment approach such as regular corporate engagements where its impact on management and governance can do the most good.

In closing, we repeat our key assertion in the article we wrote for World Earth Day last year. That is that the pursuit of ESG in business is not in conflict with, but instead, is a condition for achieving long term sustainable profits. Highly successful visionary companies do both – they deliver consistent superior long-term profits AND contribute to the well-being of societies and the environment.

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