Zeno AN SOLUTIONS

A "Fireside Chat" on ESG

Introduction

Brian Greene from Abel Noser Solutions recently conducted a "Fireside Chat" with Ben Webster, CEO of OWL ESG. The Fireside Chat was held at the TEXPERS 2022 Annual Membership Conference in Fort Worth, Texas. The discussion was lively, with Brian not hesitating to ask Ben direct (and sometimes uncomfortable) questions about a variety of ESG-related topics. The overarching theme pertained to the challenges asset owners face when thinking about incorporating ESG into their fund policies. We found Ben's responses to be refreshingly candid and showed a deep appreciation of the practical realities that asset owners must consider as prudent stewards of their funds.

We believe the dialogue would be of value to a wider audience and have therefore reproduced much of the discussion below. We hope you find it as interesting as we did.

An ESG Discussion at the TEXPERS 2022 Annual Membership Meeting

Brian Greene

Hello and welcome to this afternoon's session on ESG and how it can assist asset owners with their investments. I am Brian Greene and am joined by Ben Webster from OWL ESG. I will let Ben introduce himself and OWL ESG, but for those of you who don't know me, I work for Zeno AN Solutions which is the asset owner division of Abel Noser Solutions.

Abel Noser Solutions is one of the largest and oldest trade cost analysis firms in the industry. We have been assisting asset owners since the early 1980s and analyze over $30 trillion each year in equity, fixed income, FX, and derivative transactions on behalf of our clients.

Most importantly for today's session, we take great pride in being able to process large amounts of data and distill it into clear and concise reports that provide our clients with meaningful insights and actionable items. This empowers our clients to exercise their fiduciary oversight responsibilities in a more informed and prudent manner.

While we are only now looking into how we might better assist our clients with monitoring manager compliance with fund ESG policies, I know that Ben and OWL ESG are some of the most thoughtful and practical subject-matter experts in this field. I am excited about the opportunity to ask Ben some perhaps uncomfortable questions and take advantage of his expertise to learn more about what asset owners could or should be considering when it comes to ESG. So, with that, let me pass the microphone to Ben.

Ben Webster

Thank you, Brian. OWL ESG is in the business of helping institutions understand how companies are treating the environment and how they are treating their stakeholders, whether that's employees, customers, investors, vendors, and the communities they live and work in. And finally, we help track how well companies govern themselves ethically.

That said, I want to be very clear; our job is *not* to tell people what to invest in or what to believe from a values or ethical perspective. We merely provide the data to let people express what they care about and what their values are - whether they want to invest in certain things and not invest in others. We have no judgment on what those choices are.

Brian Greene

Ben, as an advisor to asset owners on trade cost analysis, Abel Noser is in the business of trying to provide practical insights and actionable follow-up suggestions to our clients. That's the lens I use when I look at what's going on in the ESG ecosystem. But as I look at ESG today, I find that I have more questions than answers.

So as an initial question at a very high level, can you talk a little about what ESG is and why, in your view, asset owners should care about it?

Ben Webster

Great question, Brian. ESG is not new. It has been around for hundreds of years most commonly in the form of socially responsible investing. The Quakers, for example, were one of the earliest well-known socially responsible investors. The Dutch East Indies company also, at one time, employed socially responsible approaches to their allocation of capital.

Long story short, it's been around for a long time, but it has been on the fringe of the investment world until the early 2000s. In the early 2000s, it was rebranded as ESG and, quite frankly, expanded its focus to encompass additional areas of concern.

In recent years, the E of ESG is why ESG took off. There was a lot of research that came out, hundreds of research papers, looking at how ESG-related matters had an operational impact on the way in which companies performed - from a fundamentals perspective - like earnings growth, sales growth, cost of capital etc.

People realized that some of these ESG issues were material to different types of companies. It followed that if those companies monitored and improved in those areas, they could survive longer and hopefully grow faster and outperform their peers.

In effect, ESG represents the intersection of social responsibility and materiality. My expectation is that over time more and more research will be poured into ESG such that it can better help companies manage risk and outperform their peers.

As far as asset owners are concerned, at a high level, they should always be looking at material issues that affect their portfolio. I know it's not as simple as that because there is a lot of disagreement on what's "material" for different industries. But asset owners need to focus as much as they can on making sure that they are reducing the material risks in their portfolio.

I also think that many asset owners may, themselves, have stakeholders that care about certain ESG-related matters. For example, there may be a trustee who, from an operational perspective, feels that social issues are more important than governance issues, or vice versa. If so, the asset owners may want to try and get ahead of, and be proactive in developing, an ESG narrative that their own stakeholders will be comfortable with.

Brian Greene

Thank you, Ben. If I can follow-up on that issue, when I look at other investment-related areas I have a very clear sense of who the different firms are and what they do. So, for instance, if an asset owner wants to invest in public equities, there are general consultants who will help determine an asset allocation and then help find the managers

that need to be hired. Once hired, those managers invest the client's assets and utilize broker-dealers to execute the manager's trades. The custodian bank holds the asset owner's assets and settles their trades. And the asset owner receives a report each quarter from their general investment consultant and various boutique consultants like myself, so they know what their fund's performance is. It all fits together very nicely such that asset owners know exactly who they should be working with when performing their fiduciary and oversight duties.

However, when I look at the ESG landscape, there are so many moving parts. Some vendors appear to be doing similar things while others are doing different things. Can you shed some light on who the players are in this space? And if an asset owner wants to conduct ESG-related due diligence, who they should be talking to?

Ben Webster

You are correct, Brian. There are a lot of vendors out there and there are a lot of different niche players focusing on different types of ESG data. I break down ESG data into four major categories, which are very popular and common.

The first category is ESG ratings agencies. These are like bond rating agencies - S&P, Moody's, and Fitch - and they are trying to measure how well each company manages the material ESG risks relevant to that company's industry. Now, these agencies don't necessarily do that well, but they try to.

Then there are vendors that provide what we call ethical screens, to enable investors to identify and potentially exclude companies that are in lines of business the investor does not believe in ethically. For example, if I as an investor don't want to invest in companies that sell adult entertainment products, or I don't want to invest in companies that are in the tobacco industry, I can make those policies known to my managers and then monitor their compliance with my directions.

The third type of vendor tracks when companies are associated with newsworthy controversies. For example, if an energy company is involved in an environmental catastrophe of some kind like a major oil spill, or if Chipotle is involved in multiple food poisoning incidents, those controversies could have a very material effect on the company's performance.

Last but not least, there are vendors that focus on quantifying carbon emissions and related issues. This type of data has become extremely popular.

In fact, earlier this year the SEC stated that one of the top two areas they would be scrutinizing in 2022 is manager ESG practices. The SEC also indicated that ESG would be one of their major areas of regulatory focus in 2022 (crypto currency was the other).

With respect to asset owner due diligence, for asset owners not running money internally, from our perspective it is important to keep it simple. Quite frankly, asset owners just need to receive periodic snapshots, maybe quarterly, of what their managers are investing in and how the overall fund is looking.

Brian Greene

It's interesting you say that, Ben. I am constantly seeing news items talking about the growth of ESG within the institutional investment community. But when I talk to our US clients, I get the impression that many of them are skeptical either of the merits of ESG, or their ability to leverage ESG data in a meaningful manner. And of the ones that are doing something, most seem to be limiting their oversight to asking their managers qualitative due-diligence questions.

In fact, many of our clients have said they worry that applying ESG criteria to their investment guidelines could potentially limit their managers' investment opportunities. And those clients therefore feel that imposing such a limitation on their managers might breach their fiduciary responsibility to maximize the growth of their funds. How would you respond to that view?

Ben Webster

ESG is a very subjective topic and I want to be very transparent. In my opinion, it's really about disclosure. How do ESG risks impact what you need to know as a fiduciary? What makes sense for your stakeholders in a prudent risk-adjusted manner?

It's important to note that ESG is huge. Trillions of dollars are being invested using ESG data and ratings. Whether an asset owner or manager pays attention if MSCI or one of the major rating vendors upgrades (or downgrades) a company into (or out of) an index because of ESG, that will affect your fund's performance. If the market is pumping up ESG stocks, and penalizing non-ESG stocks, that will affect you – regardless of your personal views about ESG.

Ideally, ESG should be a means of asset owners voting on what they believe is materially relevant to their long-term goal of growing capital and meeting their fiduciary duty. And if there's anything ethical that you want to trade off, for example if you decide you don't want to invest in tobacco despite knowing that there may be cycles in the market where tobacco outperforms, that's up to you and your stakeholders.

You need to be on top of that in some way, even though it may seem overwhelming. However, I don't think asset owners should be pouring over spreadsheets and excel tables. What you need is a monitoring tool that maps ESG data and ESG metrics to your portfolio. That way, you can set up a compliance regime or methodology that fits what you want to do like a glove and use that tool to monitor how your managers are doing - according to what you care about.

Transparency is key. It's great when managers tell you what they're doing; but how do you know they're actually doing what they say?

To be clear, I don't think it's necessary for asset owners to go out and license ESG raw data and have teams of analysts doing it all internally. All asset owners really need are simple oversight tools that employ a top-down approach to help monitor their managers' ESG practices in an efficient and cost-effective manner. And don't let anyone tell you to do something you don't want to do.

In a way, this is similar to how asset owners use trade cost analysis. You can look first at your portfolio as a whole and then at certain managers who outperform/underperform their peers. Similarly, asset owners can talk to both existing and potential managers about if/how they are managing their ESG risks.

Brian Greene

Ben, that makes perfect sense. But I must ask you a very practical question. When I first began looking at ESG, I quickly noticed that in addition to OWL there are four or five other vendors that are in the business of rating companies based on their ESG compatibility. As you mentioned earlier, ESG ratings are much like S&P, Moody's, and Fitch rating different bonds. However, unlike those bond-rating agencies, the ESG rating providers often seem to view the same company very differently.

In fact, I believe I saw an academic study conducted by MIT which calculated that while the bond ratings of S&P and Moody's have a correlation of 0.92, the correlation of the ESG rating firms ranges from only 0.38 to 0.71.

Can you help me understand why there is such a wide range of ratings? And for asset owners who want to assess their managers' adherence to ESG standards, how can they rely on ESG ratings when there's such a wide divergence of opinion even among the experts?

Ben Webster

That's a very fair point Brian, and I don't want to minimize its importance to anyone attempting to monitor their managers' compliance with ESG policies. The goal of ESG scores and ratings is to try to let you know which companies are doing a better job at managing those risks. The major ESG ratings vendors out there in the market are firms like MSCI, Sustainalytics (which is owned by Morningstar), Robecco SAM (which is owned by S&P Global), and a few others. The critical problem that all asset owners and managers need to recognize is that these firms' ESG ratings can diverge dramatically.

Tesla could have a good E-rating with MSCI but a poor rating with another rating provider. This is not because anyone is trying to falsify scores. The different ratings providers have different ways of assessing, for example, which environmental impacts are important (i.e., "material"), and which are not important to the outperformance of Tesla. Those different opinions are reflected in the different scores and ratings assigned by each respective ratings vendor.

Unfortunately, most asset owners don't have the time to sift through whether Sustainalytics' ratings are right or if MSCI is right or if S&P Global is right. And as you say, that can make an asset owner very hesitant to take concrete actions. Happily, machine learning and artificial intelligence actually provide a solution, which OWL ESG and a few others have begun harnessing.

For example, OWL ESG provides what we call "consensus-driven" ESG scores. As the consensus ESG rating company, we aggregate ESG-related data and ratings from hundreds of sources including more than fourteen of the major ESG ratings vendors and compile ESG scores based on the consensus view of that group. In a sense, OWL is like the consensus earnings estimates of financial analysts. In this way, the consensus ESG scores provide a solution to the inherent subjectivity that exists in today's ESG ecosystem.

OWL ESG also provides controversies, carbon, and exclusionary screen data. If an asset owner determines that they don't want to be involved in certain types of ethical activity business lines, this data can help craft portfolios that focus on both ethical as well as materiality issues.

Bottom-line, asset owners who previously may not have had a clear understanding of what they could do can now easily design an oversight program that really reflects the issues important to them, whether those issues are environmental, social, or governance related.

Brian Greene

Thank you, Ben. That was very illuminating. To round out everything before we finish up, I would like to get your thoughts on three questions we've heard from multiple asset owners:

What are your thoughts regarding greenwashing?

Can you talk a little more about carbon emissions?

How do US asset owners differ from European asset owners with respect to monitoring ESG?

Ben Webster

I'd be happy to. Let me take each of those questions in turn. With respect to greenwashing, companies are starting to publish annual sustainability reports or corporate social responsibility reports. These reports are just like annual reports, 10-Ks, and 10-Qs.

In these reports, companies disclose their track record, progress, and goals across a variety of ESG issues. Basically, greenwashing is when a company gives ESG a lot of lip service in those reports but hasn't really taken any meaningful action. I've read hundreds of those reports and in most instances the companies truly are taking meaningful actions. However, given the current political environment, many people are skeptical about the assertions made in these reports; and to be blunt, in some cases the skepticism is justified.

Just like you have auditors of your financial statements, there are auditors of sustainability reports. That's a good thing. Greenwashing is a problem that exists. However, I do believe that most companies are generally trying to do a good job. But it's hard to verify what they say, and sometimes the data is just not there.

In discussing carbon emissions, keep in mind that this can sometimes be a loaded topic. Take car manufacturers for example. There's a thing called Scope 3 carbon emissions which focuses on companies that put their products into the marketplace. These companies have to publish the carbon emissions of their products in the marketplace when they're used by others. However, that's hard for car manufacturers to estimate since they don't know how many miles people are driving those cars, etc. So, to a certain degree, this requirement is an unrealistic expectation by investors of what a company can monitor.

And those same investor blocks often completely ignore the negative effects of supposed green technology. Truth be told, there's a lot of green technologies that have very bad environmental negative effects, but it's not talked about. For example, wind turbines kill bird populations and can even end species of birds.

Also, while a lot of scientists agree that we want to lower our carbon emissions, that doesn't mean fossil fuel companies are evil. In fact, they're necessary. Elon Musk recently observed that if we got rid of fossil fuels right now, society would collapse. We're simply not ready for that; and fossil fuel companies play a valuable role in making the world work and ensuring people have heat in their homes and food on their tables.

I think another aspect that might not be looked at as well as it should, is the idea of comparing say fossil fuel companies to the broad market. This isn't necessarily an appropriate comparison. Rather, you might want to look at them within their sector or their sub-sector. Sometimes the right thing to do is not to necessarily take the company out of the portfolio by banning them; but instead measure each of those companies against their peers and say who is doing a good job and trying to make things better.

I just want people to be objective, fair, and balanced. Of course, I understand how hard it can be to gather all the relevant facts. And we've already talked about how difficult it is to process the new data in a meaningful way. But asset owners shouldn't worry about all those things; that's what I worry about. It's my job to try and translate these requirements and the degree to which companies comply with them. That's what OWL ESG's consensus scores try to do by utilizing the "wisdom of the crowd" approach.

With respect to your last question, there are definitely significant differences between the policies and views of many US and European asset owners. It seems to me, in the US we view ESG-related matters as trade-offs and

many asset owners are willing to risk some return to achieve these other goals. Other asset owners are not prepared to do that and that's okay. Each investor must make their own decisions based on their own judgements.

In contrast, institutional investors in Europe see ESG as a vital component of their lives. Many people growing up in Europe do not want to do business with companies that they view as harming the environment. And if you talk to those European investors, they will say that if a company isn't addressing its environmental impact, they simply are not a long-term viable investor.

Particularly in Europe, there is a huge generational desire to work with, invest in, and be a buyer or purchaser of goods and services that are perceived to be environmentally friendly or positively impactful. From the US's perspective that is rare. It's more common in Europe. Bottom-line, regardless of whether ESG truly has an impact, if people believe ESG is real, that will affect stock prices right now.

Brian Greene

Thank you, Ben. I unfortunately see that we are out of time. This has been a fascinating session, and you have certainly given us all a lot to think about. I hope we can continue this discussion in the near future.

Ben Webster

I would love to. There's a lot of work that remains to be done, and the more asset owners understand what's possible, the better we'll all be.

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