

To ESG or not ESG, that is the question

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Recently, there has been a lot of focus on sustainability and ESG investing, where the environmental and societal impacts of a company are factors that are considered when selecting investments.

The argument is that climate change is in itself an investment risk so divesting away from unsustainable companies will improve risk adjusted returns. For long term investors, this is mostly true. However, the market has been subconsciously aware of this fact for many years. This is because most companies that are labelled as “unsustainable” actually have poor to average economics. Think of most oil and gas companies – their profits depend on the price of a commodity which is often unpredictable. They are also capital intensive with long lived assets. Without diving into the details of arcane accounting rules, a capital-intensive company with long-lived assets will always exaggerate how much profit it is making because depreciation is usually much smaller than the actual replacement cost of the asset. This is a known factor and is priced into equity valuations already we would suggest.

Another argument for the shift towards sustainable investing is moral – and this is more complicated and not something that we wish to debate at any length other than to say that more efficient use of any asset that is in limited supply will prolong its life.

Market cycles are driven by changes in capital allocation either towards an area or away from it. It just so happens that the technological change of the past twenty years directly impacts us as consumers and therefore people focus on it more than other changes such as robots rather than humans mining in the Congo, which has transformed the mining industry. Oddly, the recent announcement in the UK to limit new car sales to electric cars from 2035 is actually a form of regulation which will reduce returns for the car industry and will likely limit choice over the medium term, not least as the industry itself re-allocates its capital away from the internal combustion engine.

Any industry that generates superior returns sees these returns reduced over time through either increased competition or via increased regulation.

Ultimately sustainable investing has the ability to direct investment towards certain industries and away from others. This could lead to a change in pricing behaviour and the long-term valuations attributed to certain sectors and companies. This is a concept known as “reflexivity”, coined by the financier George Soros. It essentially means that people’s beliefs can influence reality, regardless of how accurate the belief is.

This could permanently impair capital values in the future and is a risk Tacit considers very seriously. We have always incorporated these factors into our investment approach but only after careful thought and not because they are the consensus view. Anything that can erode the cashflows generated by a company will ultimately impact its price and remembering this is more important to us than the EGS label.

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