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THE ESG FACTOR

The official newsletter of ESG Ireland

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Turning Intention into Action

"Part of my joy in learning is that it puts me in a position to teach; nothing, however outstanding and however helpful, will ever give me any pleasure if the knowledge is to be for my benefit alone. If wisdom were offered to me on the one condition that I should keep it shut away and not divulge it to anyone, I should reject it. There is no enjoying the possession of anything valuable unless one has someone to share it with." - Seneca

Purpose: Talk or Action

Larry Fink, Founder, Chairman and CEO of Blackrock, got everyone talking about purpose in 2019 after his annual letter to CEOs – "Purpose and Profit" – this time last year.

I will leave it you to decide whether it was based on a genuine sense of purpose - what he calls "the essential check on actions that go against the best interests of stakeholders" – or whether it was just purposeful marketing.

Purpose is another one of those words that is open to interpretation and manipulation, just like responsible and sustainable. They can have real meaning, or they can have no meaning. At a personal level, I attach meaning to the words through action.

I have been immersed in responsible investment for the last two and half years, since working in impact investing in Guatemala in 2017. It hasn't been driven by financial reward or because something told me to do it. I have immersed myself in this area because I find it interesting and challenging on so many levels.

Jürgen Klopp, Liverpool FC manager and one of the best football managers in the world, once said: 'You can talk about spirit or you can live it'. It is the same with purpose. I choose to live it. Everyone has their own choice to make.

Get in touch if you want to learn more about the purpose of ESG Ireland. I have a busy schedule over the coming weeks in Dublin, but the aim is to meet with more stakeholders all over Ireland this year.

Be part of the solution in 2020.

Vincent McCarthy, CFA
Founder
ESG Ireland

A Seinfeld Take on Plans

WRITTEN BY VINCENT MCCARTHY, CFA

When it comes to building a sustainable future, we continually see great plans being made. One problem; they fall short on the most important part, the execution.

In 2005, the financial sector initiative "Who Cares Wins" put forward key objectives and targets for the integration of Environmental, Social and Governance (ESG) factors across all stakeholders. Fifteen years later, we are finally starting to see some real momentum behind the integration of ESG, but we are still a long way from where we need to be.

Then in 2015, leaders from 193 countries created a plan called the Sustainable Development Goals (SDGs), 17 goals and 169 targets, to make the world a better place by 2030. "The Goals and targets will stimulate action over the next fifteen years in areas of critical importance for humanity and the planet". A third of the way in and the plan is off track.

There were other lofty plans; like the 1997 Kyoto protocol. Ex-Uruguayan President Pepe Mujica has described the failure of the Kyoto protocol as shameful, directly calling out world leaders.

Still, what else to do but make another plan with even bigger goals and targets. The sad reality is that the targets keep getting more audacious because the scale of the challenges keep increasing due to the failure to meet the previous targets. The 2015 SDGs are beyond lofty considering previous failures.

"This set of 17 goals imagines a future just 15 years off that would be rid of poverty and hunger, and safe from the worst effects of climate change."

World leaders are clearly very good at making plans; there is no shortage of imagination.

There is also always a great show around the announcement of any plan, with every leader vying for their moment in the limelight. To plan is deemed a success. Unfortunately, it is the execution of these plans where they continue to fall short.

It reminds me of a Seinfeld episode where Jerry Seinfeld arrives to pick up the car he reserved. The desk attendant informs Jerry that the car he reserved is unavailable.

Jerry: I don't understand. Do you have my reservation? I made a reservation.
Attendant: Yes, we do. Unfortunately, we ran out of cars.

> To plan is deemed a success. Unfortunately, it is the execution of these plans where they continue to fall short.

Jerry: But the reservation keeps the car here. That is why you have the reservation.
Attendant: I know why we have reservations.
Jerry: I don't think you do. If you did, I'd have a car. See, you know how to take the reservation. You just don't know how to hold the reservation. And that is really the most important part of the reservation, the holding. Anybody can just take them.

That is my fundamental issue with the continued failure to meet grandiose plans. These leaders know how to make plans. They just don't know how to execute those plans. And that really is the most important part of the plan, the execution. Anybody can just make them.

That 2030 future imagined is now only 10 years off. Soon it will be time to start making another plan.

Stoic Conviction to ESG

WRITTEN BY VINCENT MCCARTHY, CFA

The interest in ESG and responsible investing continues to gather momentum, with events and forums being held in cities across the world in 2019, from Dublin to Taipei.

This is a positive development. However, there is one caveat. Every year, well intentioned people attend these events, proclaiming their feelings of leaving 'inspired and motivated'. Once back into the grind of regular life that euphoria wanes rapidly and too often the action needed to bring change fails to materialise. Reasons on why to cling to the status quo begin to emerge.

I think it is worth bearing in mind the words of the Stoic philosopher Seneca as we think about how best to cultivate the required follow through over the coming months and years.

In one of his letters to his friend Lucilius, Seneca wrote "the perfection of wisdom is what makes the happy life", a pursuit that he argues must be lived every day. "Philosophy is not an occupation of a popular nature, nor is it pursued for the sake of self-advertisement."

In the same vein, ESG is not a periphery subject that we can visit now and again, or something that we merely pursue for self-promotion, be it an individual or an organisation. It requires genuine conviction for it to be meaningful.

Seneca writes on the need for building one's conviction to philosophy and the perfection of wisdom: "Yet, this conviction clear as it is, needs to be strengthened and given deeper roots through daily reflection; making noble resolutions is not as important as keeping the resolutions you have made already. You have to persevere and fortify your pertinacity until the will to good becomes a disposition to good."

The Stoic legend could easily have been talking about strengthening our commitment to ESG, the conviction needed to turn individual intent into meaningful action.

ESG is a way of thinking as much as applying a set of rules or principles, an internal compass that can help decision making at all levels. In line with Seneca's point and in the context of implementing ESG, that "will to do good" will only become "a disposition to do good" when ESG becomes part of the consciousness of decision making.

This applies across business, investments and public policy, with those at the top carrying the most responsibility.

It is a cultural change which is needed, something that requires leadership, conviction, cultivation and authenticity.

The two biggest challenges I see to this cultural shift are:

1) closing the knowledge gap around the practical understanding and application of ESG.

2) changing the linear mindset in which people view ESG, something which limits its potential to make a difference.

These are not easy challenges to overcome. But I like a challenge and that is why I set up ESG Ireland; to help expedite the cultural change needed for the security of our future and that of generations to come. **To turn intent into action when it comes to ESG.**

ESG Case Study: CRH

WRITTEN BY ROSIE FRENCH
ESG ANALYST, ABERDEEN STANDARD INVESTMENTS

CRH is a global building materials company that supplies aggregates, lime, cement, concrete and asphalt for a wide range of construction applications. These include major public roads and infrastructure projects, commercial buildings and residential communities.

ASI is a signatory of Climate Action 100+, an investor initiative targeting engagement with the world's largest corporate greenhouse gas emitters. As part of the CA100+ initiative, a report was published by the Institutional Investors Group on Climate Change on the construction materials sector, which informed and drove our decision to engage with CRH on its climate change approach. **As a large shareholder in CRH, we have closely engaged with it in the past on corporate governance. This marked our first climate change-focused engagement.**

Following a letter sent to the chairman in June, we participated in a meeting with the head of sustainability. This meeting focused on CRH's alignment with the TCFD and its participation in the Construction Preparer Forum; the group's CO2 emissions reduction targets and plan; governance of climate change and other ESG matters; and, finally, its public policy approach and involvement in industry associations.

In many ways, we see CRH as a global leader in its approach to climate change. Climate change sits both as a core part of the group's risk management framework, as well as an integral part of its long-term strategy and potential business opportunities.

The group is participating in a TCFD preparer forum which should lead to full disclosure in line with this framework – seen as best market practice – by January 2020. We also saw CRH introduce a new Safety, Environment & Social Responsibility Committee in 2018.

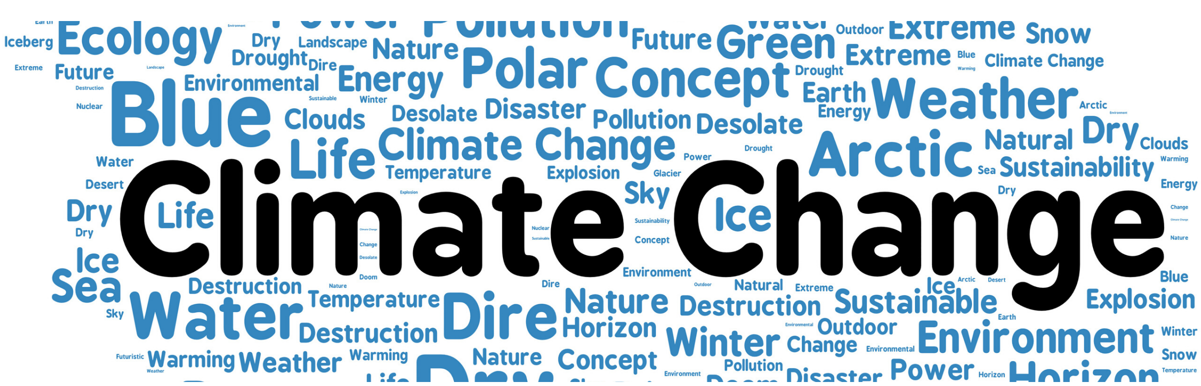
What is perhaps most impressive is the group and management's involvement in multiple cross-sector initiatives to develop solutions to reduce the lifecycle carbon emissions of cement. While there are many leading elements to the group's climate change strategy, we offered several recommendations that we believe could help further strengthen and solidify a leading approach.

• CRH will publish its carbon emissions roadmap later this year. We encouraged it to set ambitious, science-based targets for 2030 and 2050, which would support a 1.5 degree warming scenario. We also look for a clear plan on how to meet these targets.

• We recommended that its carbon emissions targets be linked to executive remuneration to ensure alignment of incentives.

• Finally, we encouraged CRH to carry out an exercise to ensure the alignment of its membership association policie with its own climate change policies and ambitions.

The engagement with CRH was largely positive, with open and constructive dialogue. Many elements of the group's governance, risk management and strategy on climate change are strong. However, we will remain engaged to ensure the introduction of ambitious, market-leading carbon emissions targets. We have requested a meeting with the new chairman once he takes up the role from January 2020 to continue engagement on this topic.



The Cloak of Social Responsibility

WRITTEN BY VINCENT MCCARTHY, CFA

One of the standout characters when it comes to free market economics and the role of business is the free market economist Milton Friedman. In 1970, the New York Times published his c. 3000 word article entitled: **"The Social Responsibility of Business is to Increase its Profits".**

Friedman argued that people talking about the social responsibilities of a business were "preaching pure and unadulterated socialism". From the outset, he leaves no doubt in the minds of readers on how he feels about such people: "Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades."

He was plugging his book "Capitalism and Freedom", and it is obvious that his world view is defined by two sides, Capitalism and Socialism, what he sees as the market mechanism and the political mechanism, representing freedom and conformity. His perspective is clearly shaped by the USA v Soviet Union backdrop.

Friedman's catchy article title is regularly cited in articles on social responsibility, sustainability and the profit motive. However, I would encourage everyone to read the piece and then read it again, and regularly.

One might not agree with everything (or anything) Friedman argued but 50 years later the article is still relevant. It is rich in discussion points that still need to be debated openly. Decision making bodies across companies, investments and politics have to go on their own philosophical journey to arrive at a practical and implementable position.

In fairness to Friedman, he is upfront with his opinions, something that not many people are willing to be. Even when companies or executives get off the fence and commit to something publicly, it can be very difficult to decipher between what is genuine and what is just PR.

Friedman takes major issue with pious executives and companies proclaiming to be socially responsible when their actions are ultimately driven by the self-interest of the corporation. He uses the example of a major employer in a small local community, making contributions to generate goodwill in the long-run interest of the company. He calls it “a cloak of social responsibility”.

“Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds rather than a reason for those actions....one way for a corporate to generate goodwill as a by-product of expenditures that are entirely justified on its own self-interest.”

For him, companies using the cloak of social responsibility are misrepresenting their underlying commitment to profits. This he feared would ‘give strength to the

to the already too prevalent view that the pursuit of profits is wicked and immoral and must be curbed and controlled by external forces ‘.

It is black and white for Friedman; there is no grey area. ‘The only social responsibility of companies is to make profits, within the rules.’ (Of course, his caveat “within the rules” opens up another debate on the rules and the setting of those rules).

“It would be inconsistent of me to call on corporate executives to refrain from this hypocritical window-dressing because it harms the foundation of a free society. That would be to call on them to exercise a "social responsibility"! If our institutions, and the attitudes of the public make it in their self-interest to cloak their actions in this way, I cannot summon much indignation to denounce them. At the same time, I can express admiration for those individual proprietors or owners of closely held corporations or stockholders of more broadly held corporations who disdain such tactics as approaching fraud.”

Strong words. If Milton Friedman was still alive, his review of Larry Fink’s 2019 letter to CEOs would be entertaining.

In one sense Milton Friedman has a point. The world needs more authenticity; there are a lot of fugazis out there. However, the important point is that even the staunchly capitalist Milton Friedman recognised that developing goodwill with other stakeholders could be in the self-interest of companies to increase profits over the long term. He just wanted businesspeople to be honest about their motives.

If more companies were genuinely open with their motives with respect to social responsibility, then it would add more credibility to their organisation. It would also help lift us out of our culture of short termism. An obsessive focus on short term profits compromises the future. Taking social responsibility seriously is consistent with developing sustainable profits over the long term.

Profits are not a bad thing; but they must not come at the expense of people, the environment and other stakeholders.

Source: “The Social Responsibility of Business is to Increase its Profits” Milton Friedman, The New York Times Magazine September 13, 1970

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>
> Milton Friedman

Responsible Companies and Impact

WRITTEN BY VINCENT MCCARTHY, CFA

A responsible company

Given that intangible assets, like brands, now make up a large part of the value of a company, companies spend big money on creating the appearance of being good corporate citizens, to protect the status of their brand. This can make it more difficult for investors and consumers to differentiate between branding and genuine corporate social responsibility.

For me, a responsible company is one that explicitly considers the long-term impact of their decisions on all stakeholders, including the environment. Therefore, the focus of capital allocators should be on the company's business model and how they are delivering a net positive impact on society.

The global financial crisis provides the most obvious example of the failure of companies to act responsibly but every year we are provided with examples of corporate fraud, malpractice and blatant disregard for stakeholders. Many of the implicated companies talk a good game when it comes to corporate social responsibility, but the reality is very different.

Impact Investing

Impact investing has provided hope of a fresh approach to how investors think about the impact of the underlying companies they invest in. The concept emerged from the philanthropic space in 2007 with the Rockefeller Foundation laying claim to the coining of the term. The basic idea started with the application of business principles to philanthropic money in order to better measure its impact.

Since then, mainstream investors have taken more control of the direction of the sector, such that the definition has expanded to traditional impact investing and mainstream impact investing.

Working in impact investing in Guatemala in 2017, one of the things that surprised me most was the vagueness of the sector, allowing all sorts of firms to declare themselves impact investors. Having said that, we are in the early stages of the self-proclaimed revolution so we will see how it unfolds. The skeptic in me would consider it slightly concerning when venture capital and private equity firms from the US and other developed countries are moving aggressively across Latin America and other continents under the flag of impact investing.

Impact Spectrum

While impact investing evolves, the stewards of capital – investment managers, consultants, trustees and ordinary investors – still have to incorporate impact into their decision-making process and hold companies to account.

The focus must be on responsible companies delivering a net positive impact on society, within the context of assessing the impact across all stakeholders. Driven by their own moral compass, defined in the investment process, capital allocators can decide where to invest across the spectrum of impact e.g.

- from companies focused on implementing an impact business model,
- to companies who offer products and services that transform society,
- to companies that directly target the challenges our society faces.

The ESG framework and the 2030 Sustainable Development Goals, if applied in the right way, can be a core part of measuring impact in a consistent way.

After more than two and a half years of being immersed in responsible investment, I think a lot of it really comes back to acting with common sense and respect for our planet and its inhabitants. Many people just need to re-examine their common sense. To quote the philosopher Alan Watts:

"What I think an awakening really involves is a re-examination of our common sense."

Playing both sides

WRITTEN BY VINCENT MCCARTHY, CFA

The proliferation and evolution of hedge funds has been spectacular over the last three decades. From a relatively niche investment option in the early 90's for sophisticated investors, hedge funds are now part of the mainstream. For better or for worse.

An allocation to hedge funds can make sense if it is consistent with the objectives of the overall portfolio. However, given the complexity of hedge funds and their higher fees, advisors must provide sufficient education on the mechanics of these funds in order to manage the expectations of clients.

ESG Hedge Funds

Hedge funds have shown themselves to be extremely nimble, successfully seeking out new sectors and markets to infiltrate. **The momentum behind ESG investing has not gone unnoticed and we are now seeing more hedge funds enter the ESG space, proposing their own twist on how ESG can be used to enhance returns.**

Recently, an investment firm announced that they will be launching a new long-short ESG fund as their hedge fund unit 'is interested in bets based on environmental factors'. It will be up to an investment committee to determine whether such a fund aligns with their responsible investment policy. But consider one potential conundrum that could play out.

Assume company A is a standout sustainable company that ranks highly on their environmental performance. As a result, the stock price has risen in value due to investor preference for companies who have shown strong environmental performance. The Long-Short ESG fund looks at the stock price and even though it ranks highly on environmental performance, they judge the stock price to be overvalued based on the irrational exuberance of green investors.

Now take company B. Their environmental performance has been horrendous, and the stock has suffered a sharp decline after weeks of negative news flow regarding protests related to the behaviour of their subsidiary companies in Latin America. The Long-Short ESG fund looks at the stock and while the company has shown complete neglect of basic environmental rights, causing many big-name investors to sell, the long-short manager considers the stock cheap on a valuation basis.

Without any baseline standard in terms of an acceptable level of environmental performance of the companies they invest in, the long-short ESG fund may end up going long (buying the shares) the environmentally destructive company and going short (borrowing the shares to sell them) the environmentally conscious company.

It runs counterintuitive to what the average investor might expect of an ESG fund. **An important factor will be whether the hedge fund takes a fundamental position on the acceptable environmental performance of their investments.** Otherwise, the use of ESG is merely an indicator to determine whether a stock is overbought or oversold based on the preferences of a growing cohort of responsible investors.

Such a fund using ESG merely as a technical indicator is indifferent to the impact of a company on the environment. Hence, capital allocators need to look beyond the ESG label when it comes to fund selection. It is also a reminder of the importance of having a well-thought-out robust responsible investment process.

Too Early or Too Late?

WRITTEN BY VINCENT MCCARTHY, CFA

In the "Investment Consultant Services Review" published by Principles of Responsible Investment (PRI), with input from Mercer and Willis Towers Watson, one of the consultants interviewed noted that: "It's much less risky to be late to ESG than early".

In my conversations with various stakeholders – from right across the fiduciary chain – I have also heard some people share this perspective. Echoing the sentiment expressed by the consultant, one trustee recently told me: 'it is safer in the middle of the pack than to lead. I will wait for the consensus to develop, as most trustees will'.

For me, this attitude represents a reneging of one's stewardship responsibilities. If everyone was to wait for the consensus to develop then we would never move forward. Individuals and organisations have to take the lead; if more firms and people publicly join this debate – rather than just throwing out the latest soundbite – then there is real potential to make the ESG framework a powerful decision-making tool.

Preaching to those comfortable in the status quo is not going to change the culture. The general population – such as the average pension scheme member – must be empowered to ask meaningful questions of those in stewardship roles. Only then will we see them take ESG more seriously. It is not good enough to just say: ' sure members are not asking any questions on ESG'.

Some trustees have also mentioned 'the legal risk to trustees if these funds underperform'. This is probably the least genuine argument. First of all, it is best practice to develop a meaningful responsible investment policy and not just treat ESG as a tick the box exercise.

Adding an ESG fund to appease market sentiment or regulation is not fulfilling one's fiduciary duty.

Also, trustees are not tasked with selecting the best performing funds. They are tasked with selecting a range of funds to align with the objectives of their members. ESG is about better aligning funds with a range of member values, as well as risk and return objectives.

The inertia around taking a definitive position on ESG all comes back to the consensus argument. Precedent has shown that the stewards of capital have felt safer in the crowd, even if it is over the edge of the cliff together. Just go back to the last financial market crisis and the domestic bias to Irish assets.

The consensus asset allocation is the average of the Irish managed funds, who at the time were overweight Irish assets. However, since these funds were focused on relative performance more than pure absolute performance, they remained anchored to the consensus so as not to veer too much from their peers. As a result, the managers and hence the consensus stayed overweight Irish assets, which suffered some of the steepest declines during the financial crisis.

That is the flaw in the system. The consensus will only evolve if those that make up the consensus take the lead, or when it is too late. Today it would be considered foolish to have such a domestic bias to Irish assets. The crisis brought that change. Still, **leaders don't follow the consensus. Leaders lead.**

The legendary football manager Alex Ferguson wrote in his book "Leading":

"There is also the question of when you should make a decision. There are probably only two times to do so – too early and too late. If I was going to err on making one of those mistakes, I far preferred to make the decision earlier rather than later. That's much easier to say than to do. After all, it wasn't until I was approaching 50, in 1990, that I fully appreciated this."

When it comes to ESG, it is much better to be early. Just be genuine about it.

About ESG Ireland

WRITTEN BY VINCENT MCCARTHY, CFA

ESG Ireland™ is an independent platform delivering thought leadership and insights on the integration of Environmental, Social and Governance (ESG) factors, within decision-making frameworks, across business, investments and public policy.

Our core purpose is to be part of the solution for a more secure and sustainable future, to make Ireland a beacon for other countries to follow. We can only achieve this by working together and so we invite interested stakeholders to be part of this collaborative effort.

1. Practical Knowledge: Our aim is to bring clarity to how ESG can be practically applied in the real world. Conveyed in the right way, knowledge can be a tool to engage individuals. There are high quality reports being produced but the length and complexity limit their reach. ESG Ireland has been established to make this theme more accessible to a wider audience.

2. Empower Individuals: Positive as it is that younger generations are marching for governments to take action on climate change, the real power remains in the board rooms of the world.

A more informed population on the role of business and investment is needed, so that individuals can better understand how their consumption and investment decisions have the potential to influence corporate behaviour.

A more informed population is a good thing. If we have more informed consumers and investors, company efforts around sustainability and the integration of ESG will be better rewarded. Therefore, companies can better align their business strategy with changing demands in order to build loyalty with their investor and consumer base.

3. Stakeholder Approach: A collaborative effort from all stakeholders remains integral to sustainable development. A major challenge right now is the lack of consistency on how ESG is implemented across the fiduciary chain. While many stakeholders are taking a silo approach to addressing ESG we believe in the need for much greater collaboration and an open sharing of perspectives.

ESG Ireland has been established to foster collaboration among stakeholders and to bring their respective challenges to the fore, with the goal of moving this theme forward.

> Our core purpose is to be part of the solution for a more secure and sustainable future, to make Ireland a beacon for other countries to follow.

Working together more openly can help stakeholders to take real control of their ESG policy, raise the level of knowledge across all decision makers and help avoid this simply becoming a burden on resources. We are of the firm belief that ESG represents an opportunity to lead.

Incorporating Environmental, Social and Governance (ESG) factors into decision-making frameworks is fundamental to managing new and emerging risks. Taking a responsible approach to capital allocation and investing is not about sacrificing returns, it is about delivering more sustainable returns over the long term and in turn securing the future.

Join us in this effort. Be part of the solution.

(For more information on membership email: membership@ESG.ie)

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