PULLED IN MANY DIRECTIONS

Gatekeepers may feel torn when it comes to balancing different stakeholders' ESG priorities, but harmony is possible

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What's that saying about good intentions?

When ESG-minded clients seek investment solutions that take into account more than just asset class exposure and risk-adjusted return, gatekeepers are tasked with reconciling the competing priorities of economic and non-economic factors. An intelligently constructed portfolio should be able to align the priorities of most stakeholders, and ideally, that alignment should then become self-reinforcing.

That's the one true dream in ESG land, having built a fully aligned and integrated portfolio. However, there are some stakeholder priorities that may never perfectly align, and when evaluating managers in ESG terms, this issue of alignment raises a broader question: How should gatekeepers go about identifying those dissonances and determining which trade-offs are acceptable and appropriate?

MEET THE PLAYERS

Start by thinking about who the stakeholders are. For a company, public or private, those stakeholders include the owners (equity), the lenders (bondholders and banks), employees, contractors, management, landlords, suppliers, vendors, customers and even the communities where the companies operate, employ, pay taxes, pollute and donate. Much like zooming out on a Google map, you can see upstream and downstream stakeholders from farmers to nation states, taking in everyone from governments to indigenous populations and whole ecosystems.

If we strictly look at the invested stakeholders who hold the debt and equity of a company and put all other considerations to the side, even their priorities are aligned until they aren't. If everything is going to plan, the business does well, bondholders receive their coupons and eventually their principal. Equity holders receive share price appreciation and even the occasional dividend. That's great, everybody gets paid. However, if things go less well, precisely where you sit in the capital stack makes all the difference, and that senior secured lender is not going to be concerned with diluting shareholders to zero when resolving a default. This is the way of things.

One of the main rationales behind positioning ESG in the middle of the investing mainstream is that stakeholder interests should be considered broadly, and those interests should be in balance, or at least not wildly off-kilter. But, as with the capital stack, priorities are not always shared – particularly when outcomes are measured in quarters or even trading sessions – and difficult choices must be made.

Human capital is an obvious place to look for that misalignment. From an investor's point of view, the most capable, least expensive and most elastic workforce is probably the best. On the other hand, from an ESG perspective, living wages, benefits, flexibility for childbirth or family care and stable long-term employment are priorities. If a company is struggling to grow its top line and needs to shrink its bottom line to unlock shareholder value in the near term, what happens to the human capital? Compensation cuts, reduced benefits, temporary 1099 workers, offshoring and other practices that are not exactly human capital-friendly.

A graphic example of this unfolded recently in New York, where a certain online retail giant scrapped plans for a second headquarters because a wide range of stakeholders were not in sync. Concerns had bubbled up on everything from local infrastructure to the ratable tax base, and from what types of jobs would be available to the extent to which those jobs would be filled by workers drawn from the surrounding community.

FINDING THE GREATEST GOOD

Stakeholder tensions are often on full display when companies are a work in progress from an ESG perspective. Many managers promote the idea of ownership and constructive engagement as a means to drive positive change in ESG terms, but they have to accept that not all stakeholder criteria are aligned or will be addressed in the short term. Some areas of engagement are supportive of short-term profit-oriented shareholders, such as curtailing absurd executive compensation packages that are divorced from the interests of equity and bond holders. Others are not so cut-and-dried. Compelling a company to clean up prior environmental messes, move to fair trade sourcing or divest out of controversial lines of business might have clear environmental and societal benefits – in addition to profit and loss improvements in the long term – but in the near term, that could impair capital and share prices.

Even under the big ESG tent, stakeholder tensions can emerge. What is the greater good if a business is creating economic opportunities for underemployed indigenous or minority communities, but the business is in a dirty extractive industry? What consideration wins out when the choice is between economic justice or environmental justice?

Stakeholder tension is natural and even productive. It challenges stock and bond issuers to be more integrative, more collaborative and more environmentally and socially minded, while still unlocking ample value for investors. But what does that mean for analysts? If your primary responsibility is risk-adjusted return measured in days, weeks and months, that argues for a purely accommodative approach to stakeholder alignment when available and alpha permitting.

By contrast, extending the time horizon, which is a better investing discipline anyway, allows systems-level considerations to take over. When you assess the big picture over the course of market cycles and generations, exploitative and destructive businesses give way to regenerative companies with competitive business models, healthy and happy workers, customers, communities and ecosystems, and plenty of profits to pay employees, taxes, bondholders and shareholders.