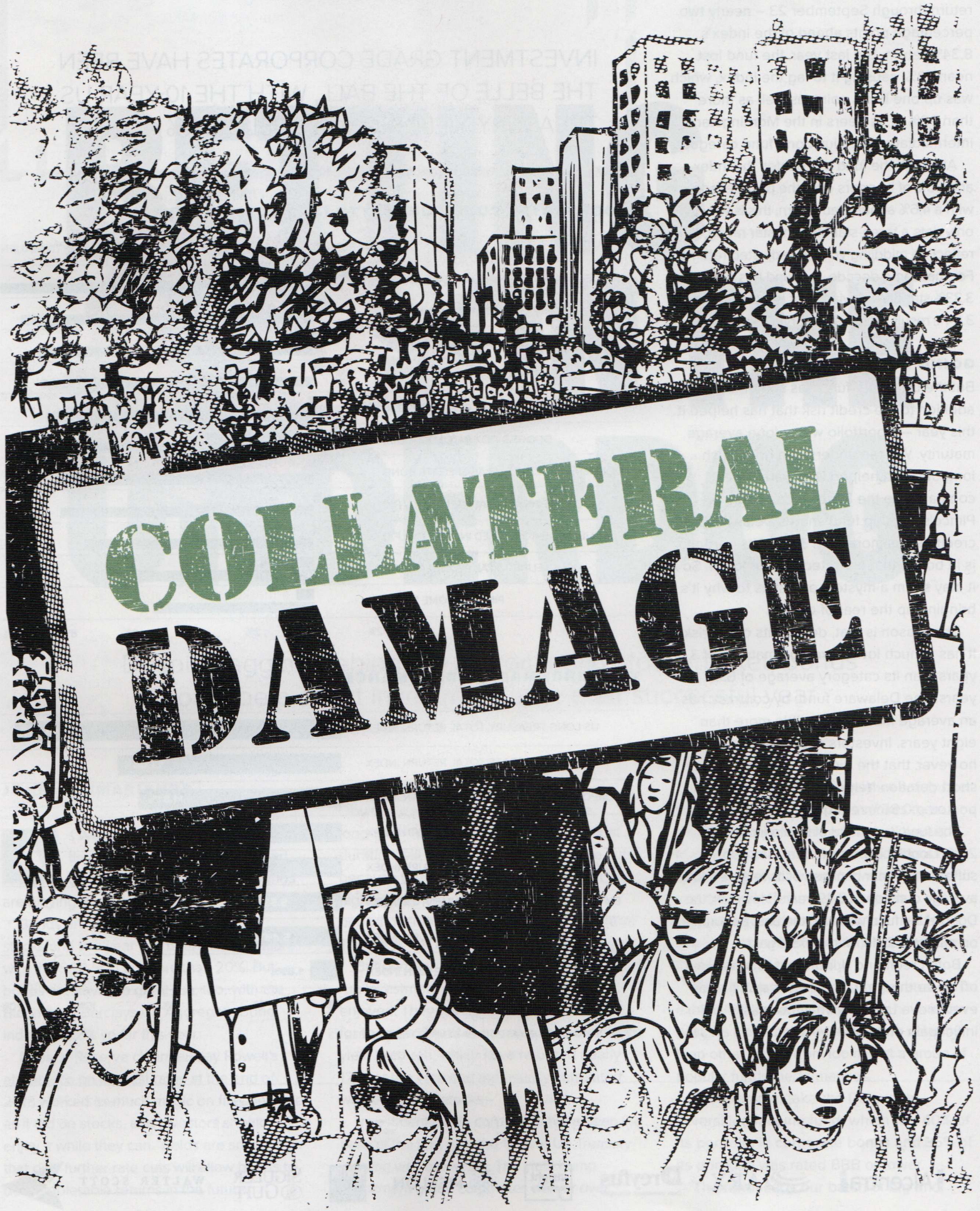
COLLATERAL
DAMAGE

Companies ignoring their impact on the ecosystem will soon witness their valuations crumble

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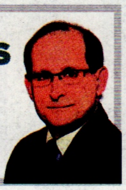

How impaired are your equity portfolios due to ESG externalities? Okay, maybe first, what is an ESG externality? Let's start with Merriam-Webster's dictionary definition: 'a secondary or unintended consequence.' Could you use it in a sentence? 'The opioid crisis is an externality that has come home to roost for pharmaceutical companies.'

More informally, we can think about ESG externalities as the things that seem to matter to everyone else but not to the companies creating them. As communities and societies, we are dealing with corporate externalities every day. Increasingly, investors are having to deal with externalities as portfolio considerations as well. These are outcomes that have tangible negative impacts on the planet and society as well as being unpriced risks to the companies creating them.

ESG managers and their predecessors have been dealing with externalities for a long time, and many investors have been experiencing the negative consequences to risk and return of leaving externalities unaddressed for much longer.

PAYING THE PRICE

Tobacco is an easy one to start with. Lung cancer is not an intended outcome of smoking. Say what you will about tobacco companies, but making customers sick is not a corporate objective. However, it is a predictable and observable consequence that is directly linked to a company product, operation or behavior. Society then decided it no longer wanted to shoulder the care for tobacco consumers who had become avid users.

The opioid addiction crisis is another externality that has severely affected a meaningful section of society, while pharmaceutical companies continue to operate and doctors continue to write prescriptions. The athlete recovering from a ruptured Achilles, the mother of two with sciatica or the post-op cancer patient are directly affected; then employers, families, friends, and emergency and social services are affected. But the drug companies and doctors continue with business as usual because they are not taking ownership for the unintended consequences.

There are bigger and smaller externalities that can be found everywhere you look. Environmental activist Greta Thunberg and millions of students across the world are protesting against climate change, which is probably the most significant corporate externality of our time. Downstream pollution from effluents from power generation, mining, mills and factories destroy habitats, water supplies and communities. Plastic microbeads in personal care products have found their way into nearly every corner of the global ecosystem and even into the human food chain.

THE BIGGER PICTURE

Even where community-based systems exist to mitigate corporate externalities, they may not be that effective. We all pride ourselves on being surrounded by green and blue buckets, earnestly believing that all of those cans, bottles, bags and plastics are being kept out of landfill and returned to the new product cycle. But in many communities, things like small plastics less than two inches in any two dimensions fall through the grates of the sorters and end up going to landfill. Dirty food containers may get sorted and tossed, along with items that still have paper labels. The clean material may also not end up where you think since China has drastically reduced its intake of recyclable waste from the West. Who owns the responsibility for that take-out sandwich clamshell?

As we have seen again and again, there are eventually portfolio consequences for not considering externalities when assessing a company's long-term value. Corporates have experienced meaningful impairment or had their estimated value utterly obliterated when the market finally factored in the unmanaged things that seemingly did not matter to the business historically. These market-to-market events can be driven by crisis, public sentiment, new science and policies, competitive innovation, or just a steady erosion of trust that eventually removes the market bulwark against devaluation.

What is absolutely critical to understand is that this valuation risk is not exclusively a byproduct of a particular political, social or environmental campaign. Companies exist in systems of markets, communities and ecosystems, and these systems are not infinitely resilient. Eventually, they begin to break down and collapse. From a long-term strategic point of view, there are benefits in working to preserve and perpetuate those systems. It is very hard to sell products and services if there are no communities left to buy them. ■

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