

SELF-REFLECTION OR SMOKE AND MIRRORS?

Asset managers talk an increasingly good ESG game.
But do they practice what they preach?

MARK D. SLOSS

CHIEF EXECUTIVE,
REGENERATIVE
INVESTMENT STRATEGIES



How many clichés can we throw at this? What's good for the goose is good for the gander. Judge not lest ye be judged. Maybe people who live in glass houses should not throw stones?

Financial consumers of all stripes, from individuals to institutions, who fold ESG considerations into how they assign wealth and asset management mandates are looking more and more comprehensively at the entirety of the financial services supply chain for consistency with their

guiding principles. The idea of a supply or value chain is a recurring theme in equity and bond analysis, and takes on an even deeper meaning when ESG considerations are added. Oddly though, the critical analysis of the entire supply chain behind an investment product is not broadly practiced in ESG due diligence, even though it is ubiquitous in evaluations of the underlying portfolio securities.

This does not mean that the company cafeteria only serves alphabet soup with Es, S's and Gs. But it does mean there is an expectation that the companies involved in making and delivering investment products comport themselves in a way generally consistent with the standards to which they hold their portfolio investments. Even further, if financial firms have taken the step of

becoming a signatory to a global standard like the United Nations Principles for Responsible Investment, financial consumers expect those principles and frameworks to be manifest in their providers and not just in the products they manufacture.

Blue recycling buckets, volunteer days, philanthropy and carbon offsets for travel are table stakes in corporate responsibility. A company is not going to be rewarded for doing things like this, but there will be more than one or two arched eyebrows if they do not.

What matters? Leadership for starters. From the top of the house, is the executive team leading by example in terms of decency, respect and ethical conduct? Transparency – is the firm opaque or can stakeholders, including employees,

AN ACTIVIST EQUITY TEAM THAT ENGAGES DEEPLY WITH PORTFOLIO COMPANIES BUT DOESN'T ADDRESS SIMILAR CHALLENGES IN THEIR OWN FIRM MIGHT COME OFF AS DISINGENUOUS

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business partners, shareholders, and most importantly clients, see, understand and evaluate the firm's performance on ESG metrics? Accountability – does the firm own its successes and failures in ESG terms, and have the structure, plans and resources in place for reinforcing the good and addressing the bad?

Why does this all matter? Let's answer the question with a question. Why would financial consumers be interested in social, economic and environmental justice but not care how those investments get from the farm (market) to the table (account)?

The other reason is simply pragmatic. An ESG break in the financial supply chain destroys value and introduces risk. This can be reputational, like a senior executive openly disrespecting women, or a firm's training programs disrespecting women, or... you see where this is going. The value and risk could also be operational, from opening fake accounts to insider trading to data breaches.

Financial consumers have scrutinized

their supply chains for some time, and increasingly do so as more options become available to them.

These are questions of corporate character. Clients are interrogating prospective consultants and advisors about their companies' involvement in controversial business activities unrelated to the service or product being proposed. This could include predatory lending or underwriting environmentally destructive industries that get front page coverage in newspapers.

They are calling on asset managers and investment banks to tackle problematic headlines arising from business conduct, leadership failures, and ethical lapses. They are looking to see whether the commitment to principles of sustainability on offer in a service or product relationship are observed with any level of consistency elsewhere in the supply chain, from individual portfolio managers, analysts and traders to custodians, banks, brokers, dealers, accounting and law firms, and data and research providers.

The biggest risk may simply be being cast in the role of hypocrite. An activist equity team that engages deeply with portfolio companies but doesn't address similar challenges in their own firm might come off as disingenuous. A firm that sponsors a gender-inclusive strategy but lacks diversity from the boardroom to the mailroom may not be seen as committed. This is not just a question of moral rectitude or woke culture.

An essential part of the ESG discipline is the fundamental investment case that ESG-informed companies, communities, or governments will perform better over the long term in both risk and return by ensuring the sustainability of the systems in which they operate. If this claim is true at the portfolio level, why would it not be for the service providers, partners, bankers, brokers, consultants, advisors, platforms and markets?

A financial consumer committed to ESG, whether for principle or for profit, is going to insist on this throughout their financial supply chain to maximize desired outcomes. ■