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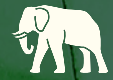

Stewart Investors
Sustainable Funds Group

Challenging the Greenwash

In 1946 George Orwell wrote an essay titled 'Politics and the English Language'. His main point was that:

> **the great enemy of clear language is insincerity. When there is a gap between one's real and one's declared aims, one turns as it were instinctively to long words and exhausted idioms, like a cuttlefish spurting out ink.**[1]
>
> George Orwell

In this essay Orwell railed against the use of 'euphemism' to defend indefensible political ideologies and 'pretentious' language in the world of art and literary criticism to mask poor performance. Were Orwell alive today one can only assume that he would be horrified by the 'catalogue of swindles and perversions' found in the outpourings from businesses and investment professionals on the fashionable topics of ESG (Environment, Social and Governance), responsible investment and sustainability.

Never knowingly slow to exploit an opportunity for asset accumulation and fee growth, the investment management industry is jumping on the ESG bandwagon. According to Mckinsey, ESG-oriented investing has experienced a meteoric rise with global sustainable investment now topping US$30trillion – up 68% since 2014 and tenfold since 2004.[2] It varies from country to country but sustainable investing strategies now represent 26% of all investment assets under professional management in the United States (Global Sustainable Investment Review 2018). This proportion is expected to grow as investors' attitudes have shifted from 'why to why not'[3], particularly amongst younger investors.

The UK Financial Conduct Authority has faced mounting pressure since 2018 to take action against accusations of 'greenwashing', making products appear more environmentally friendly than they are, or even miss-selling from the investment industry. One large global investor removed the 'socially responsible' funds category from its platform as it was found that only 4% of the funds explicitly referenced ESG in information documents.

The terms 'ESG' and 'responsible investing' are used often interchangeably. Indeed, for many investors 'ESG', 'responsible', 'impact', 'green', 'ethical' or 'sustainable' are synonyms. Blurred definitions are undoubtedly convenient for the army of sales personnel working on commission, but it doesn't help investors. Rapid growth in enthusiasm and assets has widened 'the gap between real and declared aims'[4]. As usual, the victim is likely to be the well-intentioned but potentially misguided investor.

Our philosophy at Stewart Investors is to invest in 'quality companies' and our process for identifying them has incorporated a rigorous evaluation of ESG for over three decades. However, our analysis of ESG has never stood in isolation, and must be taken together with assessment of management, franchise and financials.

Quality is a nexus[5] between the sustainability of people, franchise and financials. If one element is not quite right then it will be reflected elsewhere. For example, high quality stewards are unlikely to practise low quality governance, mistreat employees

or take the environment or their license to operate for granted. Nor would they allow themselves and the franchise to be reported by misleading financials and obtuse language.

Stewards have a choice on how they represent and account for their values and actions. We prefer meaningful ESG statements versus short soundbites in the same way we prefer conservative rather than aggressive accounting policies. We aim to evaluate the quality and sincerity of these choices. Take, for example, the many ESG funds invested in tobacco or hydrocarbon companies. Companies in these two sectors may show an improving ESG score and provide attractive press releases but their franchises are harmful to society and the environment, and they are deeply challenged from a sustainability perspective.

A recent ESG statement from British American Tobacco (BAT)[6] is a case in point. In this document the company boasts of two positive initiatives: 1) Sustainable Agriculture for Rural Communities and 2) Empowerment. Further details include: farmer education workshops (tick), actions against rural poverty (tick), efforts to improve biodiversity (tick), access to water (tick), partnerships with NGOs, charities and local communities (tick, tick, tick). This is topped off with a proud association with UN Sustainable Development Goals 15 and 17 and a thumping charitable contribution of £14.4m[7], out of a yearly operating cash-flow of £7bn! Not once is it mentioned that their products contribute to the death of seven million people annually[8] which undermines BAT's 'declared aim', "to be long standing investors in communities."[9]

We are concerned that highly standardised ESG reports promote a box-ticking analysis of ESG credentials or worse yet, an excuse for inaction. That these ESG scores are then often used to construct indexes used by passive funds is a further concern. This is because it can encourage the gaming of ESG reporting without the scrutiny and encouragement provided by engagement from active managers.

In Asia the MSCI China ESG Universal Index is increasingly popular as the basis for exchange traded funds (ETFs). A quick google search shows a well-known Swiss bank charges 65 basis points (bps) for a China ESG ETF, based on the MSCI China ESG Universal Index – plus an extra 10bps for hedging currency risk. This fee is in line with mainstream or non-ESG China ETFs because the differences are few. Indeed the fund's prospectus states that it 'uses minimal exclusions from the MSCI China Index'.

One reason for this might be revealed in the MSCI methodology paper which states that the corporate response rate to MSCI was only 26%.[10] The paper presented this statistic triumphantly as a 'doubling in responses' from 13% in 2017, but omits the point that 339 Chinese companies were not responding or that MSCI relies on self-published ESG disclosures for 74% of their index constituents. This presumably reduces confidence in the sincerity of their analysis. Accordingly, a China ESG ETF looks similar to a standard China ETF and is heavily weighted to internet companies and state-owned banks. We have discussed our concerns on the governance of China internet companies in previous articles, so now we will focus on the reporting of 'Green Finance' amongst Chinese Banks.

In 2018, in Davos, Xi Jinping pledged to 'bring back blue skies' within three years. The front page of the annual report of China Construction Bank[11] (CCB) indicates a willingness for quick compliance. Inside this cover the rhetoric has changed from 'economic growth' to 'ecological civilisation' and the reporting on ESG criteria has improved from a low base.

Ten years ago the annual report had just one page titled 'Corporate Social Responsibility' which reported: "the group fulfilled its social responsibilities and acted as a good corporate citizen…and was fully committed to the rescue efforts, disaster relief work and post disaster reconstruction".

Eight years later the same report extends to five pages with a section dedicated to 'environmental protection'[12] written in a more cheerful tone: "It has vigorously improved the green credit policies and system, developed green credit businesses, strengthened environmental and social risk management, and enriched green credit products and services. At the end of 2017, the balance of green loans was RMB1,002,521 million, up by 12.74%".[13]

Again this progress should be celebrated and it is admirable that China through CCB is making an effort to price environmental risks. However, study of the loan book[14] reveals that reality falls short of published aims. In 2017 the absolute amount of credit extended to environmentally harmful sectors

(power and mining) was 65% higher than the amount in green loans. Moreover, loans to these sectors had grown by 60% over the last seven years.

As the second largest bank in China and with a focus on infrastructure credit, CCB is at the sharp end of development challenges: land requisitioning, local government zone permissions, as well as environmental and economic impact studies. Historically, these areas have shown a high incidence of corruption and it was only three years ago that Chinese authorities identified irregularities that cost the CEO of CCB his career and freedom. With this in mind, one must approach the ESG report with scepticism and question the sincerity behind published aims such as 'Driving Sustainability'.

At Stewart Investors we believe that sustainability drives investment returns as an indicator of quality, helping the avoidance of future liabilities or absolute losses from stranded assets.[15] For thirty years we have assessed ESG considerations as studiously as we scrutinise the policies and notes accompanying the financial statements.
This is to determine the difference between a company's 'real and declared aims' and to gauge quality.

Financial history teaches us that "the propensity to swindle grows parallel with the propensity to speculate during a boom."[16] The popularity of ESG is booming currently. As such we grow ever more sceptical of pretty pictures and bland statements. We have a strong preference for sincere and achievable targets. As ESG financial products proliferate, investors must approach fund providers, as we approach companies, with a focus on substance over appearance.

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1 G Orwell (1946) *Politics and the English Language*.
Source: https://www.orwell.ru/library/essays/politics/english/e_polit

2 W Henisz, T Koller, R Nuttall (2019) *Five ways that ESG creates Value*, McKinsey Quarterly.

3 S Bernow, B Klempner, C Magnin (2017) From *'why' to 'why not': Sustainable investing as the new normal.*

4 G Orwell (1946) *Politics and the English Language*.
Source: https://www.orwell.ru/library/essays/politics/english/e_polit

5 A connection, or a series of connections between two or more things.

6 For illustrative purposes only. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and our research process, and should not be construed as investment advice or investment recommendation of those companies. Companies mentioned herein may or may not form part of the holdings of Stewart Investors.

7 As a disappointing contrast, yearly income at Cancer Research is £634m.

8 Source: https://www.who.int/news-room/fact-sheets/detail/tobacco

9 Source: https://www.bat.com/csi

10 MSCI (2019) *China Through An ESG Lens*, P7.
Source: https://www.msci.com/www/research-paper/china-through-an-esg-lens/01608507056

11 China Construction Bank (CCB) is the third largest weighting in the MSCI China ESG ETF.

12 China Construction Bank (2017), Annual Report, P81. Source:
http://www.ccb.com/en/newinvestor/upload/20180817_1534487897/20180817143224827527.pdf

13 China Construction Bank(2017), *Annual Report*, P81. Source:
http://www.ccb.com/en/newinvestor/upload/20180817_1534487897/20180817143224827527.pdf

14 A loan book is the collection of loans made by a financial company.

15 Stranded assets are assets like oil and gas which might never be taken out the ground if government policies change.

16 CP Kindleberger, (1978) Manias, Panics and Crashes: *A History of Financial Crises*.

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