Purpose, profit and ESG with Alex Edmans – Part Two
Baringa's Climate and Sustainability Trailblazers Podcast

Emily Farrimond [00:00:00] Welcome to our Climate and Sustainability Trailblazers podcast with me, Emily Farrimond. And this is part two of our discussion with Alex Edmans, professor of Finance at London Business School and author of Grow the Pie: How Great Companies Deliver Both Purpose and Profit, which is also a Financial Times Book of the Year. We're going to start by delving into whether ESG can be value accretive, and I think that comes from a position of worrying about the burden and costs of associated regulation, reducing risk, influencing a just transition, all of that in the context of trying to remain a profitable business.

Alex Edmans [00:00:38] Yeah, this is a really important question. I think the first thing to point out is often people use the term ESG as an umbrella term. So, is ESG good or bad? Is it value accretive or value dilutive? But ESG comprises lots of different dimensions. So not only is it environmental and social and governance, but within environmental, there's water usage, there's climate, there's carbon emissions, climate change, there's biodiversity, there's waste generation within climate change, there's physical risk, transition risk and climate change mitigation and adaptation. But for some reason we just use this umbrella term and sweep lots of things under the carpet, not recognising there's a lot of heterogeneity beyond the umbrella.
So, I view ESG, and this was the main point I made in my End of ESG paper, as being just like any other type of long-term investment, which then dovetails to why I got into ESG to to start with, it's long-term investment. Now, is investment value accretive? Well, it depends on the type of investment, some investments are and some are not. And also you're not always value accretive, there will be diminishing returns. So, I think this is a problem with ESG because it has a special label, people think, well, everything within the ESG bucket is value accretive and everything is also value accretive without limits so let's try to have as much ESG as possible. Whereas yes, we do want to treat our workers well and pay them well, but if we pay them too much, we're going to be running into cost issues. So, I think this question here, it is a difficult question, but I would say it's no different to any other type of trade-off that companies grapple with in terms of just their normal business. For example, let's think about our raw materials. How do you remain profitable when trying to buy higher quality raw materials to increase the quality of our products? Well, there's a trade off, but we see that better quality raw materials will help us make a better product. But after a point, we don't want to have more. And obviously calibrating that trade-off and finding that sweet spot is difficult. And I wouldn't say that this is a silver bullet to it, but companies have existed for centuries trying to think about these costs and benefits, and I think this is the same for ESG. Let's decompose it into individual issues and then think about, well, what is the benefit of doing this versus the cost. If I pay my employees well, this will be beneficial because I'm going to have less turnover, more retention. What is the benefit of this? Well, I can look at data. How much does it cost me in order to hire a new worker? Often some elements, some estimates might actually be 150% of their annual salary in terms of replacement costs, new hiring costs and so on. What is the effect of higher wages on recruitment and retention? I can look at that with data. So, I would try to use data to the extent possible to assess these trade-offs. But I think the first place to start is to recognise that a trade off exists because often we see these blunt things, like more ESG is always better, the high ESG rating a company has, the better it definitely is, when just like any other investment, there are diminishing returns.

Emily Farrimond [00:03:54] Thank you. We see, particularly in some of our clients, that there are challenges and opportunities, particularly in the asset manager and asset owners space around how they decarbonise, not just their portfolios, but also the real world. I'd be really interested in your thoughts around how they best manage that juxtaposition.

Alex Edmans [00:04:19] Well, Emily, you've asked the really important question here. So how do we decarbonise the world, not the portfolio? And so the first thing to ask is, is divestment going to really matter? So, there are cases in which portfolio decarbonisation will lead to real world decarbonisation. But those are cases in which there are not substitute forms of capital to come in and reverse what we're doing. So with listed equities, I think there are lots of substitutes. If I sell, there's loads of other types of investors which might buy, but for things like relationship bank lending, that is less likely to be the case. Why? Because what matters is the relationship with a particular bank. So if, say, the UK main lenders are saying we're not going to be financing new coal projects, which is what Lloyds has done, then actually this can have a large effect because maybe your relationship for a long time has been with Lloyds whereas with shareholders you might not know many of the people who hold your shares. So, to the extent to which you have fewer substitutes, because a relationship is an issue, then decarbonising your portfolio will lead to real world decarbonisation. But then what do we do in listed equities? I think you can do two things. First, with the active engagement that you mentioned, it could well be that you're working with companies in order to hold them accountable for putting that transition plan into practice. If they don't, what can you do? You can vote against directors, you can vote against executive pay, you could put in shareholder proposals, you could nominate your own slate of directors, which is what Engine No. 1 at Exxon. So active engagement either individually or collectively. There's collective engagement frameworks or organisations such as The Investor Forum, where many investors together can collaborate behind a shared agenda. But the second thing you can do, in addition to engagement, would be selective divestment. And what do you mean by selective divestment? Rather than selling out of an entire industry, you pursue a best in class strategy. So, what this might involve is under weighting the fossil fuel sector, but being willing to hold companies which are best in class, such as the leaders which are really having a credible transition plan, as I referred to earlier. So why might that be better than outright divestment? Outright divestment will lead to a fossil fuel company thinking this. Well, there's no point in me reforming myself because I'm going to be sold no matter what. But if I know that investors have a best in class strategy, that they will invest in me if I'm a leader, then this gives me more of an incentive to reform, because I know there's a chance that the investor will own my stock.

Emily Farrimond [00:07:20] And just to embellish on that a little bit more, I know you talk about at length in Grow the Pie, one of the things I think our clients are challenged by is the interplay between active engagement, fiduciary duty and stewardship and how that drives sustainable outcomes.

Alex Edmans [00:07:41] Yes. And what is important is to understand that there are certain actions which might be in contradiction with fiduciary duty. So fiduciary duty is your clients, and to clients, it's to generate long term returns. In maybe 80-90% of cases, these things will completely overlap, so what's good for society is going to be good for investors. However, we do need to deal with the tricky trade-offs where these things will be conflicting in the absence of a carbon tax. Maybe it is actually more profitable for you to keep polluting because you're not having to pay the consequences of that pollution. Now in these cases, often, well, nearly always what will be paramount and win is long term returns because as an asset manager, you're not here to pursue your own social goals. You are custodians of your client's money and your clients invest in you in order to achieve long-term returns. So, what does that mean? This means that making sure that anything that you do to serve wider society that doesn't clearly reduce returns. Now there might be certain things that you do which might be neutral to return, but that's fine. So, let's think about diversity. The evidence on diversity and performance is hugely mis portrayed. There are many papers which try to claim that diversity boosts performance, but due to confirmation bias, we all want this to be true and so people lap this up uncritically even if the evidence is really, really flimsy. What the most rigorous evidence suggests is there is no effect of diversity on performance, but that it's still encouraging, because that means that companies can pursue diversity with not a sacrificed returns. You effectively get diversity for free. So, this does allow you to pursue social goals which are not at the expense of returns, only in the case where there is going to be a clear cost to financial value might you want to oppose this? For example, there was a shareholder proposal to require Sainsbury to pay the living wage. So that is higher than the minimum wage. That's set by a completely separate body, the Living Wage Foundation. And in that case, because none of the other large supermarkets were paying the living wage, doing so would severely threaten Sainsbury's long-term future profitability. And so many investors voted against that proposal because there was a case where they saw a clear trade-off between their responsibility to their clients as fiduciaries.

Emily Farrimond [00:10:26] I'm really interested in as to whether you would advocate for a carbon tax, actually.

Alex Edmans [00:10:32] Oh, I absolutely would. And I nearly every investor, every economist I know, advocate. I do not know of any economist who's come out and said that they don't agree with this. Why? Because the whole climate problem is an externality. The whole issue of an externality is even in the long term, you don't bear the consequences of your actions. So many things, yes, you do internalise the consequences. If I treat my workers well in the long term, they won't leave. But an externality is that I could be a fossil fuel company and who was losing? It could be an owner of a beachfront property because they will be flooded. And so, given I'm not going to bear the consequences, the way to force me to do that is a carbon tax to cause me to internalise that externality.

Emily Farrimond [00:11:18] Perfect. Just wondered whether you've got any thoughts around the challenges that a number of our clients are having around aligning their various stakeholders who have very different objectives and how to get consensus and buy in over almost any decision in the ESG and climate and sustainability space.

Alex Edmans [00:11:42] Well, I think there will be many decisions, but not all where there should hopefully be a trade off because these are things that are good for the business long term success. So, this is why a lot of my research has been on how to make the company sustainable and profitable in the long term. That's how I came to the topic to begin with. But there are cases in which there are trade-offs. So sometimes there might be trade-offs and disagreement between different shareholders. And so there could be some shareholders who believe that climate change is so important that they would sacrifice financial returns from doing so. And other clients who say, no we really care about financial returns, we can't have that sacrifice. And so, for an asset manager, what that would mean is that you would offer different products. You might call some funds 'impact funds', where you're sacrificing financial returns, and other funds you would call 'more sustainable funds'. You could be clear that we're using sustainability characteristics to enhance returns rather than being at the expense. I think where there's a lot of confusion and modelling is if funds market themselves as claiming we're going to achieve all of this social progress with no cost to financial performance, when there are not always win wins, as we've discussed previously. But then what happens within stakeholders themselves, beyond shareholders, for example when employees lose from a closure of a plant, but the environment wins. I think it's just to recognise that a company cannot be all things to all people. This is why purpose has to be focused. We need to recognise who is first among equals, among our different stakeholders. Yes, we do care about employees, but maybe we're an energy company who thinks that climate change is so important, that that comes first and beyond everything else. And then what do we do with the stakeholders who lose? Well, first we need to recognise it's not a company's responsibility to solve every single one of the world's problems. There is the government here. Should a company's goal be to reduce the unemployment figures and therefore they should not make anybody redundant? No, because if you're not going to make anybody ever redundant, then you're not going to close polluting plants, you're not going to be firing underperformers who are worsening the culture of your company or the performance of the company. But this is why the government comes in with things such as unemployment benefit. This is why we have nationally funded education to allow people to retrain. Sometimes these things might be insufficient, and so sometimes companies will go above and beyond, and they will try to invest in outplacement. So, when Airbnb cut 25% of its workforce in the pandemic, it converted its recruitment department to an outplacement department. However, they didn't say as a responsible company, we should never fire anybody. They recognise that to be sustainable, sometimes this does require downsizing. Sometimes we put too many expectations on companies, not only as you mentioned at the start Emily, we expect them to take all 17 SDGs, we also expect them to make no decision that might harm somebody. Well, if that was the case, we would never have had banks introduce cash machines, because cash machines could make some people redundant. We might never have even had before that, say, washing machines and irons, because people were concerned that that technology would keep people out of jobs. The same with tractors, that now we see as taking mundane work and removing that from something that humans have to do.

Emily Farrimond [00:15:17] Thank you. Just moving on to, I suppose, capability building. In one of your recently published articles, you talk about applying economics and not gut feel to ESG, really calling for more, I think, analytical roles in organisations around data, economics and finance. Do you feel organisations are focusing on the right skillset when it comes to developing their in-house ESG capabilities? And if not, what more do they need to do?

Alex Edmans [00:15:46] I think the first thing to recognise is the skillsets of the client. So often people think, “ESG, that's sort of fluffy, we can go by gut feel and if the person's a nice and moral person, they're going to make the decisions in the right way”. But ESG requires a huge amount of expertise. So yes, I did mention financial expertise. In this paper, Applying Economics: Not Gut Feel to ESG, I highlighted how a rigorous understanding of economic principles can help us navigate these really difficult trade-offs. But it's not just me talking my own book as a finance professor, some of these skills will not just be economics skills we might want climate scientists to understand how credible is this transition plan. I know of venture capital funds which will invest in health care, where they will have ex doctors who will work there because they can really understand the science behind these innovations. But what this means is that we do need, number one, a diversity of skillsets, so it's not just finance, it's finance, climate, knowledge, biodiversity and the like. But number two, just to respect the skill and not necessarily have somebody who might be well intentioned, but without the expertise to make these difficult decisions. Sometimes we get people from outside the corporate sector, so they might have been working at charities. Obviously charities are huge amounts of good and maybe we can bring some of that expertise within the company, but making a corporate decision where you do have a trade of with financial returns, that's something where analysis might be needed or we might want to have specific expertise from somebody who is a climate scientist or is somebody with expertise in healthcare, in addition to just obviously having the right general values and objectives.

Emily Farrimond [00:17:31] Thank you. I think we're starting to play that through with some of the rhetoric from the FCA as well, in particular around expectations of people who fulfil these types of roles. So lastly, I just wanted to move on and get your thoughts around what makes a business a great place to work. And the reason why I'm asking this is, as you know, Baringa is and has been consistently deemed a great place to work, but we're also a B Corp. So ,I think we've definitely seen the value in both of those in our organisation, but interested to hear your thoughts on that.

Alex Edmans [00:18:05] So Blueprint for Better Business, which is an organisation to promote purposeful business which I'm honoured to be a member of the Advisory Council, they define it as being a winning team on a worthwhile mission. So let me pick this apart. So, the second part is obviously important. A worthwhile mission – we need to not just be making profits. Profits are important, like companies are not charities, but we make profits by serving wider society. But the first part is often forgotten. We want to be a winning team. We want to be successful. To be a great place to work means winning. We want to achieve our objectives. If we think about a football team, certainly one which is lifting trophies is going to be one where the players are going to be much happier than in a losing team. And so why, again, I think this is important is to highlight that ESG should not be divorced from standard business principles. Often the best way that you can serve society is by being great at your job. So, this morning I gave a lecture to my students as part of my job at London Business School. What is the best way in which I created value? It wasn't by the fact that I biked to the tube station and then took the tube rather than driving. Yes, that did reduce my carbon footprint, but for me, the best thing that I might have done is just prepare for that lecture thoroughly, make sure that it has rigorous theoretical content, but practical examples that those examples were modern and updated, they apply to different industries and so forth. So, excellence at your core business can often be even more important than ancillary ESG activities. So, to be a great place to work, yes absolutely we want to serve wider society. And if companies do things like employee volunteer programs and maybe matching charitable donations for people running for the London Marathon, that is great. But often just being really good at what you do through professional pride or recognising how what you're doing serves wider society. If I'm a children's toy company, what I sell is not just making money, but I'm helping to entertain and educate children, how is that sense of purpose and that sense of purpose leading to winning, that's something which makes a great place to work.

Emily Farrimond [00:20:17] Fantastic. Thank you. And also, congratulations on your role with Blueprint for Better Business and well reminded that we also had Dee Corrigan from Blueprint on our podcast previously should anyone want to listen to that that. Alex, it's been an immense pleasure having you on our podcast. It's been really insightful and I'm sure will resonate with so many of our listeners. Thanks again for taking the time and of course, thank you to all our listeners.

Alex Edmans [00:20:43] Thank you so much, Emily. It's really a pleasure for me to be on your podcast.

Emily Farrimond [00:20:47] Please do follow, like and share, and look out for future instalments of Climate and Sustainability Trailblazers.