AESG – THE GOLDILOCKS OF RESPONSIBLE INVESTING

ESG has been an incredible movement. It has had a momentum and acceleration that was seemingly unstoppable, and for good reason – everyone wants to save the climate; everyone is for treating employees, customers and communities with respect and everyone is for good corporate governance. Yet, for several years, many people, particularly behind closed doors and in private conversations, have been skeptical about ESG investing, and this skepticism to ESG investing has come to a head lately.

Why is this? It is because there is a tremendous disconnect between ESG as a philosophy and ESG as an investment product. ESG is a conceptual idea of new factors that market participants should consider in investing in and managing corporations. Many ESG investment funds took this idea and exploited it as a marketing tool to raise assets in strategies that relied on quantitative data and ratings that were easily manipulated, and that were way too passive to create any real ESG change. Moreover, there is a widespread perception, if not reality, that ESG investing means sacrificing returns.

Now, a bear market has exposed these weaknesses, and for the first time, the ESG investing movement has been losing some steam. Even worse, these exposed deficiencies in ESG investment funds have opened the door for funds that market themselves as the antithesis of ESG that advocate for the elimination of any social motivations to corporations and totally disregarding ethnicity and gender in hiring practices[1]. This drastic reaction to ESG funds does on the right exactly what it is criticizing on the left – it takes an extreme position that exploits the views of the far right to weaponize the opponents of ESG funds just as many ESG funds were created to exploit and weaponize the acolytes of ESG. Ideologically maximizing profits while ignoring social repercussions will lead to companies like Purdue Pharma or boards that rationalize potential oil spills through a cost benefit analysis of the potential fines and cleanup costs versus the costs to prevent such spills. How about worker safety? Should worker safety be sacrificed if the cost to keep employees safe exceeds the liability for and costs to replace injured employees? Anti-ESG funds focused solely on shareholder value would presumably forego the costs and pay the liability. Moreover, does anyone other than these anti-ESG funds really believe that a board or management team is not better when it has qualified members with a diversity of perspectives and life experiences than when it is all white and male?

Of course, environmental, social and governance factors should be considered by management teams and investors, but they are factors that need to be weighed, not mandated. These decisions are more complex than either side acknowledges. They cannot be made quantitatively, with generalizations or by extremists. They need to be made qualitatively, by an active participant weighing the pros and cons and pragmatically advocating for a position that benefits all stakeholders, including shareholders. That is what AESG does.

AESG, or active ESG, investing is when an activist investor takes a position at a company and actively (usually from a board level) and qualitatively analyzes and improves not only financial, operational and strategic facets of the company, but also its ESG footprint. Funds like Inclusive Capital and Impactive Capital are the leaders in this area and look at every investment not only through a shareholder value lens, but an ESG lens as well. In many cases these funds advocate for ESG practices at their portfolio companies that actually advance shareholder value. Other activists, while more focused on operational,

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[1] Source: www.strivefunds.com as of Sept. 27, 2022.

financial and strategic matters at their portfolio companies, are realizing that while they are actively involved at these companies, they are also in a unique position to improve ESG practices at the company. Accordingly, many of these funds, like Starboard, ValueAct and Third Point have dedicated ESG executives to help focus on such opportunities. And we are seeing many more of them starting to adopt such practices.

These AESG investors realize that you cannot accomplish ESG objectives by investing in the "best" ESG companies and excluding the worst. Nor can you expect management teams to blindly adhere to ESG pressures regardless of the effect they will have on shareholder value. Instead, AESG investors analyze both ESG issues and opportunities and the company's financials and operations to pragmatically develop company strategies and practices that either further both ESG and shareholder value or further one of them without hindering the other.

Accordingly, AESG solves the problems with ESG investing as (i) it is genuine, not a marketing ploy, (ii) it relies on qualitative analysis, not quantitative metrics and ratings, (iii) it uses engagement to actually effect ESG change without sacrificing shareholder value, and (iv) it has the alpha that has historically been associated with shareholder activism. Moreover, AESG investors are not only looking to change ESG practices at their portfolio companies during their engagement, but to change the long-term culture of the Company so that ESG is ingrained in management's thinking as something to weigh and consider in all future business decisions.

ESG Investing is a phrase that combines two concepts – ESG and Investing. However, most investment funds on either side of the debate tend to focus on only one of these concepts and ignore the other. Responsible ESG investing means not just being responsible to environmental, social and governance factors, but being a responsible investor to both ESG factors and the goal of attaining outsized capital appreciation. This is a main tenet of AESG Investing.

Because there is a limited number of investors who have the skillset, characteristics and inclination to actively engage with management of portfolio companies, AESG investment strategies will always be a small subset of aggregate ESG assets. But it will be an increasingly important subset, and those who engage in AESG Investing will add a much-needed active component to ESG Investing to effect real change and generate real alpha. ESG Investing is still a nascent strategy and will continue to develop and evolve. As we see more and more activist managers also start to focus their efforts on ESG improvements, AESG is becoming a significant part of this evolution.