The Politics of ESG Investing

Speaker Key:

DP David Pett

MG Martin Grosskopf

KM Kevin McCreadie

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00:00:06	DP	Environmental, social, and governance investing has gained more traction over the past few years, but not everyone is a proponent of the theme, whose purpose is to provide capital in the pursuit of a more sustainable future. On this episode of Inside Perspectives, Kevin McCreadie, AGF's CEO and chief investment officer, welcomes AGF portfolio manager Martin Grosskopf to discuss a mounting political backlash against ESG and what it means for investors. I'm your host, David Pett. Let's get into it. I was just going to say, we should probably meet each other in the gym because that's where I see you guys all the time.
00:00:46	MG	Well, he was coming out and I think you just left after I got in. You didn't see me.
	DP	So, you were in yesterday because I hadn't seen you in a while. I don't know whether you were away or whether I was away, but it's nice to have in the gym.
	KM	A healthy company is a good company.
	DP	Yes, absolutely. Martin's workout is intense, though. He's got all the bands going.
	MG	A lot of balance stuff.
	DP	Yes, a lot of balance.

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	KM	I'm too old. Things would tear. I'd be afraid.
00:01:11	DP	Whereas I've decided to get a… I'm using the trainer the last couple of weeks.
	MG	Are you?
	DP	Yes. I figured after 35 years I need a bit of a change, but to be honest with you, it's not that different than what I was doing. So we'll see if it gets better.
	MG	There're so many apps you can get now, too, if you just want a good workout.
	DP	It's true. Yes. And you do a lot of your… It's for biking, though. That's your big thing, right?
	MG	Yes, but because I busted my ankle, I'm trying to do more balance work just because I want to get skiing this year again.
00:01:38	DP	Yes. So anyways, it's great to have it in the office. It makes it pretty convenient. Let's get into the heart of the conversation today now. As both of you are aware, but I just want to remind listeners, ESG investing has exploded in recent years and is now one of the most widespread investment themes going. In fact, PwC, the global consultancy firm, recently put out a report saying ESG assets are on pace to constitute 21.5% of total global assets under management in less than five years.
00:02:12		Yet, despite that growth and obvious buy-in from investors, there is an alarming anti-ESG trend that has emerged among the political class over the past year or so, especially in the United States, where a fight has broken out between Democrats and Republicans on the issue. If we can just talk about what this argument is that the Republicans and Democrats seem to be having in regard to the issue, what's at issue here? Kevin, maybe I'll start with you and perhaps a bit of background on ESG is important first.

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00:02:40	KM	So some of these letters have been around a long time. Certainly, the S and G were prevalent in the 80s and 90s in different forms, whether it be the sin stock era where you couldn't own tobacco, alcohol, defence stocks. Then you get the definitional phases of that. You'd say to a client base, does IBM count as a defence stock because it sells semiconductors into weaponry? You'd have this definitional mess. But we've been around these issues for many years and governance is something we've always looked at from an investment lens typically.
00:03:09		We've proxy-voted forever, for a really long time. It's really this development of the E part of this over the last, I'd say, 15 years, maybe longer, Martin, that I think has created this collision maybe in the US. Let me simplify. We think about certain economies in the US like Texas which are heavy on carbon, heavily reliant on carbon for employment.
00:03:31		So think fracking, drilling, etc. who sees us as a threat to their economy essentially. So you have a political angle that says, let's take it to the legislature and say, if you have or are anti-carbon, then you are going to be on a blacklist and not be able to do business in the State of Texas. That could be investment business. It could be underwriting business. It could be a broad set of things. So that's where the lens starts to get, I'm taking care of my own regardless of this issue.
00:03:58		You have other states in the US which take a very different view that says, we're going to be electronic vehicles by a certain date and any company that doesn't sign a carbon pledge won't be able to do business here. So that's where we're starting to run into some of what are defined as political issues. We can delve further into that, but it's not going away any time soon, some of these issues. Certainly, nor is the underpinnings of what is, do the right thing at the same time and do well for your investors. I think you can do both.
	DP	And, Martin, maybe I'll just get your perspective. Kevin mentioned you've been doing this, meaning sustainable investing, for a long time. What's your perspective on this argument that seems to be

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		out there right now and gaining some traction, at least in the media?
00:04:38	MG	I think it's just recognition of the political aspect that has always been there. When I came into the industry, there wasn't yet the term ESG. There was the term socially responsible investing. If you look back over maybe 30 or 40 years, it really had an impetus in the apartheid regime issues. So it was really about a divestment movement that had obviously a social underpinning. Then I think there were a lot of barriers to making the E, S, and G issues more mainstream, especially E and S.
00:05:05		So that's where the terminology came from to depoliticise it and not call it socially responsible. Call it something that seemed benign, just ESG. It's a materiality issue. So that's really 20 years ago where that movement through the UN came from. We were involved in that and defining that terminology, but what was lost along the way was that there was always an underpinning of values associated with it. Mark Carney wrote a 500-page book on value versus values. That has always been the underpinning issues within the ESG community.
00:05:37		How much of it is just around risk, which everybody should be managing appropriately? How much is it about an agenda? I think there has always been an element of an agenda involved in it. We've been trying to progress liberal democratic values probably with a progressive bent through this particular approach in the markets and I think while everything was moving in the right direction in terms of performance and asset growth and everything, it was very difficult to stand in the way of that. But now, a different dynamic with Russia raising its head in the Ukraine.
00:06:08		So now the geopolitical element of it is also on the table. I think Kevin mentioned Texas. It probably has as many jobs now in the wind industry as it does in oil and gas. It just doesn't want to be preached to in terms of where the capital should flow. But if you look back, take a step back from the environmental and look at it just talking really about armaments and weapons, there's now states that say you cannot invest in weapons manufacturers and

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		there's others that say, if you don't, if you explicitly exclude them, you can't do business in this state. So it's pretty bifurcated.
00:06:41	KM	So one of the things I've learned over the years is this idea of not investing in it. It hasn't changed much of anything. There's always still alcohol companies. There are still gun manufacturers despite mass shootings and other things. There's always other capital willing to… If you don't want it, we'll take it up. There's an argument out there, whether it's right or wrong, that would say to you, if you want to cause change, take a position. Get a group of folks like-minded to take a position in a company and force change on that company through basically your rights as a shareholder. So that's part of the debate, too, this idea of, not own it, versus, own it and be active. That too collides on the political scene.
00:07:12	DP	I want to touch back on this idea of value versus values because it seems to me in particular the focus here is on public pension plans and also retirees and their ability to retire and this idea that asset managers have a responsibility, a fiduciary responsibility to create value or a return for them above all else. Are we getting that wrong? Can these coexist together, value and values?
00:07:37	KM	So in the US, the pension system, for instance, where this is coming up right now… There's a dual role of loyalty and responsibility to the plan and to the end retirees or the pensioner. So anything that theoretically changes that hierarchy of what's important and trumps… Puts something else over the top of it and says that those take a backseat to some other issue is where this runs afoul.
00:08:00		So I think you can do both, which is, do well for your investors and do good for society, but I think where this becomes political is, do you place an emphasis on one of these themes or letters over the retiree? Again, I think there are ways around it, but I think that's where the fiduciary issue certainly is in the US.
00:08:21	MG	I think the challenge is, in an inflationary environment and in a fiscal tightening scenario, that's very different than where we were over the last ten years. ESG grew up in an era of availability of

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		capital and it happened to dovetail very well with growth as a factor. You flip that around and you say, well, what about mining companies? What about traditional oil and gas companies that are generating so much cash flow in this period? And yet you know that putting a lot of money to work, for instance, in oil and gas companies today may impede your ability to meet your fiduciary's needs around climate change 20 or 30 years from now. What's the priority? Is it the near-term reaping of the cash flow or is it the long-term positioning for the future?
00:09:03	KM	You've raised a really good point here, which is this transition issue between the future. Climate change is a real cost. Climate will be a real cost to companies, society, etc. versus doing a near-term thing today, putting that aside, and saying, let's do the best thing I can today regardless. Because at some point, if you don't make that transition and start to move toward that, that cost will become real and larger over time. We've seen countries who have basically opted for a shorter transition period to help get to that initiative and have borne some pain. So when I think about it, I think you have to consider that as a cost that we have to move toward but do it in a prudent way. Martin, I think you've been on that for a long time about this idea of healthy transition.
00:09:43	MG	Yes. It's a challenge because every day you're making a decision on, which fiduciary are you considering? Is it today's fiduciary? Is it the future? When you're talking a pension plan, they may have an indefinite future of responsibility to retirees, but do you prioritise the current recipients and their need versus that future, which is impeded sometimes by decisions you're making today?
	DP	We've talked a lot about what's going on in the US. Is this debate pro versus anti-ESG sentiment, for lack of a better phrase? Is this just a US phenomenon or is this happening in Europe or Canada or other developed countries?
00:10:19	MG	I'll jump on that. I think it's just the most obvious in the US. I think in Europe there is a greater acceptance of ES issues. I think the populace generally is on board with most of the directionality of the EU Green Deal or the taxonomy or those types of things. In the

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		US it's just far more bifurcated. And don't forget, in Canada it's quite bifurcated, too, if you're looking at, for instance, Alberta versus BC or versus Ontario.
00:10:44		But I think one of the underpinning challenges here is that we've all become signatories to something like the PRI, which explicitly says you have to integrate and you have to promote ESG considerations within the financial community. And now you have in the US certain states that say, if you do that, you're not open for business.
00:11:02	KM	I think in the US it is so much more visible and it definitely has a larger political connotation to it. It's here in Canada, but it's quieter. It's less visible. People in Alberta maybe less so embrace, but even then, if you go out to that part of the country, people think about, we have to change and there has to be a transition. It doesn't have the hot-headedness that it feels like in the US right now with other tags being put into this, whether these be red issues, blue issues, etc. So I think that's where it differs.
	DP	And it's interesting. When you guys talk about the energy transition, it seems to me that Europe is experiencing a crisis on the energy side and yet there seems to be a greater acceptance towards ESG. It's not getting in the way of that, at least yet.
00:11:41	MG	It's challenging when you do it that quickly, as we were just discussing. So, Germany made some decisions, especially after the nuclear crisis in Japan, to shut down a lot of baseload capacity and do it very quickly. So, they were getting away from coal and nuclear at the same time. Renewables are intermittent. You put any kind of dynamic into that system that stresses it and then you're going to have some issues. So, I think it actually means an acceleration now again towards renewables because you want to get off rogue regimes. You don't want to be dependent on them. So, I think it's just a question of having the appropriate backup in that system to allow that to happen.
00:12:14	DP	Let's talk a little bit about managing money when this is all going on, this debate, if you will. How disruptive is it, seeing these

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		headlines almost on a daily basis that this anti-ESG sentiment or sustainability-linked investment sentiment is becoming more negative over the last year?
00:12:30	MG	Well, we're always trying to position for a reality regardless of the politics to some extent. The politics, if they fall in our direction, is great. The IRA as a piece of legislation is extremely powerful in terms of where it's directing capital and that's actually ex-Republican or Democratic. Really, if you net that out, it's a benefit as much to Republican states as it is too Democratic. So, we love pieces of legislation like that, but we don't depend on them. But the political aspect of it is challenging in the sense that we want clients in Europe, we want clients in Canada, we want clients in the US, and they're taking different approaches to how they're addressing these issues.
00:13:07		So, if you want to be classified, for instance, under Article 9 in the EU taxonomy and SFDR regulation, you have to be very foot-forward in terms of how you're addressing ESG issues. It has to be very explicit, very transparent, and you need to make certain thresholds. Then, if you did the same thing with the strategy and presented it to some of the Republican states, they'd say, can't do business here. So now it's really complicated, how you want to position a strategy depending on where you're marketing it. So that's more the challenge than necessarily, is there investment opportunity? There's plenty of investment opportunity.
00:13:44	KM	If you think about the transition that has to be made on many of these fronts, certainly on climate, the investment opportunities in the future are going to be vast and potential to have real gains in things because the transition is so substantial. As you move away from carbon to other things, whether it be wind, solar, it's going to be a massive transition, a massive investment of capital, a massive opportunity. But it is this definition of transition, how long and when.
00:14:09		One of the other things I've seen is, what you do over here may not resonate well in this country. The first time I have not seen in this debate. An asset manager in the US has come forth and said, we are going to expound on something called excellence capital or

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		excellence capitalism. We're not going to care about the issues. We're basically going to find the best companies that provide excellence in what they do for their clients, their products, etc. So, they're trying to take this extreme approach.
00:14:33		When you boil it down, though, it is the same political underpinning, but people are going to put terms and tags on things that… They don't want to say anti-ESG to them, but at the end of the day, when you really get under the hood, that's what they are. I think again trying to regime-focus this, one size is not going to fit everywhere. Then you're going to have these other outlying voices trying to put some other tag on it that says, just do the right thing regardless. When you really, again, get under the surface, it's not the right thing.
00:15:00	DP	From an end investor's standpoint, do you worry that… Again, hearing the headlines that it clouds the opinion of end investors, all of a sudden, well, maybe I need to rethink this approach if I've been gung-ho on or a proponent of ESG or sustainable investing. Does it cloud that a little bit or do you worry about that?
00:15:19	MG	I think often the end client is more certain about it than those who work in the industry. They know what their values are and how they want to see them expressed in their investments. So, I remember Mario Gabelli years ago when I first got into the industry and there was this debate of SRI. Who does it? It was such a niche. It was almost so odd to be doing it. He actually spoke up and he said, look, I manage money for nuns, and they don't want to invest in certain things and I'm perfectly fine with that. They're comfortable with that. I'm comfortable with that.
00:15:46		As long as the end investor knows what they want and finds that investment opportunity, there's nothing wrong with that. There's always been an underlying perhaps political aspect to that. I just call it more values than politics, but it's just within the community, in the investment community, because so much asset flow has happened into this area and it has received so much attention and regulators are into the area now that it's confusing it, I think, for market participants more than for the end consumer.

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00:16:14	KM	I go back to some of these strategies that, as you know, exclude certain sectors. When you exclude things and that sector does poorly, they look… The population that excluded them looks great and then the opposite can happen when you exclude things and they run away, off-the-charts returns, and you don't have them. You do poorly, right? The debate, it feels to me, is really this post-2020 where a lot of these strategies didn't own energy and they looked terrific. Remember, we had a period of time in May of 20 where a barrel of oil traded at zero for a few days, to this year where… Forget what the commodity has done.
00:16:45		The stocks have done 60% or 70%. So many of these strategies don't own them and all of a sudden now you're hearing this noise level rise about, why are these not working? And the reality is, you have to put both those periods together and look at it and say, did I meet the end result for my investor and what they wanted and the values that they subscribe to? But that's what a lot of the noise I think you're getting today is about. When you take a snapshot in time about something, it creates this, again, new language around, is it working, is it worth it again, etc. and we've always had that.
	DP	Yes. I wonder if we think political noise out there is a concern. Really that's not the concern. The concern is probably more monetary policy, inflation, and what that has done to the universe, right?
00:17:24	MG	Yes. Look. It's a challenging year for a strategy like the one that I run that doesn't invest in conventional energy. It's the segment of the market that's doing so well, right? So, you want to be involved in some fashion. I always go back to, what did we explain to our clients? What were we trying to achieve with this strategy? Were they aware of that? Were we fair in terms of how we presented that? In certain years, you're going to have this type of issue. 2020 for us… Huge alpha on top of benchmark. This year we're giving some of that back, but I think most of our clients are quite aware of that dynamic. So, it's not like we're under pressure to say, why don't you own all the integrated oil and gas companies? Well,

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		they know that that's not part of our approach. They own it elsewhere likely.
00:18:02	KM	I get very comfortable with the fact that the people who hire us and firms like us who do this… And to Martin's point, if you articulate what you do and why, they're not going to be surprised by this. They have and believe [?] this in their value system. I think the other thing… You touched on higher rates, David. I look at the higher rate issue as the longer-tailed potential issue because a lot of these strategies are early-stage growth companies that have to be financed.
00:18:28		When you have much higher interest rates and those earnings are so long-dated into the future, when you present-value those back with higher rates, those companies all of a sudden become very much more expensive in the eyes of an average investor who doesn't have Martin's lens for that long term about transition and the need for these technologies and other solutions to help get us to this change that we need. That to me, I think, is a bigger issue in the near term about, will capital help support these industries and technologies to help them mature to a place where we can actually get to the right transition?
00:18:58	MG	That probably, from an underlying perspective, has been the biggest challenge year to date. Forget about whether it was energy or mining or what's doing well. It's a duration change in perception, and we do have a lot of companies that are capital-intensive. We have capitals that are positioning themselves to provide the key inputs, for instance, for that electric vehicle that's absolutely needed. We all know directionally that's where we have to go and they need to put that capital to work, but it's the patience in terms of saying, oh, geez, you're taking up your capex by a billion dollars and you're a $5 billion company? In this type of market? You have to have the stomach to bear that in the near term.
00:19:35	KM	One would hope that as people remain on side with these strategies and more money comes to play, though, that they can see through that near term and help again make those

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		investments. Because there's such a groundswell about this being the right thing to do and we need to do for the future, certainly around climate, that may be different from other things. This capital can get deployed and maybe it's a short-term phenomenon, but it has certainly been impactful about people thinking about just the duration that it will take for some of these companies to become profitable.
	DP	And this argument about duration doesn't just impact ESG issues, though, right? It's broader than that and yet the political attention that's paid to ESG seems over the top.
00:20:16	MG	They're bucketed with any other growth company in terms of challenge of capital when your interest rate environment changes. The difference is, we have corporate and government commitments around a transition. So, the question is, well, how long are you going to pump that out? You saw a big foundation in Canada today say, we're actually rolling up our endowment and putting $100 million into specific transition-type projects now because if we don't do it now, if we don't draw in other endowments and other private capital, we're not going to make any of those targets. That's, I think, very interesting, to see that happening.
00:20:51	KM	And that's what's different about these technologies and these growth companies that support this arena versus if I was some early-stage software company that had nothing to do with this massive change toward transition. Then I don't see the massive capital coming to support it. Versus, there are investors who are going to come around this and say, we have to do this.
00:21:14	DP	Martin, you talked about the IRA, not the Internal Revenue Agency, the Inflation Reduction Act, which was passed in the US in August. It's a huge catalyst potentially for ESG investing and is on the other side of the coin to some of the anti-ESG sentiment that we're seeing. It seems to be of two minds in the US a little bit. Can you just maybe describe a little bit of the opportunity that the IRA affords someone like yourself?

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00:21:40	MG	I almost make a distinction there between ESG broadly as maybe an investment approach and something like the IRA, which is solidly trying to position the US as a leadership country in future industries. So, there's some very interesting opportunities through that, including accelerating the cost curve for things like hydrogen where if you're producing green hydrogen… We use a lot of hydrogen in the economy today.
00:22:04		We use it for, in particular, ammonia production in fertilizers and in the refining industry to knock sulphur out, but that's all coming from nat gas primarily, breaking out the hydrogen. So can you convert some of that to green hydrogen? Can you use renewable power to generate the hydrogen that's then used in those processes or can you use it for trucking? So now it's a compelling investment opportunity today. So it has brought forward the economics and made that profitable for companies doing that.
00:22:31		Carbon capture obviously… We can't reduce all the emissions at source. We've got to capture some of the emissions and that's a very costly endeavour to do, right? So the act actually improves the economics of doing carbon capture to the point where, if you were looking at it in Canada versus the US and you had assets in both countries, you'd spend all your money in the US. So the dynamics are now very acute for Canada to also come up with some legislation and then it goes through as well into the electric vehicle supply chain.
00:23:01		It incentises local manufacturing of battery components. It incentises purchases of electric vehicles to the tune of some $7,500 per vehicle. So there's a lot in there that's going to really catalyse spending in the US, make it a hub for some of these technologies, and really it's a bit of a, let's compete with China and Europe. That's what they're trying to do.
00:23:23	KM	And the fact that you are dealing with such a fractured political environment in the US that this was one of the few things that actually got through in these last two years tells you that this had quiet but broad support even though the vote looked a little different, but it got through. But there was not a lot of objection to

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		it, the politics aside on the visible level, but this was one of the few things that actually got through that wasn't COVID-related really in the last two years in the US. So it should tell you something.
	DP	We're near the end of the year, so maybe you can give us some flavour as to what you'll be looking at in terms of opportunities heading into the New Year and through 2023.
00:23:59	MG	Well, look. We do have a longer-duration view. You don't make net-zero commitments without having a longer-term view. You're talking out to 2050, 2030 as an interim target. So what we're trying to do is really use a bit of that time arbitrage where the market gets very short-term-focused and we're looking at names to say, okay, you've had in some cases a 50% change in valuation here in eight months and yet the long-term dynamics improved.
00:24:23		So the market is just saying, we're not interested in you right now, and we're trying to say, okay, well, if that secular opportunity is still there or this company is still the one to own, how can we re-engage? What does the weight need to be to reflect that opportunity? So it's a challenging year, but I think it's actually setting us up maybe for some pretty compelling opportunities.
00:24:43	KM	I don't disagree. I think one of the things… and I tried to frame it earlier. The environment we're going to go to will not reward speculative growth, but it will reward purposeful growth for things like this that have had their valuations really compressed, but the end game is still there or the end strategy is still relevant and the timeframe to get there hasn't changed materially. So I think you're going to see that differentiation.
00:25:04		I'd say it's hard to see another year like this with some of the carbon components of a portfolio. It's hard for me to look forward and say that energy is going to be up another 65%. The world is going to start to slow down. Inflation is going to start to roll. So I think that has been a headwind for these strategies that don't own them and at the same time I think interest rates probably start to peak next year, which again… That other headwind starts to

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		abate as well. So, relative to what we just went through this last year, I'd say next year sets up pretty well.
00:25:35	DP	Great. Fantastic stuff, guys. We'll end it there. Thanks, Martin, for being here. Kevin, as always. For a full transcript, visit agf.com/podcast, and don't forget to subscribe to hear more from us at Apple Podcast, Spotify, Google Play Music, Stitcher, Podcast Addict, and Pocket Casts. This episode of Inside Perspectives was recorded on November 29th, 2022 at AGF's offices in Toronto, Ontario, Canada.
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