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Quantifying externalities is difficult and imprecise but one "should not fall into the trap of making the perfect the enemy of the good" and not try

ESG, the acronym for Environmental, Social, and Governance, is now established as a mainstream financial topic. With multiple frameworks – SASB, GRI, CDP – providing the basis for even more ESG ratings that propound to help investors "do well by doing good", companies can point to a single score as proof of their ESG credentials.

For example, French food conglomerate Danone has an ESG Evaluation score of 85 from S&P Global Ratings while Unilever scores an 89, with "[(h)igher numbers indicat[ing] stronger sustainability]".

But can you really measure impact with a single number?

"I have objections with the notion that we are going to be able to create a total impact score for firms, and that this will be meaningful and useful in some way," says **Andrew King**, Questrom Professor in Management at Boston University. "You're taking a distributed decision-making system, and you're centralising it. You're now going to have a few people making decisions about what the impacts are for all these other entities in the world.

"All that involves a lot of complicated valuation decisions. Some of that stuff simply cannot be done very well. To really understand impacts you have to know what consumer surplus is for a firm. You have to do all the externalities.

"The notion that all this can be done accurately was debated in the last century, and the answer was no."

QUANTIFYING THE IMPOSSIBLE?

The OECD defines externalities as "situations when the effect of production or consumption of goods and services imposes costs or benefits on others which are not reflected in the prices charged for the goods and services being provided". Carbon emissions are the most easily understood externality but **Wong Dan Chi**, Schroders's Head of ESG Integration, APAC notes that "the definition of externality keeps growing", citing the example of private education companies in China "being viewed as causing mental stress".

Adrian De Groot Ruiz, Executive Director at Impact Institute, concedes that measuring ESG is a complicated matter, but adds that it is precisely the reason why measurements are needed: "If it is so complicated, how can you expect a manager or policymaker to make an informed decision? By making this complexity understandable and explicit, it will lead to better decisions. It won't be perfect data, but it will be better data than what we have now."

He continues: “What we can rely upon is that the scientific consensus will be better than the estimate a single manager or policymaker can come up with.”

Shawn Cole, John G. McLean Professor of Business Administration at Harvard Business School offers this perspective: “Should we not think about measuring and monitoring carbon emissions because we can’t trust that? Or that unelected officials won’t get it right?

“It’s not clear when the world will have the collective willpower to impose a carbon tax that gets the social cost of carbon right. Until then, if we can make some progress through capital markets [in the form of ESG ratings and ESG funds], I absolutely think we should.”

Cole adds that some things should be codified and monetised, such as a living wage, but points out the danger of ignoring things that are important but are harder to monetise, such as literature or that which are “impossible to quantify or monetise such as religious beliefs and whether humans should eat meat”. “One might argue that by getting CEOs and corporates really interested in measuring and managing carbon, we are at least making it a lot easier to get the easy wins in carbon reduction, and build the political coalitions around more thoughtful carbon regulation.

“I think we shouldn’t fall into the trap of making the perfect the enemy of the good.”

INFORMING INVESTORS AND GENERATING ALPHA

Michael Tang, Head of Listing Policy & Product Admission at Singapore Exchange (SGX), observes that companies listed on the exchange are building ESG information into their annual reports. But he adds: “The market consists not only of impact investors but a whole spectrum of investors, from traditional ones who look purely at financial statements to those who consider some ESG elements with exclusionary screening requirements.

“From our perspective, there ought to be clarity for each group of stakeholders as to the information that is required in order for them to generate their own investment decision-making. I think informational needs will be something that regulators will be focusing on.”

For **Dave Chen**, CEO of sustainability-focused asset management firm Equilibrium Capital Group, regulators paying attention on sustainability is proof of “public markets and capital voting”.

“You can be sceptical but the markets are voting,” notes Chen. “All you have to do is look at the oil and gas sector turning into a stranded asset sector to get a sense of the magnitude of the changes that are taking place.

“In the last three or four years, our clients have begun to demand visibility into our sustainability and impact programmes. It’s gone from very fuzzy notions to increasingly the alphabet soup of three-letter acronyms or four-letter acronyms. We can’t afford, as an investment manager, to lose sight of that fact that we are an investment manager and not a reporting shop or data collection shop.”

Chen emphasised “generating alpha” as his main goal, and he expressed his belief that high ESG-rated companies’ premiums are already baked into valuations. As such, “if you want to generate alpha, go find unpopular sectors and find a company where the management of the company is sincere about making changes, and you’ll get the benefit of the ESG premium. You’re not gonna get that from a score.”

He adds: “I’ve been writing about this deep concern that I have that we’re now so concerned about metrics that we forgot our work – and I mean this as a joke – of saving the planet, investing in saving the planet, but we’re focusing all our attention on measuring stuff and taking our eyes off what our work is, which is to scale our investment so that we can actually make a difference.”

Andrew King, Wong Dan Chi, Adrian De Groot Ruiz, Shawn Cole, Michael Tang, and Dave Chen were panellists at “Panel Discussions on ESG Measurements & Standards” webinar that was held by the SMU Sim Kee Boon Institute for Financial Economics and the Singapore Green Finance Centre on 31 August 2021. Professor Dave Fernandez and Associate Professor Liang Hao of the SMU Lee Kong Chian School of Business were moderators. The webinar was a side-event at 4th annual Global Research Alliance for Sustainable Finance and Investment (GRASFI) conference that was held on 1-3 September 2021.