ON ORTHODOXY, TAXONOMY, AND TEN COMMANDMENTS FOR ESG DISCUSSIONS

ESG – THE NEW UTILITY FUNCTION?

Dr. Oliver Roll

"AS WE ARE INCREASINGLY FACED WITH THE CATASTROPHIC AND UNPREDICTABLE CONSEQUENCES OF CLIMATE CHANGE AND RESOURCE DEPLETION, URGENT ACTION IS NEEDED TO ADAPT PUBLIC POLICIES TO THIS NEW REALITY. THE FINANCIAL SYSTEM HAS A KEY ROLE TO PLAY HERE. THE FINANCIAL SYSTEM IS BEING REFORMED TO ADDRESS THE LESSONS OF THE FINANCIAL CRISIS, AND IN THIS CONTEXT IT CAN BE PART OF THE SOLUTION TOWARDS A GREENER AND MORE SUSTAINABLE ECONOMY. REORIENTING PRIVATE CAPITAL TO MORE SUSTAINABLE INVESTMENTS REQUIRES A COMPREHENSIVE SHIFT IN HOW THE FINANCIAL SYSTEM WORKS. … BOLD AND AMBITIOUS POLICIES TOWARDS MEETING THE CHALLENGES OF CLIMATE CHANGE, ENVIRONMENTAL DEGRADATION, RESOURCE DEPLETION, AND SOCIAL SUSTAINABILITY CAN ONLY BE SUCCESSFUL IF TACKLED WITH THE RIGHT PRIORITISATION AND SEQUENCING."
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Last year, I was attending several conferences in which ESG investing and all that - i.e. SRI/sustainability, impact investing, green finance, climate change - not only featured prominently, as in previous years, but was presented as the new paradigm of our industry. If I was to describe that paradigm: investors' utility function $u = u\,(RaR)$ - depending predominantly on risk-adjusted return parameters *(RaR)*, given a certain set of available instruments - is to be replaced by a new utility function $u' = u'\,(RaR + ESG)$, which is qualitatively broadened and fundamentally redesigned - ultimately geared towards a more sustainable and greener economy, as stated in the EU manifesto.

A paradigm is a nice and cozy frame, making sense by stating model problems and providing solution heuristics for practitioners, i.e. investors and asset managers. But as such it is subject to other problems, like confirmation bias, claiming orthodoxy, and creating the need to have a full new paradigm in place, before contradicting facts are able to provide avenues for finding new ideas and solutions. This is what occurred at all the conferences I was attending: declarations of belief, reiterating do-good objectives, at times emanating an almost religious fervor. If this wording would suggest to you that we are not 'convinced' of the validity, the warrant, or the dire need to re-do things on our planet, and that we have not grasped the ethical implications towards future generations - rest assured: we have - and this first 'disclaimer' is part of the problem, as we need to discuss all this politically correct.

It was during conference presentations, radiating so much conviction, that we started asking ourselves if the 'financial system' had found a new purpose, a new moral raison-d'être, making up for everything that went wrong (can it?), or whether this was a new fad-and-fashion, something to-be-replaced (with a new paradigm) soon, or a super-hyper-mega-trend, but foremost: what is the rational foundation for the motive of everybody promoting this development, and are we tackling the problem in a way that will help find and implement the best solutions?

The Problem

This commentary is about taxonomy, fallacious rhetoric, and orthodoxy. The latter should not prevent an open discussion as to why the quest for taxonomy, for ESG-'standards', metrics, benchmarks, etc. in sustainable investing are beset with problems. The problem with orthodoxy is that 'dissenting' views, skepticism, and engaging in problem-solving activity based on a scientific approach (i.e. presuming and requesting falsifiability) are being dismissed as heresy. We need to focus on the *imposition* of the new utility function *u' (RaR + ESG)*: the why and how to make asset management (and the 'financial system') the trailblazer for a political, environmental agenda, and the instrument to implement the 'comprehensive shift in how the financial system works'. At stake is that we are giving up something in this process (and this is not 'return'). If you deem this a good idea, and a welcome development, in line with what you have been thinking for some time: Like in religion, the problem is that such developments are not resulting in a work of the best and the brightest, but causing potentially the best and the worst. We are concerned here with some shutting the door for the brightest. We claim that we need the brightest ideas and strategies to find solutions for the "catastrophic and unpredictable consequences of climate change and resource depletion". Problems of such scale need creativity, and ideas.[1]

The Second Disclaimer

We are not taking sides here with either Luddites, or neo-Luddites, or neo-Malthusian pessimists, nor with the cornucopians, or any neo-liberal or libertarian optimists. We do not question the validity of any ESG-related argument. We do not disavow the need to change things on the planet, in our economy, in society, on consumerism, etc. We do see the consequences of climate change - but we do see likewise that the reasoning on why investors should be concerned with climate change is becoming heavily loaded - with doomsday scenarios, apocalyptic fear-mongering, and: dogmatism. Politics of fear has never been a good development, and never produced any beneficial results. In our industry, it puts the charge on investors and the fiduciary duty for being agents of change - which again, you may think is a good idea. But note: The grand narrative (or metanarrative) of anthropogenic global climate change is framed in a there-is-no-alternative, in a 'this-time-is-different' fashion.

Back to the Problem - and a Second Problem

We mentioned the problem of language - and it is a problem of how we speak about ESG integration, as this 'translates' into how we do it, or have to do it, and that determines the options we have, and the potential to find the best solutions. Once again: Should the reader think, based on my previous paragraph, that we are critical of ESG integration: Rather not. Rather, we are concerned with the rhetoric in all these conferences, and what we read in publications. And this is why you may find fault with almost every word in the quote at the beginning, though presumably it was phrased with a lot of political acumen, and in a long 'comitological' process in Brussels. Let us make clear: the author is not a climate change denier... We did learn about this invective only recently. (An even more questionable version is 'climate denier' - what senseless term is that, but a derogatory muzzle?) What we are very much concerned about is such language which is posing false dilemmas, or is abusive, charging heresy, commanding groupthink on a large scale, and allegiance.

All politics? Yes and no, it affects all we do. Quite bizarre publications by reputed scientific publishers, (not to speak of political activists), stay only short of suggesting to make 'climate change denial' a criminal offence. How low is possible? To quote: "This depiction [retelling of the story of arguments between climate scientists and climate deniers] presupposes a clear-cut conflict between objective bearers of true knowledge on the one side and a group of interest-driven distorters of true knowledge on the other." Bearer of true knowledge sounds like a scribbler in a medieval monastery.[2]

The 'Archimedean point', on which everything hinges, is the statement of an absolute novelty and global scale of the problem, market failure, and the ethical responsibility to save humanity. That makes one modest and mute.

The Third Disclaimer

We verily believe Hans Jonas has provided a valid philosophical foundation, setting out an Ethics for the Technological Age (his 'Imperative of Responsibility'), and his 'heuristics of

[1] As we will argue in the next sections, this is not limited solely to the question of political action, policy making, and policy implementation instruments, i.e. regulation. A wonderful up-to-date and very balanced assessment of thinking on state action, regulation, and all that can be found in many excellent chapters of: Tanzi, Vito: "Termites of the State. Why Complexity Leads to Inequality", Cambridge 2018.

[2] Against the background of the publisher (Palgrave Macmillan/Springer), an interesting objective of analysis (q.v. the title), and what appears to be an academic piece, one marvels what a biased, tilted and prepossessing language prevails throughout: Ruser, Alexander: "Climate Politics and the Impact of Think Tanks. Scientific Expertise in Germany and the US", Cham 2018.

fear' is a helpful methodology to discuss ethical implications - for instance - in the use of nuclear power, and why and how to integrate ethical responsibility into long-term consequences of technology and human activity.[3] However, his admirable heuristics, work and writing is lacking in normative elements to provide a methodology to work out and arbitrate between the immediate necessity ("keep-off pushing the red button") and the Promethean curse of any technology. Ethics and policies are not only 'digital' (do vs. do-not), but more often continuous, not black and white, but showing many shades of gray.
That and all on normative ethics is for another article; we need to make clear that we believe in the justification for many, if not most, claims that ESG considerations make - in all three (E, S, and G) dimensions. Many good things to take into consideration. However, we need to have choices, to explore the shades of gray. Why? Only two reasons to mention here: Particularly, 'S' and 'G' factors depend heavily on our (Western) value system, and are time and culture dependent, subject to change. In regards to the 'E' dimension, let us remind how much we rely on environmental science findings and engineering, yet history beckons us to remain skeptical (and open!) of virtually everything that seems a well-established fact in these fields. In a jocular hyperbole, we can emulate Carlyle's dubbing of economics[4] as the 'dismal science' by the following description of environmental engineering - similar to ecology or sociology - as the science of

1. hidden parameters,
2. unintended consequences,
3. chaotic behavior,
4. action-at-a-distance.

This is not to debase environmental science, on the contrary: to recall what complex, interdisciplinary, challenging and multi-purpose endeavor it is. The point is to make sure that any 'E'-consideration can be dealt with in a 'scientific' way, i.e. subject to possible falsification, permanent revision, and ongoing improvement.

Hence, all factors are 'moving targets'. At any point in time, we need to accommodate for potential change in how we factor in these dimensions, and remain flexible to the utmost degree to find the best and brightest solutions.

[3] Hans Jonas, the German-American philosopher, published his "Imperative of Responsibility: In Search of Ethics for the Technological Age" in his native German "Das Prinzip Verantwortung" (1979); Kritische Gesamtausgabe der Werke, I/2 – 1. Teilband "Grundlegung", 2. Teilband "Tragweite und Aktualität einer Zukunftsethik". In a telling "Berliner Podiumsvotum/Mitverantwortung für das Klima" (1992, 2. Teilband, p. 405-406), he states: "Diejenigen, die heute die Gefahren für die Zukunft als sehr ernsthaft ansehen, haben da die große Verantwortung, ihre Bedenken zu verbreiten, die Basis für die beschriebene mögliche Änderung [Verzicht auf unmittelbare Wunscherfüllung] immer breiter zu machen. Aber ich will schließen mit dem Bekenntnis, daß ich nicht weiß, wie man das macht."

[4] There are some unsettling parallels in how language and certain words develop a 'life of their own', when looking into the history of the 'Dismal Science'; q.v. for instance Levy, David M.: "How the Dismal Science Got Its Name. Classical Economics and the Ur-Text of Racial Politics", Michigan 2001. Here, our concatenation – another wonderful term - uses some concepts from physics (hidden parameters in quantum mechanics), Robert K. Merton's popularization of unintended consequences (in his 1936 publication on "Unanticipated Consequences of Purposive Social Action"), chaos theory (sensitivity to initial conditions, also called butterfly effect), and again physics (esp. the universal law of gravitation).

The Third Problem

During those conferences, we were asking ourselves why our clients, institutional investors, should or would embrace ESG considerations, in the first place - if not yet dwarfed by that colossal responsibility of saving the planet, rebuilding the economy, and making this a better place for all humankind? (The same applies, mutatis mutandis, for asset managers - with the additional motive to position themselves in competition, and re-brand their companies as a strong ESG expert.) Let us group the motives for ESG integration under four C-headings, not completely disjunct, but with potential overlaps:

C 1: **Consensus:** Matter-of-fact, "we just do it"; "this is the way to do it", "everybody does it"; etc.

C 2: **Consideration:** Economic thinking and deliberate choices suggest in either a 'weak form', i.e. from a risk management perspective to avoid risks by not taking into account ESG factors, or in a 'strong form' warrant ESG integration by a belief in the economic 'smartness' of sustainable investing. ESG integration based on seeing these dimensions financially and competitively being actually material.

C 3: **Conviction:** the assets 'have an objective', a mission, agenda: based on a political philosophy, idea, or dedicated purpose.

C 4: **Command** - or directive: Somebody told them to do so!

C 1, consensus, represents any inconsiderate or simply proselytized acceptance of the new paradigm, which you may not find many to admit doing, while in fact it just happens. Whether we can differentiate from matter-of-conscience decisions - in which case we could almost put it in category C 4, is debatable. A 'new definition' of what good governance and/or fiduciary duty involves is likewise not clearly type C 1, but probably of type 'directive'. We will return to this shortly.

A consideration of risk-avoidance and mitigation (2.) does certainly make a lot of sense, economically, from a very long-term perspective (an almost inane integration of a 'sustainability' dimension into the long-term evaluation of economic developments) to a brand and/or image related perspective. It includes matter-of-prestige decisions, and can be seen in modifying the utility function in its depending on an extended risk-dimension only (i.e., $u = u(R'aR)$).

The question of economic value of ESG integration in a qualitative and full-fledged manner has been an academic contest for many years, but constitutes in this catalogue the truest acceptance, not troubled with any political agenda. With policies enacted everywhere, it will become a self-fulfilling assumption.

C 3: Many investors do have a concrete mission how to run their assets, such as foundations, churches, etc. - and a lot of earlier negative-screening approaches are also easily seen as translating a purpose or conviction of sorts into capital allocation. Therefore, if that or similar thinking is the leitmotiv, ESG integration is a consequential thing to do, especially if and when it reflects the mandate of the investor, or the fiduciary, managing the assets.

The command, or directive (4.) is the most problematical. We may ask first who 'somebody' was, and there are two agents that we need not bother with in further discussion: owners/principals, and clients. It would be 'excellent reason' for ESG implementation, if your clients (buying your financial products, your old-age pensioner, etc.) were demanding it, and certainly there is no questioning if the owner of your company was stipulating it. (However, which of the reasons no. 1 to 4 make them require it? Or have they just been told to do so?) The other 'somebody' could be the government or legislator, the EU commission, NGOs, the IPCC, the scientific community, one of us?

If ESG integration takes place because somebody tells the investment industry to do so, that would be in itself a large-enough problem, and an embarrassment. Even if many would deny that this is the case, sometimes bordering on self-deception, we need to deal with at least three note-worthy problems with enacting directives, and they will be addressed in the next section.

Is an 'evolution' in the consensus view sufficient reason? More than a decade ago, lawyers, charged by the UNEP FI, spend considerable time on evaluating whether sustainable investing was in fact in line with fiduciary duty, and the findings stated in a diplomatic way that they were 'permissible', while suggesting a positive slant to it ('arguably required'). This has changed: If one listens to Al Gore's statement on the UN PRI website[5], one learns:

"Outdated conceptions of fiduciary duty cannot be allowed to stand in the way of progress toward a better economic system."

Such reasoning is of type no. C 1 and C 4 multiplied ('command consensus!'): a factual statement of a 'new reality' which the EU commission quotes in establishing their Action Plan – new reality with newspeak? The major problem lies not only in the recurring need to refer back to the 'Archimedean point' in justifying such strong infringements into investor's freedom of choice of investment style, asset allocation, used instruments, etc., and their being exploited to become the agents of changing the 'economic system'. (Let us assume that this urgency is in fact given.) The response of most participants in our industry is then to call for a taxonomy, metrics, or yardsticks by which to gauge sustainability factors, and make the new utility function 'measurable'. Particularly if somebody tells you to implement ESG, i.e. if not reflecting your own convictions in a completely individualistic manner, it would make your job easier to have measurable, transparent, understandable, generally accepted standards, guideposts, and rule books. Good idea?

We are afraid the call for 'taxonomy' or standards is flawed, no matter how many positive adjectives and nouns are combined, but it is a problem not to go away. It would be quite unrealistic to presume employees of institutional investors would not want to opt for making their life easier. First of all, it compounds the problem with reason no. 4, as – again – somebody else will instruct investors and asset managers where and how to allocate capital. It will add complexity instead of straight forwardness, and who can decide whether that should be done best by consultants, index providers, scientists, NGOs, governmental bodies, agencies, commissions, the Big Four, high-level-expert-groups? All have good ideas, good intentions, and vested interests. Second, as soon as there will be a published (issued, decided on, released, prescribed) taxonomy, everybody will realize that it will not be what was expected, hoped for, reasonable, easy to implement, yet complicated, restrictive, and not fitting reality. Many will criticize whatever taxonomy they will have to use, and rightly so, and some will potentially curse another bureaucratic monster. Thirdly, it will constitute another cost (like an index, like an auditor, ...). Unless the whole accounting system will be revamped, one should not expect a taxonomy which will take care of investors' ESG responsibility (just remember on came out of fairvalue accounting, to give only one example). We venture to say that we can expect misallocations of capital, attributable to flawed benchmarks, metrics, or inane taxonomy, and plenty of rent seeking, instead of value creation.

The Forth, Fifth, and Sixth Problem

Let us return to the three fundamental questions why ESG integration by fiat, command, or directive, will not serve most of us:

- Who issues the directive? Which instance knows best? Who knows what is best?
- Taxonomy, metrics, standards, benchmarks – all stand for that somebody-else-is-deciding, and all are 'one-size-fits-all'-problem affected. Any advantage will be outweighed by complexity, cost, and conflicts.
- How to create an 'environment' fostering creativity, problem solving, and not keep capital in strategies or projects we deem to be the 'right' ones for the future - but only from today's vantage point?

If we accept the basic premise, based on the diagnosis 'we must change the economic system' (corollary: 'the way we allocate capital', 'the way we invest', etc.), be it for reasons of observed environmental and/or societal necessity, where is the logical nexus to knowing 'which system', or 'which is the solution'?

Attempts have been made to put environmental factors as externalities into the equation. The presence of externalities may provide a prima facie argument for remedial action by governmental, regulatory or fiduciary bodies. Despite externalities being ubiquitous, and itself a flawed economic concept, quite often the resulting situation is interpreted as 'market failure'. The more you read about a need to regulate, to curtail, to prescribe and to constrain investment activities, the more one tends to take sides with those who think it is more appropriate to remain skeptic as to whether government, the state, the scientific community, or any of the bodies or committees pretending to represent the 'Global Community' - is omniscient, omnipotent, or purely benevolent.

This argument is not based solely on an 'outdated' belief in laissez-faire, or an invisible hand of the market. The rationale

[5] "Fiduciary Duty - The Sustainability Revolution", Al Gore in the video on https://www.unpri.org/fiduciary-duty/al-gore-introduces-fiduciary-duty-in-the-21st-century/245.article, retrieved January 6th, 2019.

is that with any material ESG criteria in economic assessments, science and scientific evaluations enter the equation. However, like in science, a productive environment (in fact: the only one) will not be one of order and decree, or by 'tick-the-box' based on what standard-setters prescribe. Idea generation can be secured only by a diversity of voices and opinions. We are advocating diversity in all cultural and social settings, here versatility is key. ESG 'taxonomy', benchmarks etc. will have the same effect as capital-weighted indices had on asset allocation.

Much better if this will stay a challenge for investors, and asset managers alike: the need to discuss with each other, exchange ideas, views, convictions - and potentially move on to work with somebody else, if no 'alignment' is achieved. Responsibility cannot be outsourced, and standards would curtail opportunities and stifle creativity. It is exactly the (competitive) situation we need, as the good, and the best ideas, approaches and strategies will prevail. Time is running out? If so - the things the polity can create, justifiably, are new market places, instead of prescribing what and how should be traded (in existing markets). Compelling investors via directives to reorient capital flows is one way, but maybe political action could be addressed to creating new market places of different nature (and incentivizing using them), or explore new 'adaptive markets'. We are afraid that instead we are producing a 'market failure': in the market for the best ideas.

The Last Problem

Not many things - most certainly not this commentary – will redirect the thrust of ESG discussions, or make policy-makers rethink any 'Action Plan'. The train is unstoppable – and again, assume we are not lamenting that. Many investors will be using the new utility function deliberately, but others will be subjugated by regulations to do so. In the spirit of Karl Popper though, we suggest trying to keep an "open investors' community", and avoid the traps of conformity, orthodoxy, and ideology, to keep searching for better, possibly 'a' best solution. In so doing, no infringements on property rights are necessary. All that starts with a discourse without fallacies, and important caveats to bear in mind:

The 'Ten Commandments'

1. Stay Modest!
Beware of our lack of knowledge and uncertainty, incl. 'chaotic' behaviour, and 'action-at-a-distance' in environmental and social science. Conclusions on any ESG topic may be true here and now, but not a stable basis for policy decisions. Here and now, experts - by design - will have to overstate findings. Check for 'checks and balances', particularly in policy making based on complex models.

2. Beware of ESG as Moving Targets, Panacea, or Scapegoat!
Beware of ESG assessments depending on scientific conclusions, reasoning, value systems, subject to peer group pressure – they all remain moving targets at all times. Neither SRI, or any ESG factor is a panacea for corporate success. However, they will be used at times to justify poor performance.

3. Beware of Multiple 'Best' Solutions!
In none of the ESG criteria one finds a 'one-size-fits-all'; allow testing, trial-and-error, and finding multiple, or competing solutions. Beware of multiple or unstable 'equilibria'.

4. Do Not Covet for Standard Setters!
Keep your approach open, open-minded, attuned to finding the best ideas, kind-of-scientific. Beware of standard setters, taxonomy, metrics, and all experts who want to tell you what is 'right'. Do not believe your responsibility can be outsourced.

5. Keep an Ongoing and Open Dialogue!
Do not believe in reducing your workload – or your responsibility – by relying on standard-setters, 'tick-the-box'-criteria, indices, or benchmarks. Constantly discuss, probe and defend what you do, what investors ask for, and what asset managers offer. Honor diversity in approaches and ideas.

6. Honor your Mandate!
Do not overexert yourself by intending to change the economic system, to save the planet, not even the moon. Adhere to your mandate $u = u$ *(RaR + whatever)* and keep off agendas of redistribution, industrial policies, and dogmatic objectives. However, should you have one: do not let others (standard-setters, consultants, NGOs, the polity, 'high-level-expert-groups') do that job for you. Philanthropy needs a different utility function.

7. Beware of Overconfidence!
This advice may apply to all portfolio mangers, but as qualitative ESG criteria ('private information') become crucial in investment decisions, all findings of behavioral economics will see boosted relevance (emotional factors, framing, etc.). As agents tend to overestimate the relevance and precision of their private information, they will significantly affect trading volumes, risk levels of their portfolios, and be causing momentum effects. The complexity of the ESG-utility function will make 'bounded rationality' an even more pronounced problem area.

8. Beware of Red Herrings and Snake Oil!
Environmental and social policy making is prone to Red Herring fallacies to a degree seen hardly anywhere else. Red Herrings will prosper in the competition for capital, as story telling is at the root of all E, S, and G due diligence. ESG 'marketing' will produce potentially dubious information, and it will be onerous to determine whether this will be 'material', or 'not material'. Do not invest in snake oil production, stay clear off any story containing moral absolutism.

9. Thou Shalt Not Worship Other 'Gods' - which are not in your Utility Function!
Beware of dangers of Ponzi schemes, and the greater-fool-fallacies! Market values may not be justified, only for reflecting a political purpose. Do not help build up bubbles.

10. Thou Shalt Not Bear False Witness!
Beware of language with obfuscating terminology, and rhetoric claiming orthodoxy, or charging heresy. Avoid dogmatism!

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