Deutsche Bank, Apple, Volkswagen and BP. These well-known, global companies—all leaders in their respective industries—have one thing in common: They’ve been slapped with fines from regulators for violations related to environmental, social and governance (ESG) issues:

- Deutsche Bank faces a $14 billion proposed fine for questionable practices related to the sale of mortgage securities, which has rattled the entire banking sector.¹ (governance issue)
- Apple was ordered to pay of $14.5 billion for unpaid back taxes.² (governance issue)
- Volkswagen agreed to a $14.7 billion settlement for its “diesel-gate” scandal and still faces additional civil and criminal investigations. (environmental and governance issue)
- BP agreed to settle various charges related to the 2010 Deepwater Horizon accident for $20.8 billion.³ Including all compensation and clean up, BP estimates the total cost of the environmental disaster at $54.6 billion.⁴ (environmental issue)

The magnitude of the fines, which are significantly larger than those historically levied, underscore the potential risks posed by lax ESG policies. Clearly, ESG factors are no longer just a moral issue: the market is ascribing value to them and, in some cases, they have determined which companies survive and

¹ http://www.telegraph.co.uk/business/2016/09/16/ftse-100-falters-as-deutsche-banks-refusal-to-pay-14bn-fine-ratt
² http://www.wsj.com/articles/apple-received-14-5-billion-in-illegal-tax-benefits-from-ireland-1472551598
which do not. For example, in the case of coal—a case we feel serves as an early warning for investors generally—negative ESG factors have helped bring down an entire industry.

**Coal has become the canary**

Anyone who doubts that a bad ESG record can hurt a company needs only to look at the coal industry—the most environmentally unfriendly source of energy now serves as the proverbial “canary in the coal mine.”

Early coal mines didn’t include ventilation systems, so miners carried caged canaries into the tunnels. A dying canary warned of a toxic atmosphere and served as an alarm for immediate evacuation.

It’s now the coal mines themselves whose deaths are providing a warning. The coal mining companies in the United States have nearly all gone bankrupt, while those in the rest of the world are under pressure. It is the first industry to be poisoned by a poor ESG record. But if the canary metaphor holds, the coal industry is an early warning for other companies and industries that resist ESG-conscious business practices.

Although the performance of the coal industry has been driven by a multitude of factors in the last few years, including the fall in gas prices, there is evidence that environmental regulations, restrictions and extra costs have led to a significant underperformance by coal companies. As Display 1 shows, until 2012 movements in the coal sector index were highly correlated with the price of gas. The two industries tended to move together. After that period gas prices crept up again, but the coal industry struggled to gain ground. The graph suggests that the increased frequency of regulations proposed and implemented for environmental reasons has weighed on industry performance.

Europe and the U.S. have been on a steady path of increased regulations on carbon emissions for some time, but now China, which consumes around half of the world’s coal, has also started to aggressively cut coal production. Since the start of 2016, Beijing has been shutting down mines and forcing production cutbacks to curb oversupply and air pollution issues. Output has fallen more than 10 percent so far this year as the government ordered miners to lower output to the equivalent of 276 days of production, down from 330 days. China has also cut about 150 million metric tons of capacity by the end of August—equivalent to almost the entire thermal coal exports last year from Colombia and

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Display 1

**Coal: A diminishing stockpile**

![Graph from the Carbon Tracker Initiative](image-url)
South Africa. Their goal is to cut 500 million tons by 2020.\(^6\)

Other companies could face similar fates

Coal may be the first to go, but there will likely be others. As the Paris agreement comes into force legally, with its mandate to limit global temperature increases to less than 1.5 degrees, it is possible that energy companies with reserves in the ground may never be able to use them. For the world to achieve its Paris commitments, 60% to 80% of oil, gas and coal reserves in the ground cannot be burnt before 2050.\(^7\) These “stranded assets” of “unburnable carbon” would lead to significant losses in terms of the value of the assets energy companies currently have on their books.

The “stranded assets” debate has resulted in the fossil fuel divestment campaign gathering pace and support, with some investors aiming to reduce their climate change risk. The group 350.org launched the campaign and has been encouraging “institutions to immediately freeze any new investment in fossil fuel companies.” More recently, The Guardian newspaper in the UK launched its “Keep It in the Ground” fossil fuel divestment campaign, which gained support from organisations such as the UN Framework Convention on Climate Change. Since the launch of the fossil fuel divestment campaign by 350.org in 2012, more than 220 institutions have committed to divest fossil fuels.\(^8\) These include some of the world’s largest asset managers.

Although the potential pool of divested funds from pension funds and endowments is relatively limited, second order effects deriving from the “stigmatisation” of the sector can influence stock prices, close off funding channels and challenge financing. Moreover, this trend impacts not only the coal industry itself, but also the utilities sector where coal is a significant source of power generation.

In general, of course, many utilities are shifting towards gas and are doing fairly well. Those that have underperformed the most have tended to be the ones that have been least proactive in changing their energy mix. Companies whose business depends on an energy input have found that they can either suffer or be rewarded, depending on how dirty or clean their source of energy is. Falling squarely into the environmental component of ESG, this is the sort of variable for which an ESG screen would prove to have predictive value.

Nearly every major coal company in the United States is already bankrupt, and there has been broad divestment from even secondary industries like utilities that rely heavily on coal. Companies and industries that most blatantly ignore the environmental portion of ESG do so at their own peril.

Strong ESG practices are rewarded

Incorporating an ESG tilt for its value in reducing reputational, regulatory and systemic risks doesn’t have to be purely negative. Positive ESG factors can lead to positive tilts. First, strong ESG policies can help companies handle a variety of environmental and regulatory shocks. If Volkswagen had been strong on the governance factor, for example, it’s less likely that they would have compounded an environmental failure by attempting to cheat the tests, thereby digging themselves into a far deeper hole.

Second, positive ESG factors can lead to a more sophisticated understanding of long-term opportunities and help identify companies with a competitive advantage in a rapidly changing environment. By tapping into the ESG tailwinds, a small start-up has forced changes in the behaviour of behemoths. At the recent Paris motor show, companies were promoting their new electric vehicles, with batteries coming down the production line that will extend the range these vehicles can travel from 80 to over 200 miles.

These innovations aren’t just a matter of bowing to consumer pressure or having a desire to do good for the environment—instead, regulatory changes are forcing car manufacturers to change. Because most of us aren’t interested in buying a car that only goes 80 miles, they’ve had to find a way to get 200 miles. This, again, becomes a self-fulfilling trend. Five years ago, very few people would have expected the degree to which ESG-friendly firms have shaken up the auto industry. And they have done so despite low oil prices.

Capitalizing on ESG factors

In a world where “social good” is increasingly important to consumers, voters and governments, ESG factors can have significant predictive value. They present investors with a dynamic insight into a company’s relationship with regulators and with the future.

The question then becomes, “How can investors help protect their portfolios from ESG-related risks and tap into the potential for ESG-related rewards?” The simplest answer is to take ESG factors explicitly into account in the portfolio construction process by tilting away from companies with poor ESG records and giving greater emphasis to those with strong records.

By considering ESG factors, it is we believe possible to reduce the downside potential of rising regulatory and reputational risks in a portfolio. Similarly, it is possible to identify the competitive advantage of companies and capture that value.

We heed the canary’s warning and believe that now is the time to begin considering ESG factors in the investment process.

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\(^6\) Bloomberg

\(^7\) Morgan Stanley Research

\(^8\) Fn Guardian article.
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