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Viewpoint > From-the-capital

Miners need an ESG alternative

ESG investing is a sham not because environmental, social or governance behaviours are unimportant but because it is a façade for yet another investment management marketing fad.

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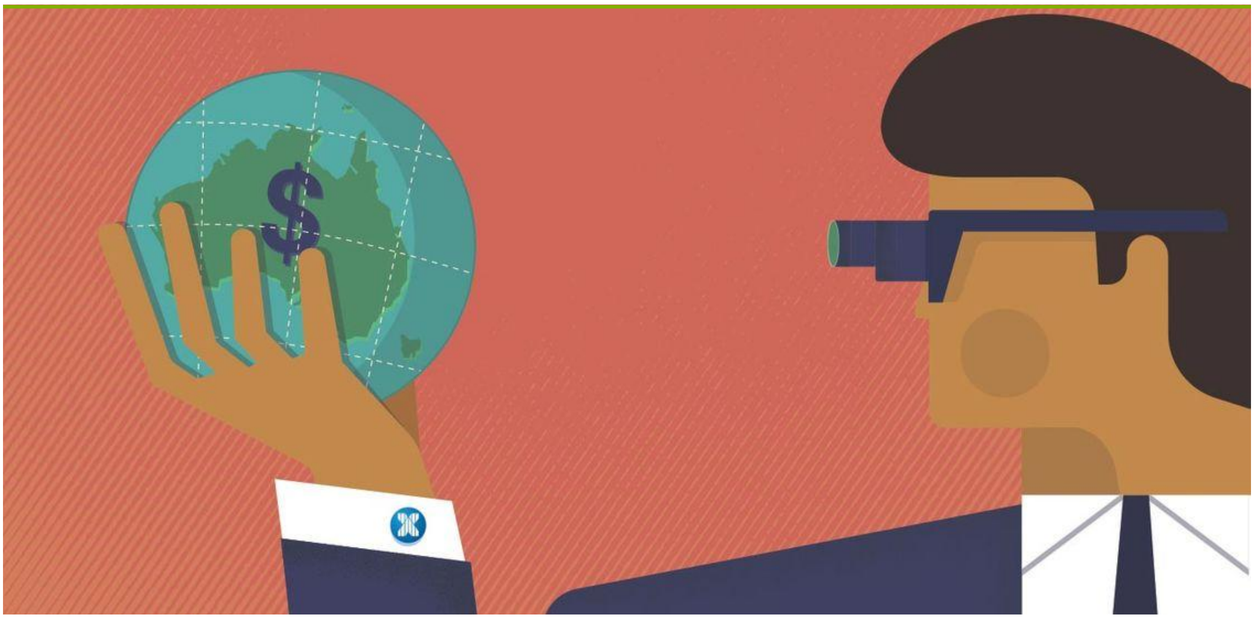

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ESG has gone well beyond being a handy acronym to describe a subset of vital business concerns. It is a movement driven by a religious-like fervour to convert unbelievers.

Cable business news network CNBC recently reported that US$30 trillion in funds were managed according to ESG principles in 2018. It separately reported that some 300 Russell 2000 companies had mentioned ESG in their earnings conference calls in 2019, a tripling since 2017.

Moody's, S&P and Fitch, among others, have modified their security ratings frameworks recently to display explicit commitments to ESG reporting. Modifying how ESG considerations are treated has not changed conclusions about corporate or sovereign creditworthiness. It turns out ESG considerations were always embedded within the analytical frameworks of ratings agencies. The change has been less steak than sizzle.

Pursuit of themes is a constant preoccupation within the financial community, not least among fund managers. Special status is given to those able to match a new theme with a catchy acronym. BRIC investing is an example. So is FANG. Widely embraced themes drive fund flows and validate higher fees. ESG is a funds management dream.

Those matters of concern to today's ESG-styled investors are hardly novel for the mining industry. In his book documenting the colourful history of the Guggenheim family (The Guggenheims, 1848-1988, Shapolsky Publishers, 1989), John H Davis recounts how Meyer Guggenheim and his seven sons built a mining presence across the Americas, Africa, Asia and Australia.

In 1906, the brothers were given control of mining in the Congo by then King Leopold II of Belgium. Davis records how the Guggenheims, hardly ESG poster boys even by the lower standards of those days, recoiled at the Belgians' violent intimidation of their workforce.

> **The mining industry needs a bespoke sustainability framework against which it can report progress**

The Guggenheims and their partners "built entire native villages for their workers, surrounded them with farms stocked with thousands of cattle, and created company stores with low, low prices" to improve worker conditions and achieve better productivity, according to Davis' account.

There was no evident sense of a strong moral conscience behind this greater ESG emphasis. Davis also records that the Bingham Canyon copper mine, opened in 1906 by the brothers using "bewildered Japanese, Hungarian and Greek miners, who knew no English", was run by the mine manager "as a virtual slave camp, backed up by the Utah state militia".

The corporatised mining industry has been grappling with what is now called ESG ever since these unpromising beginnings. More than a century later, residual effects of the Guggenheim legacy remain despite modern day mining companies having largely embraced those matters of greatest concern to ESG focused investors. An accompanying acronym to describe their progress might have contributed to a better appreciation of their efforts.

Ironically, an apparent lack of focus on ESG-related matters by companies often reflected a financial market bias. A heavy emphasis on financial and production numbers has been a drag on companies talking more fulsomely about their ESG initiatives in the past.

Over the years, my roles in two top-10 ASX-listed companies involved contact with investment communities in Australia and overseas. Attempted conversations with analysts about activities touching on what are now categorised as ESG would have been typically labelled window dressing and redirected to next year's depreciation provision, or some similarly obscure financial detail.

Security issuers are now being bullied into rearranging their reporting to accommodate a new investment style in what may amount to little more than a presentational change rather than a substantive modification to business practices.

Companies with an ESG focus produce better investment returns, according to the movement's adherents. In the mining context, ESG promoters have simply subverted the blindingly obvious to their purposes. A company with a failing tailings dam, a high on-site death rate among its workers and oblivious directors would have always been a fundamentally poor investment, even in pre-acronym days.

In any event, it is too early to be dogmatic about the impact on investment returns. The rapidity of the move to ESG-themed funds and security choices will have created a momentum effect. The flow of funds itself might be at least partly responsible for any noticeably higher near-term returns.

Fund flows might have to normalise over several cycles before firm judgements can be made about how well ESG-themed investing and the corresponding returns are connected.

Interestingly, in this context, returns on high-risk corporate bonds do not link positively with ESG scores, although the expected positive correlation between returns and ESG ratings does exist within higher-rated corporate debt.

The apparent discrepancy between ESG ratings and returns from high-risk bonds may have a link to the disproportionately large number of energy-related securities in the category.

Mining industry equities are similarly composed of heavily beaten down stocks which, in the event of improved cyclical conditions, will probably show outstanding investment returns, if they survive long enough. Companies with the best returns in a cyclical industry are likely to have some of the lowest ESG ratings.

Within mining, environmental, social and governance considerations are not the only vitally important contributors to project sustainability and, consequently, anticipated value. A minimum ESG score or even a relatively high score may do little to confirm investment attractiveness if other critically important project guideposts are not met in an industry in which binary 'fail or succeed' outcomes are common.

The mining industry needs a bespoke sustainability framework against which it can report progress at a project level. A tendency to avoid risk attribution - shown starkly in feasibility study valuations leading to investment decisions - works against this happening.

ESG reporting could be ignored as an inconsequential fad if an alternative framework more suited to the nature of the industry existed. And, if the industry could come up with an acronym for what it was doing, so much the better.

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