From Mortgages to Wheat – Part 1

- Responsible investing, in our view, is about making conscious choices in every step of the investment process.
- We should be careful with creating an objective and uniform definition of what is 'ESG'.
- What we invest in matters, but the way of investing and its impact surely matter just as much.

By *Harold de Boer, Transtrend* – Transtrend has had a Responsible Investment policy in place since 2010. It was not coincidentally written soon after the Credit Crisis, which provided a stark reminder of the interdependence between our financial markets and our society. While some in the financial sector no doubt felt like this crisis happened to them, in reality we (the financial sector) ourselves were to a very large extent responsible for it. And its consequences were severe: people lost their homes, their jobs and their savings, banks were bailed out by tax payers' money, and the resulting extremely low interest rates are still hurting people's ability to provide for their old age. The wave of criticism of the industry that followed was completely understandable and justified. Financial firms do not necessarily have to behave as charitable organizations, but we do not deserve our pay if we do not feel responsible for our own actions.

Back in 2010, Responsible Investment policies mainly focused on evaluating companies based on certain environmental, social and/or governance (ESG) criteria. Which, if you think about it, is ironic at the very least given the mess the financial industry managed to make in its own backyard. Responsible investing should therefore start in our own backyard.

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A recurring point of discussion with respect to responsible investing is whether ESG considerations are in conflict with financial best interests. We have absolutely no doubt that responsible investing will benefit investors. Surely in the longer run. The Credit Crisis painfully proved that irresponsible investing will dramatically hurt most investors.

The crisis taught us something else as well. At that time, Responsible Investment policies tended to focus on avoiding thorny issues like tobacco, weapons or child labor, often through exclusion lists. However, at the root of the Credit Crisis was a mortgage bubble in the United States. In itself there is nothing wrong with providing mortgages. It only ran out of control when banks and investors started to massively invest in these mortgages through collateralized debt obligations (CDOs). It seemed that many had no idea what they were really investing in. The most important thing seemed to be that these CDOs were triple-A rated. The mortgages themselves didn't harm society – the rather naïve and irresponsible way of investing in them did.

This is one of the reasons why we believe that Responsible Investment policies should go beyond merely evaluating companies based on (standardized) ESG criteria and utilizing exclusion lists. It is entirely possible to apply such practices without taking responsibility for the choices made. Especially now that 'ESG' is such a hot topic among investors, this could prove especially counterproductive. We believe there is a real risk of 'ESG' becoming the 'CDO' from 15 years ago. The investment community is already searching for an objective and uniform definition of what is 'ESG' and an objective and uniform way of measuring it. We do understand this desire, but we should be careful. Do we really want to see triple-A ESG-ratings (again)?

Responsible investing, in our view, is about making conscious choices in every step of the investment process, taking into account:

1. The role of the underlying asset (financial instrument, commodity, company, etcetera) in society.
2. The role of the market for (derivatives on) those assets.
3. The particular investor's role in that market.

This will probably result in different choices made by different market participants. Which is only healthy. Different participants fulfill different roles, in society as well as in the market. And just as important, different people have different beliefs. We should embrace this diversity. A healthy adaptive society requires that people can, and do, act upon their own beliefs.

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Historically, large changes in society would not have happened if everyone would have waited for consensus, or, even worse, general acceptance. Forerunners took the lead in for instance the abolition of slavery, general education, industrialization, and the digital revolution. And the large energy transition that is happening right now is also led by activist forerunners. Historically, successful investors tended to be part of this group. This is another reason why we do not believe in the effectiveness of general ESG standards implemented through generally accepted definitions and measures. Standards stifle progress.

Let's apply our Responsible Investment framework to the main ingredients of the Credit Crisis – mortgages and CDOs:

1. The role of the underlying asset will be clear: mortgages offered low and middle income families the opportunity to buy a home. This principle was embraced by both sides of the political spectrum in the United States.
2. The fact that these mortgages could be traded on a market – separately or bundled into CDOs – offered lenders the opportunity to offset their risk. In itself, this is an important role of the market. But one could have questioned whether this specific market wasn't becoming too technical and miraculous at the expense of transparency.
3. And an investor's role in that market? The answer to this question is different for every market participant. But which participant's role is it to buy something just because it is triple-A rated? (And who should have addressed this issue?)

This same set of considerations can be applied to every other investment. For instance in wheat. The role of this 'asset': wheat feeds a large part of humanity. Not many will see harm in that. Does this, however, justify a passive long-only investment in wheat futures, either directly or as part of a broader investment in commodities? This depends on the answer to another question: would such an investment contribute to feeding the world? Different investors will have a different view on this, ranging from:

a. yes, positive impact;

b. no (significant) impact;

c. no, negative impact;

d. not clear / haven’t thought about this / no idea.

We have our own stance on this particular question, and those of you who wish to know more may read the “Trading in risk” section of our Responsible Investment policy. However, our view on this question essentially isn’t that relevant. From a responsible investing point of view it suffices that only investors who believe that a) or b) is the case invest in wheat futures in this particular way. And even more important, that investors who would answer c) or d) refrain from doing that.