StraightTalk

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Moral Issue, Moral Hazard, or Both?

Should an investment manager consider moral issues when investing capital for shareholders? And, if so, who should decide those moral issues – those managers, shareholders, or the free market?

These are questions that are currently being debated each day across our great nation at dinner tables, in board rooms, and in the markets. The catch phrase for this question as it relates to investing is Environmental, Social, and Governance standards, or ESG for short. The goal is a simple one – to invest in things that do good for humanity, and to avoid those that profit from things deemed harmful.

Taken to an obvious extreme, investing in such horrific blights on humanity like prostitution or drug trafficking would be a clear no for all of us. However, the devil is always in the details when deciding where to draw the line on "good" or "bad" social and environmental issues.

For example, does the moral concern about oil and gas companies contributing to pollution and CO_2 emissions outweigh the potential return to shareholders? On one hand, the extraction of crude oil from below the earth's surface clearly has damaging environmental effects – but on the other hand, the discovery and proliferation of fossil fuels lifted billions of the planet's residents out of poverty in the last century. There is a clear and undeniable economic difference between those in the world with access to affordable, abundant fossil fuel energy, and those that still burn wood and animal dung for cooking and heat. So, which is it – good or bad? Or more specifically, as it relates to investment portfolios, should this industry be included or not?

Furthering this line of thinking, should a group of investment managers try to force behavior changes on companies to bend their operations to a moral code of behavior? Or should the free marketplace decide if they represent a moral hazard to society at large?

What if you change the industry in question to gun manufacturers? Clearly, none of us ever wants to hear a report of another mass shooting, so should we exclude gun manufacturers from our portfolios? And, if we do, does that include defense contractors who make weapons for our military to keep our citizenry safe? On one hand, the 2nd Amendment of the U.S. Constitution does explicitly state "the right of the people to keep and bear arms." But on the other hand, a commonsense judgement is that this was written at a time when "a well-regulated militia" was necessary for our new nation's security. Obviously, the framers of our country could not possibly have envisioned a time when assault weapons could be bought and sold on the internet.

An environmental issue that is currently being debated is domestic electric vehicle manufacturers and the government's attempt to shape that market. On their surface, EVs are a delight to drive and ride in – silent and fast, with zero emissions. However, if you live where the weather stays cold for part of the year, or you travel long distances – they are not as impressive. It is also well documented (but not as well reported) that the mining of the materials in those EV batteries is an order of magnitude worse for the environment than tailpipe emissions. And there is also a moral issue, in that there are countless findings of child labor abuses in cobalt mines. Forbes reports that 80% of the world's supply of cobalt is in the Congo, and 20% of all those mines are "informal artisanal mines" that use children in hand dug tunnels prone to frequent collapse.

However, it is also worth noting that each year that an EV lasts on the road, it's "carbon footprint" gets smaller, whereas the longer a vehicle powered by an internal combustion engine lasts, the larger and more harmful it's carbon footprint. So, there really is no easy answer – this is a complex and multi-faceted issue, and what is right for one investor may be wrong for another.

Herein lies the beauty of a multi manager, competitive, diversified, capitalist portfolio – one investment team may eschew industries or sectors of the economy for moral or environmental reasons, while another may be agnostic to those possible hazards, and just focus on maximizing investment return. The free-market answer of simply owning both investing styles makes complete sense.

There is an old economic joke which gets updated every few years. It goes something like this: a pet food company launches a massive campaign for its new dog food, including a fancy rebranding, a new label, celebrity influencer endorsements, and even TikTok videos. Despite all the hype, sales go nowhere. When the CEO demands answers, the head of marketing simply says, "It's those damn dogs. They just won't eat the stuff."

The joke is meant to illustrate the inherent weakness of central planning. Assumptions by executives or elected officials can lead to resource misallocation and inefficiencies when free market preferences are ignored. In a truly global economy, billions of consumers will decide, *on a daily basis*, if a company is a moral hazard and react quickly with their investment dollars if they deem that to be the case. The corporate junkyard is littered with companies that have made misjudgments about "what the customer *should* want" instead of allowing the free market to decide those preferences. And the list of giant government mistakes in this area is infinitely longer than the corporate list, because the government always uses someone else's money.

The famous quote by economist Friedrich Hayek underscores this practice, "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."

A casual bit of research will reveal that the governmental push towards electric vehicles has hit a stumbling block. Tougher tailpipe emissions standards, EV rebates, increased domestic battery manufacturing requirements, spending for more charging stations – all of these are well meaning policies, but the free market is not there just yet. It may be that people want kids out of those mines, or better components in batteries, or greater driving range, or fewer car fires, or better cold weather performance…or all of the above. Time will tell.

The tidal wave of news in this area is getting harder to miss. I'm not endorsing or rejecting any of these companies, but the list of those cooling off on the EV mania is growing. Apple just scrapped a decade of research and development and is walking away from their EV project. Ford and GM announced each will lose $5 billion in their EV segments this year, and Tesla's fourth quarter sales fell in California.

To be clear, electric vehicle sales are still growing, but the U.S. market is signaling a desire for a slower pace of adoption than our government wishes. And very quietly, hybrid sales have picked up across the industry, growing at a double-digit rate, (which should tell the central planners something.)

In other words, this is a complex, competitive marketplace, with consumers, manufacturers, and governments each in different places on the pace of innovation and production. Include all the other industries across our national economy, and this becomes a three-dimensional chess game between those three stakeholders on ESG issues. The good news is that there is an opportunity for Artificial Intelligence to improve many of these moral issues, and in time, virtually eliminate those moral hazards. In the future, it is quite possible that A.I. will revolutionize the energy industry, dramatically reducing negative environmental impacts until renewable energy becomes affordable and sustainable. The same goes for the auto industry, and virtually every other industry in our economy.

The free market will, as it always has, sort out the winners and losers in the future. In the meanwhile, a mix of managers that come down on both sides of the moral hazard investing question is the best strategy to bridge from now to that future…