

Legislating nonsense into the system

During World War II, the Nobel laureate Ken Arrow led a team of statisticians tasked with creating long range weather forecasts to assist with planning for US bombing missions over Germany. After a time, he reviewed the accuracy of his forecasts and determined they were no better than pulling a prediction out of a hat. Arrow wrote to his superiors recommending the end of the forecasting programme, a recommendation that was declined with the following reply: "The Commanding General is well aware that the forecasts are no good. However, he needs them for planning purposes."

Decisions are not made in a vacuum. Outcomes are heavily influenced by the information that is most available and considered the most relevant by the decision maker. There is no need for the information to be useful, it must only appear relevant. Historically consequential decisions have been made based on the utterances of the Delphic Oracle, long range weather forecasts or the Value at Risk models used by Lehman Brothers. These information sources all had a "Wizard of Oz" quality; a veneer of sophistication concealing an opaque black box whose outputs only had resonance because they made the cognitively taxing activity of decision maker easier.

In our view ESG ratings fall precisely into this category (for those interested in our reasoning, the extended version is available [HERE](#)). ESG ratings are created by algorithms which convert ESG data disclosed by a corporate or sovereign issuer, into a single output score with up to two decimal places of precision. Evidencing the incorporation of ESG considerations into portfolio construction, known as ESG integration, is far easier with such a quantitative score. Each security is ranked, higher is better and lower is worse; no cognitive effort is required. To paraphrase "The Investment Manager is well aware that ESG ratings are no good. However, she needs them for planning purposes".

This is not to dispute the value to investors of collecting data, creating models and defining ESG criteria as essential steps in ESG integration decisions. However, the value in creating a model of a complex system is that it pushes you to engage deeply in the subject matter. It is unwise to place too much value on the "answer" provided by a model that describes a small fraction of the complexities of the system it seeks to explain. ESG issues raise a series of context contingent questions to which the answers are a function of which (often conflicting) values are considered paramount. From this perspective any ESG scoring algorithm is no more than a simplistic and error prone mathematical expression of the ethical values held by its creator. Why would anyone outsource their ethical values to a data oligopolist armed only with a hopelessly simplistic algorithm and a Wizard of Oz sales model?

Why does any of this matter? The European Commission is consulting on whether to incorporate ESG scores into legislation that will regulate the financial markets, embedding them into the very fabric of the financial system. In the early 19th Century, the utilitarian philosopher Jeremy Bentham proposed that morality could be measured based on the pleasure or the pain that an action causes. Following this logic, he created a system called hedonistic calculus which consisted of a morality algorithm with multiple inputs and a quantitative output measured in units called hedons and dolors. Even Bentham's most ardent supporters concede that hedonistic calculus was not a significant milestone in the history of ethics. We should all be glad his system was not legislated into our criminal justice system; it would have created a dystopian nightmare. ESG ratings, in our opinion, are doomed to a Benthamite failure. Their incorporation by legislation into the financial system should be resisted by all those who care about the integrity of ESG investing.