Atmos CAPITAL

"SLOWLY ONE GOES FAR"[1]

In a typical Jewish shtetl from the beginning of the century, village rabbis played the role of arbitrator in local disputes. From family squabbles to business disagreements, many disputes would end up in the religious leader's living room. For weeks, a complex argument over the location of a fence that divided two properties would create stir and unrest throughout the village. As it might have been expected, the decision would fall into the rabbi's hands.

When the first neighbor arrived for the decisive conversation, the rabbi's wife quickly put her ear to the door, curious to know her husband's decision. After a long and complex argument by the petitioner, the rabbi stated: "You are right." After a few hours, the respondent entered the room. The wife stood by the door to eavesdrop again and was left in utter disbelief after hearing her husband's response to the complete opposite argument: "You are right." As soon as she was alone with him, the wife – her finger in the air – demanded an explanation about his identical yet unwavering answer to inherently contradictory positions. After listening for a few minutes, the rabbi looked right at her and without blinking an eye, calmly declared: "You are right".

At any given time, we are compelled to form well thought-out opinions on complex topics. The issues surrounding ESG have been widely discussed, in a way demonstrating the development of a society that has resources and self-awareness to advance as a civilization. In the Middle Ages, elders were abandoned by their families, and lacked the ability or resources to guarantee their own survival as non-productive members of society. Modern society has, however, provided its members with the luxury of reflecting and acting on expensive short-term issues while aiming at long-term benefits.

It is our responsibility to escape the trap of falling into euphoria and avoid repeating the generation that believed it could build a war-free world through peace and love. We must acknowledge the intrinsic difficulties of a topic with infinite dimensions. These concerns deserve to be studied as the complex sciences they are, so that we understand their dynamics as permanently out-of-equilibrium. Although cognitively comfortable, adopting connected narratives seems to be a naive mechanism to deal with issues that are insufficiently reflected and discussed at a historical scale.

Investing with a long-term view requires a certain survivalist DNA. Woody Allen once said, in his customary self-deprecating humor, "I'm not afraid of death, I just don't want to be there when it happens." Insecurity as a shield. The radar must always be focused on detecting changes in the spirit of the age that affect corporate performance, either through concrete impacts - such as fines, sanctions, or sector-specific tax increases - or through second-order effects that reflexively affect the ability to attract talent and solve problems. Nonetheless, ESG is still at its essence a well-marketed bundle of specific risk factors. In this sense, the factors measured by ESG scoring methodologies[2] are relevant only to the extent that they clarify any non-conformities between corporate performance and the expectations of society as a whole. However, given that this has always been relevant from the point of view of evaluating businesses' longevity, it should not be seen as a novelty to an investment philosophy that is truly focused on long-term results.

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[1] The original article in Portuguese opened with the title to a famous song by Brazilian singer and composer Almir Sater.

[2] PRI*, Principles for Responsible Investing, defines as "systematic and explicit inclusion of material ESG factors in analysis and investment decisions."*

Time can weaken messages within a society's ever-changing customs and perspectives. In his acclaimed 1970 New York Times article, Milton Friedman argues that corporations have the responsibility of increasing the profit generated for their shareholders and insists that any action in the opposite direction would be "preaching pure and unadulterated socialism" [3]. Critics tend to overly rejoice when encountering this apparent flaw, in that they either stop reading at this point or sabotage their own understanding of what follows in the text. Friedman makes it clear throughout his article that "the responsibility of the [corporate executive] is to conduct the business (...) to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom". Since then, what has changed is not the corporation's objective, but rather the path to be followed: the fear of socialism in a Cold War scenario exits the stage, giving way to the current ethos of sustainable development.

Larry Fink, Blackrock CEO, in his letter to the company's CEOs in 2019, expands this concept above by stating that: "Purpose is not just the pursuit of profits, but the inspiring force to achieve them" [4]. This view, despite its routine interpretation as opposing Friedman's, seems to us to be conceptually convergent. Friedman gives us yet another clue that corroborates Fink's point when he argues that only individuals would be endowed with a "social responsibility" and that they could exercise it in different ways, including "refusing to work for specific companies." In other words, a company that wants to attract talent to pursue its goal of generating profits must necessarily be aware of the context in which it operates.

In an industry where chasing various investment narratives is akin to searching for the proverbial pot of gold – the likes of Small Caps, Compounders, Technology, the Metaverse – ESG, despite its enormous importance, is in danger of falling into a thematic box without adequate reflection. Each agent with their own incentives, as long as they don't create noise that compromises the core discussion. For instance, a critical issue arises when important assets related to energy transition are unjustly demonized. Such a scenario not only squanders a historic opportunity but also undermines the potential impact of addressing the matter from a rational perspective, rather than solely from a market-oriented and indirect viewpoint. In a world of abundance, it is crucial to approach the ESG matter with a balanced and insightful outlook, recognizing the broader implications it holds for the betterment of society and the environment.

Borrowing from consensus protocols in cryptography, we must steer away from excessive fixation on a "proof of work" approach, based on reports, questionnaires, and checklists, as it merely demonstrates the ability to fill in reports, questionnaires, and checklists. Such an approach is suitable for one-dimensional matters but lacks the depth required for a holistic evaluation. Therefore, the formal alignment of "proof of stake" emerges as a viable option capable of yielding superior outcomes. Long-term capitalism creates wealth through the active involvement and commitment of all participants in the value chain, and not through "checklists". The homo erectus tamed fire to improve its living conditions, not to impress a primate next door – this is how humanity advances.

"WHEN A MEASURE BECOMES A TARGET, IT CEASES TO BE A GOOD MEASURE"[5]

In an interview with David Remnick, editor of the New Yorker magazine, comedian Jerry Seinfeld was categoric when asked about the extent of humor on a show with millions of viewers on open TV: "laughter is the only limit: if the audience finds that a joke is funny, it can be told. If a joke offends the audience, it cannot be told; not because it is offensive, but because it does not fulfill its purpose of making people laugh". A good comedian is able to capture

[3] https://nyti.ms/3tvTNAU

[4] https://bit.ly/3ujvo0B

[5] Goodhart's Law, credited to British economist Charles Goodhart.

and translate the zeitgeist through jokes that amuse the audience. Similarly, the role of an asset manager continues to be to generate long-term risk-adjusted returns for clients. Changes in society's ethical standards must be incorporated into the investment strategy, not because they harmonize with the client's or the manager's personal preferences, but because of their impact on invested companies.

Clearly, fund managers are not institutions operating in a vacuum. They are organizations of people, and people have moral convictions and personal opinions about which practices should be pursued or avoided by society. However, when assigning a social responsibility to asset management that is detached from the pursuit of returns, an issue becomes clear: which moral code should the manager follow? Or rather, is there an absolute concept of morality? The dilemma underscores the conflict between normative ethics, which prescribe what is deemed right and wrong, and descriptive ethics, which merely interprets the prevailing ethical behavior within a given society at a particular moment in time. As in Andersen's parable, the emperor has no clothes – the famous and well-established conflict arises between the world as it is and the world as it should be. In this regard, a manager should not make decisions under the influence of any individual notion of morality to the detriment of the fund's return, without having explicitly agreed upon this their clients.

The path of least resistance would be to rely on specialized ESG service providers, seeking to outsource one's own morality. Based on reports and rankings, a seal of approval is issued towards the alleged path of adaptation to a more just society. The challenge as far as the topic is concerned is verified from the discrepancies in scores received from the different institutions. For example, Sustainalytics gives Facebook the lowest environmental score, whereas MSCI grants it the highest. Who is right? Is there such a thing as right or wrong? Investors who trusted rating agencies and bought subprime mortgage bonds before 2008 must still be licking their wounds. If quantifiable metrics such as financial appraisals have been historically neglected, multidimensional issues such as ESG should be treated as targets in permanent motion by these institutions. When it comes to complex issues, there is a natural convergence towards a haven. The comfort of so-called answers replaces the exhausting yet necessary reflection. Upon being accepted by stakeholders as a solution, the finish line is established, and the discussions deteriorate organically.

Besides the subject's intrinsic complexity, we cannot forget that ESG rating providers are companies with financial objectives, and therefore are susceptible to the classic incentive misalignments of businesses encouraged to maximize short-term results. A Bloomberg survey shows that what is relevant to MSCI's ESG methodology does not seem to be how much a company impacts the world, but rather how much the world can impact a company[6]. Therefore, companies with high CO_2 emission rates and immunity to regulatory risks that could impact its profitability can have carbon with zero weight in the composition of the final ESG score. Return is what ultimately matters, yet these scores feed indexes that are sold to the general public under virtuous pretenses: "better investments for a better world". In a fast-paced industry that is hungry for assets, this triggers a vicious cycle. Quick insights and conclusions are built and expressed in products consumed by an audience that is eager to purge their guilt and automatically build their own path towards a more meaningful life.

Under this bias, the materiality matrix game becomes the heart of the matter and dictates how the system is operated. The major banks in Brazil, taking advantage of low private competition and the presence of inefficient state-owned enterprises, have been exploiting consumers with excessive fees for decades. They have learned to play with the regulations in hand and have never ceased to be at the top of the ESG rankings, even if at huge social cost. The game-changer was not the pressure from the ESG community, but the competition from digital banks and the brilliant work of the Central Bank in developing its fast payment system PIX.

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[6] https://bloom.bg/3DaHAVt

Another problem arises when we are faced with a myriad of variables to be measured. Naturally, we encounter some that are easier to calculate than others, which leads to a temptation to discard what is not measurable. Even more serious are the second-order consequences that stem from exogenously defining specific metrics to be optimized by agents, rather than engaging in a profound reflection on concrete objectives: "The more any quantitative social indicator is used for social decision-making, the more subject it will be to corruptive pressures and the more apt it will be to distort and corrupt the social processes it is intended to monitor." [7]

The anxiety to solve the problem quickly creates a Ford-like assembly line. People cling to attributes and confuse correlation with causality. The history of manned flight illustrates this difference well [8]. In the Middle Ages, aspiring aviators observed the anatomy and characteristics of animals capable of flying. There were no shortages of aviators dressed as birds, crafting feather-covered wings. With excessive courage, they would leap from cathedrals tied to these experiments, but without the expected success. For centuries, generations of aviators believed that the problem lay in the design of the wings, the lack of sufficient muscles to flap them efficiently, or the quality of the feathers used. Armed only with correlational observations, the field of aviation seemed destined to fail. However, the breakthrough came when Bernoulli identified the airfoil through his studies on fluid dynamics. The object generated a phenomenon called aerodynamic lift when moving through the air. Understanding this causal mechanism, although essential to make flight possible, was not enough to make it predictable. Some experiments still showed anomalies unexplained by theoretical formulations. Nonetheless, improvements were made to adjust the equipment exactly where previous experiments had failed. Eureka! The cumulative structure of knowledge made flying not only possible but also predictable. The paradigm shift came when the understanding of causal mechanisms was combined with the empirical analysis of interactions given by the context. This is a proposition that sounds familiar to equity investors focused on long-term returns.

Filtering investments based on ESG scores would be equivalent to seeking specific attributes, giving little attention to the underlying causal mechanism. That said, considering the aspirations and expectations of the current generation, it is natural for companies with high ESG scores to have generated higher returns over time, given that both phenomena share the same root: management capable of understanding the demands of society as a whole and adapting their practices to meet them. Moreover, by focusing on shortcuts and checklists provided by a manual, we lose sight of both the context in which companies operate and the real objective we should pursue as a society, running the risk of arriving at the right answer to the wrong question. "The most common error of a smart engineer is to optimize for something that should not exist." [9]

The issue of diversity illustrates well this potential mismatch between methods and objectives. When faced with a problem, an intellectually diverse team tends to have a better-equipped “toolbox” than homogeneous ones, and in turn a higher probability of achieving a better outcome. Therefore, an individual’s value to a team depends more on their ability to improve collective decision-making than their individual ability to solve the specific problem at hand[10]. However, given the difficulty of objectively measuring the degree of cognitive diversity within a group of

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[7] British anthropologist Marilyn Strathern's formulation based on the maxim known as Goodhart's Law. When an indicator becomes a public policy target, it loses the informational value that initially certified its function as an indicator. In the United Kingdom, for example, monitoring birds living in agricultural areas used to be a relevant measure of the environmental impact of agriculture. With the accelerated decline in these populations observed in the early 2000s, this metric was included in the set of sustainable development indicators. As a result, substantial research efforts were directed towards examining the causes of this phenomenon. Soon thereafter, some adaptations were proposed in agricultural practices. The outcome was undoubtedly positive for the birds, as the decline was mitigated and even reversed in some cases. However, this indicator has unquestionably become less representative of the general state of the environment, since the results were obtained through policy interventions specifically focused on improving the indicator itself. Newton, A.C: “Implications of Goodhart's Law for monitoring global biodiversity loss” (2011).

[8] The *Cycles of Theory Building in Management Research*, Carlile, Paul & Christensen (2005).

[9] Elon Musk

[10] Hong & Page, 2004: “*Groups of diverse problem solvers can outperform groups of high-ability problem solvers*”.

individuals, we often use social diversity as a proxy, which undoubtedly helps in probabilistic terms but is not enough to reach the desired objective. To extract value from diversity, it is essential that the group's objectives are genuinely aligned, and that there are mechanisms for mediating and encouraging the exchange of divergent opinions; otherwise, the result can be counterproductive[11]. With that said, we do not view diversity as an ingredient that can be inserted from the outside into a company at any time; rather, it is the outcome of a deeper process of cultural organization. Identifying the causal mechanisms that lead companies to organically build diverse teams seems more interesting to us than pursuing isolated diversity metrics at specific points in time.

By participating without proper reflection in this erratic race to meet the diversity-related expectations of today's society, there is a risk of not fully enjoying the benefits of the movement. Superficially implementing diversity is not enough. Will Bank, a privately-owned digital bank and part of our fund's portfolio, is an excellent example of a company that understands how diversity can act as a powerful tool for culture and management. With women and people of color comprising 51% and 43% of its team respectively, most in leadership positions, the company creates a desirable and unique brand to attract underrepresented talent. Thus, it avoids the fierce competition of the larger mainstream players and is able to attract better talent. Diversity at its best. Younger companies are usually in a better position to take advantage of this benefit, with no cultural legacies and deeply ingrained prejudices, making the most of a blank canvas in a rapidly transforming society.

At the end of the day, the simple goal of maximizing profits over the long term should lead companies to discuss these issues organically. Attracting and retaining talent, building subjective brand value, and modernizing business practices should be mantras for any corporate leader. The real novelty lies in social media, which has become a tool for civil oversight, incorporating and amplifying the old adage that sunlight is the best disinfectant. And if sunlight is not enough, a democratic and institutionally mature government should be ready to correct any market failures, penalizing those who, with alleged good intentions and false long-term objectives, are actually aiming for short-term payoffs with disproportionate costs to society.

Furthermore, the weight of the discussion regarding sustainability, particularly on carbon emissions, has transcended the ethereal realm and completely traversed the scientific method, turning hypotheses into theories. Environmental externalities can no longer be neglected. Anthropogenic emissions of greenhouse gases are unequivocally responsible for the increase in global temperature over the last century[12]. This becomes evident by observing the evolution of the word choice in the Assessment Reports (AR) of the Intergovernmental Panel on Climate Change (IPCC). Over the last 30 years, the compiled scientific evidence has described the human influence on global warming with increasingly certain terms: "perceptible", "attributable", "likely," "extremely likely," and eventually "unequivocal". To address the impacts of this issue, we have chosen to write a separate, more technical letter with the support of a specialized consultancy firm.

The issues raised throughout this letter are urgent and fundamental. The ESG agenda holds significant importance in the legacy that the current generation can pass on to the next. In a way, certain fanaticisms or radicalisms are relevant instruments to pull the world out of distressing inertia – "chains of habits are too light to be felt until they are too heavy to be broken" [13]. But the anxiety to address complex matters can often lead to misguided paths. The stamina generated by the self-assurance of those who think they have all the answers thrusts us towards a place of immediate intellectual comfort. Those who position themselves as evangelists assume the comfortable role of

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[11] Mannix & Neale, 2005: "*What Differences Make a Difference?: The Promise and Reality of Diverse Teams in Organizations*" .

[12] IPCC's AR6 study states: "*This Report reaffirms with high confidence the AR5 finding that there is a near-linear relationship between cumulative anthropogenic CO_2 emissions and the global warming they cause. Each 1000 $GtCO_2$ of cumulative CO_2 emissions is assessed to likely cause a 0.27°C to 0.63°C increase in global surface temperature with a best estimate of 0.45°C*" (https://bit.ly/ipcc2021ar6).

[13] Bertrand Russell

monopolizing virtues and integrity. However, wrong choices can cause disorder and an irreversibility in the system down the road. In moments of maturity, the Rabbi's wisdom must be recalled: sometimes everyone is right, yet no one is.