ESG in investment funds

Pádraig Brosnan, of Maples and Calder, reflects on the rise of ESG and its future prospects

In the latest episode of *Billions* to air on Netflix, Axe Capital's CIO Taylor Mason proposes launching an entirely new strategy emblazoned with 'ESG' on the cover of the slide deck. This would be Axe Capital's first foray into a variation of impact investing, also referred to as socially conscious ownership, which would include environmental, social and government (ESG) investments. Taylor's attempts to sell this strategy to a Russian oil oligarch are a ruse to halt their investment in Axe Capital, but for our purposes it highlights how mainstream ESG investment strategies have become.

Over the past several years, ESG investments have risen from billions to trillions of dollars and the number of investment funds being launched in this space is now in the thousands, with launches continuing at pace.

In this article, we look at what ESG actually means, some of the significant factors which have contributed to this growth, and what we can expect to see in the next 12 to 24 months in Europe, with a particular emphasis on the European Commission's (the Commission) new framework to facilitate sustainable investment.

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ESG vs SRI vs impact investing

ESG is a method for evaluating how companies' environmental, social and governance practices might affect their performance. Examples of ESG factors are as follows:

- **Environmental:** climate change, greenhouse emissions, waste and pollution
- **Social:** working conditions, including child labour and slavery, conflict and humanitarian crises
- **Governance:** executive pay, bribery and corruption

This list of factors and the metrics for evaluating ESG practices is expanding all the time, which is evidenced by an increasing number of specialist analysts in the area providing expert advice to managers who themselves are spending a greater deal of time and investing a greater quantity of their clients' assets in ESG.

On the other hand, socially responsible investment (SRI) is a type of exclusionary screening investment policy affecting certain types of assets or companies that receive revenue from activities that are considered to be 'socially irresponsible' such as drugs, alcohol, gaming and cigarettes, or that have exposure to certain jurisdictions or regions.

ESG investing should be contrasted to impact investing, which is different in that it has two distinct characteristics:

1. it must have a direct and verifiable impact on the lives of the poor
2. companies must provide risk-adjusted market returns.

ESG investments do not necessarily need to target poverty; rather, their focus is on economic growth in a sustainable way. ESG is seen as a sharper tool than SRI as it does not just screen out certain companies or industries as a whole, which in the past has led to underperformance, and it is more flexible than impact investing because it does not focus on targeting poverty.

Determination of ESG factors and benefits

Active managers will generally determine whether investments are ESG securities or restricted by reference to SRI criteria provided by a third party. MSCI and other indices and data analytics providers are the third parties supplying the ESG information to managers, and in the active sphere, the managers will supplement that advice with their own insights.

ESG factors are considered valuable in terms of assessing companies and improving fundamentals as well as for stock returns. Managers are continuing to expand their research and expertise in ESG and on ESG factors for analysing risk and return. An ever increasing number of industry and academic studies show that companies that have integrated ESG factors into their businesses are generating alpha returns, such that there is a clear trend that companies with strong ESG principles have better corporate financial performance.

Traditionally (and particularly in the US) there have been challenges in convincing investors that wanted to have ESG assets in their portfolios that such exposure would not dampen their portfolio returns; however, numerous industry and academic reports suggest that having ESG conscious companies in a portfolio is beneficial, not just in a buoyant market, but for the reason that such investments can also provide downside protection.

Institutional investors have become the key owners of ESG stock and these institutions tend to work on long-term investment strategies, and ESG investments are attractive in that regard. Pension funds, insurance companies and mutual funds have the largest pools of assets in the world and have a fiduciary responsibility to earn market returns.

But with long-term payout obligations, they are more interested in the long-term sustainability of their investments than, for example, an individual investor looking for short-term gains. ESG investing has a strong presence in the institutional market for this reason and will continue to grow that presence.

Capital markets union and the action plan

On 12 December 2015, over 170 countries signed up to the Paris Agreement, and the adoption of the UN 2030 Agenda for Sustainable Development on 25 September 2015 marked a shift in global attitudes towards climate change and environmental degradation.

In order to meet the agreed target of a 40% cut in greenhouse gas emissions, around €180bn of additional investment a year is needed, according to the Commission. In order to achieve this target, both public and private capital will be required. The Commission, through the Capital Markets Union (CMU), has laid out a road map in its Action Plan on Financing Sustainable Growth, launched on 8 March 2018, which was followed up by legislative proposals on 24 May 2018. The aim of the proposals is to make it easier and less costly for investors to identify which investments are sustainable and ESG investments will be at the centre of this.

Under the action plan, the Commission is proposing new rules under the following headings:

- a unified EU classification system
- clear guidance for investors
- more transparency for investors
- benchmarks
- tailoring of products to meet consumers' needs

The European Parliament and Council will agree on proposals in each of these between now and May 2019, and delegated acts will follow which specify the minimum standards and content of disclosure requirements.

Let's look at two of these in a little more detail. Firstly, the preferred option in relation to taxonomy is to set harmonised criteria as to whether an economic activity is environmentally sustainable. The aim is to provide an EU-side classification system that provides investors with clarity, allowing them to make informed decisions on the sustainability of investments. This is considered an essential first step in enabling investment into ESG assets. Secondly, the preferred option of the Commission with respect to benchmarks is to create two categories: 'low-carbon' and 'positive carbon', thus allowing investors to make informed investment decisions against potential climate targets. It will, for example, provide investors with a way to invest in companies that have a low carbon footprint.

There is no doubt that this is a project close to the heart of the Commission and will be an integral part of the CMU going forward. Valdis Dombrovskis, the vice president in charge of financial stability and financial services and the CMU, was recently quoted saying: "The proposals presented today show that the EU is committed to ensuring our investments go in the right direction. They are about harnessing the vast power of capital markets in the fight against climate changes and promoting sustainability." It is clear that ESG and its investment process will be important to all managers and investors alike in the coming years.

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The future of ESG

The impressive compound annual growth of all ESG assets versus global assets continues to make ESG very difficult to ignore for everyone involved in the asset management industry. We potentially have a new battleground between hedge fund and ETF providers as investors seek guidance in an investment arena without any set standards and want to use their power as shareholders to improve corporate culture in the businesses they are investing in. It is clear there is a huge amount of political will behind the success of ESG in Europe, and although that political will is not currently present in the US, there can be no doubt from the ever increasing amount of data and research being done on ESG that investors and businesses are taking up the banner on issues such as climate change and diversity. With such 'clean energy' momentum, ESG is likely to gain increasing market share for decades to come. HFM