ESG: Let's not throw the baby out with the bathwater

We need to work out the way ahead to be creating actual socially beneficial investments

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For those working in ESG who aren't familiar with the expression *don't throw the baby out with the bathwater*, it's an idiom for an avoidable error in which something good is eliminated when trying to get rid of something bad. It was the first thing that came to mind when reading the Tariq Fancy article, *Financial world greenwashing the public with deadly distraction in sustainable investing practices*, which garnered such attention from the investment community a month or two ago.

At Natixis Investment Managers, my colleague Jonathan Barker and I are working on a series of papers that seek to expose some of the myths and legends in ESG today. We'd never heard of Tariq before, but we think he's right in some ways: even if sustainable investing and ESG can be helpful tools to manage risks, and in certain cases to generate financial performance, not enough of it does social good, unfortunately.

But we also think that anyone reading this publication, following academics and their research or listening to other thoughtful commentators, could have come to this conclusion independently from Tariq. So, in many ways, it's surprising that the article created controversy.

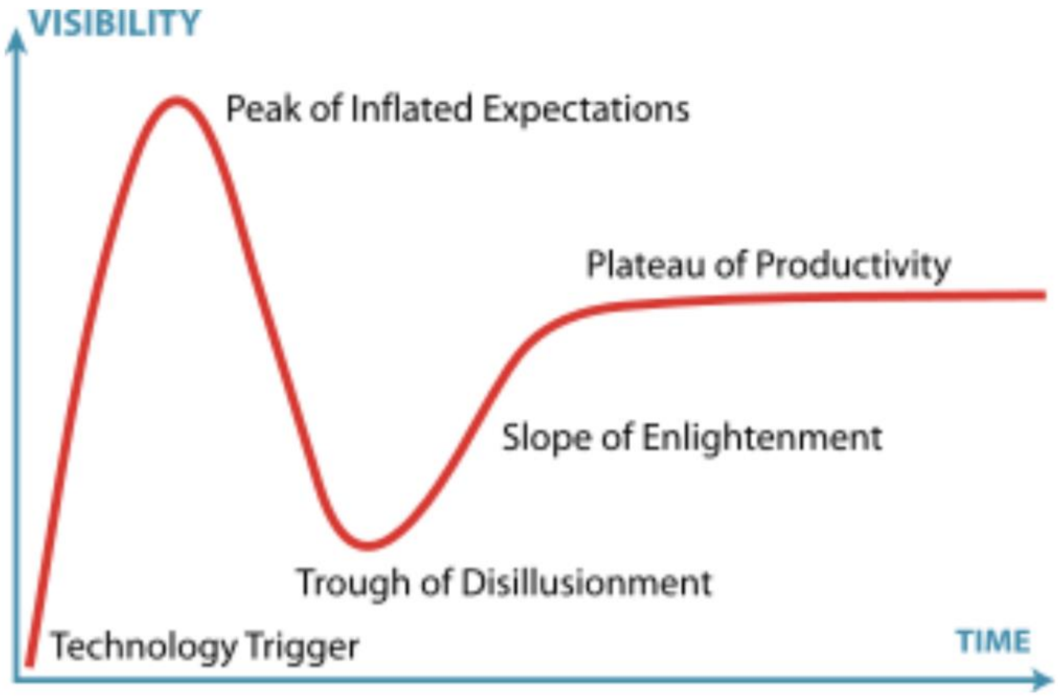
However, we don't want to point fingers here – neither at Tariq and his supporters, nor those at the other end of the debate. Rather, we prefer the philosophy of primatologist Jane Goodall (who we came across during a recent podcast), particularly her observation about protecting the environment: "It's a whole area that we should learn to address; not by pointing fingers, but working out ways ahead," she said.

Indeed, we've adopted her motto to try and make sense of what's really happening in ESG today, to work out ways ahead in sustainable investing, to solve problems, and to make better use of rigorous, evidence-based thinking.

Into the trough of disillusionment?

The thing is, our analysis of what is happening is that it is exactly what we could have *expected* to happen – and, in fact, it's what many *predicted* would happen.

Let's draw a comparison between ESG and the introduction of new technologies. The 'Gartner Cycle', developed by technology research firm Gartner [see graph], is a useful (and rather comical) graphic representation that helps us to understand how new technologies are introduced, mature and are adopted.



We might compare the introduction of the concept of 'ESG' in the early 2000s to the Technology Trigger in the cycle. The Tariq Fancy article, we think, is a signal indicating that we are now nearing the Peak of Inflated Expectations.

It isn't the only signal either. Many commentators - ESG proponents and detractors alike - have wondered in recent months if we may be experiencing an 'ESG Bubble', both in terms of inflated asset prices as well as inflated expectations. So, if the analogy holds, and we continue to follow the curve, we should now brace for a very steep rollercoaster ride down the cycle, towards the Trough of Disillusionment.

What's important to understand is that we *already know* what the Slope of Enlightenment and the Plateau of Productivity should look like; we already know what 'enlightened ESG' is and what we should be doing once we get to that plateau at the end of the curve.

What's working, and what's not?

How do we know what this Plateau of Productivity looks like? Well, we're writing a series of papers about exactly this – the first two of which, on 'blended finance', and on 'enabling vs. labeling', have already been published.

In these papers, we discuss in lots of detail where we think we need to go with ESG and impact. But it's not just our view: for these papers we've interviewed a lot of very clever academics and other experts, including John Kay (Oxford University and of Kay Review fame), Ashby Monk (Stanford University), Maarten Vleeschhouwer, (2 Degrees Investing Initiative), Ian Simm (Energy Transitions Commission, Impax Asset Management), Alex Edmans (London Business School), Victor van Hoorn (Eurosif), Luigi Zingales (University of Chicago), Florian Heeb & Julian Koelbel (University of Zurich), Danny Cullenward (Stanford Law School, CarbonPlan) and David Victor (UC San Diego, Brookings Institute) – all of whom have done a great deal of thinking and writing about finance, investing, ESG and climate change.

We will argue in these papers that:

1. Stewardship and active ownership 'work', but expectations now are that they should be *all about* ESG, rather than *incorporating* ESG. This, in our view, is making the investor stewardship tool in our ESG toolbox weaker, not stronger, when it comes to making companies more sustainable. The Kay review of 2012 said we should be thinking about "a more expansive form of stewardship, focusing on strategic issues *as well as* questions of corporate governance…" Although ESG wasn't as common a phrase back in 2012, we would say that if it were written today 'corporate governance' would be substituted for 'ESG', and the recommendation would still hold. John Kay agreed with us.

2. Impact investing should be about change that wouldn't otherwise happen (call it 'additionality' if you want to stick with consensus impact terminology). In any case, if you have tried to invest in order to achieve change that otherwise wouldn't happen you know it's actually really hard, and you will likely agree with us that tools like blended finance are needed to make it work at scale. Moreover, blended finance needs to be structured, engineered and organised, all of which requires whizzy financial expertise, in addition to idealism and intentionality.

3. Climate change is a looming catastrophe and will undoubtedly impact our investments. But, driven by this concern, what most investors are doing is *investment risk management*, which is not helping all that much to actually avert climate change. And we would also argue that most investors aren't doing the risk management particularly well, as it is often based on the belief that this 'risk' can be easily quantified and measured. Therefore we believe that another tool in the ESG toolbox that is 'working' is scenario analysis, which provides more qualitative narratives, and insights into 'what's going on'.

4. Public policy advocacy is another ESG tool that 'works', but it is the ESG World's Best Kept Secret – no one seems to know about it or talk about it (well, one predecessor in this series, Joel Moreland, has brought it up: 'We have our priorities wrong by not focusing engagement on governments'. Thanks Joel!). In our paper, we will argue that most of the ESG and SDG challenges we like to talk about also require government interventions and can't be solved by the private sector alone. Yet governments could use some help from the private sector – from smart investment analysts, for example, who understand the utility, transportation or energy sectors and can help design smart, climate-related industrial policies. And this cannot be done through tick-the-box consultation exercises.

5. Finally, we will argue that to do all of this, and to do it all well, we need to adopt the 'Enabling Mindset'. Today, many people working in ESG have the 'Labeling Mindset' – they would like to label, score, classify, measure and quantify things without first diagnosing, understanding what's going on and trying to figure out what we should be *enabling*. Which takes us back to the Peak of Inflated Expectations and the sorts of indictments raised by the likes of Tariq Fancy. "We are doing irreversible harm by stalling and greenwashing", as he puts it. We catch his drift, but would put it *very* differently: if we would all focus more on *enabling* solutions to problems, we could be much more effective.

So, five ESG tools, or *babies* if you will, that we know are 'working' and that we should very much like to bring with us, up the Gartner cycle, all the way to the Plateau of Productivity.

But, a final note of caution. We should also recognise that this may not be for everyone; not *all* asset managers are of the size or sophistication that they can put together blended finance deals, for example, or bring together resources and expertise to effectively engage with governments. And we certainly don't want to trigger the next Gartner cycle and start from scratch, inflating expectations. So, let's learn from the first decade or two of ESG experiences, and:

- Let's not all start bombarding governments with letters saying 'We the undersigned, representing $30tn, call on you to create a carbon tax!' Instead, let's build platforms for public, private, and third sector specialists, to come together and work out solutions to problems.
- Let's not start measuring what percentage of AuM are truly 'blended' or start asking 'How big is your blended finance team' in RfPs. Instead, let's determine what the barriers are to getting more blended finance deals done and see if we can remove them.
- Let's not create a 'Portfolio Enabling Indicator' that measures the degree to which companies in the portfolio have adopted the Enabling Mindset.
- We could go on and on. So, most important of all:

Let's not throw the baby out with the bathwater.