Finding Ways Ahead

ESG: WHAT'S WORKING & WHAT'S NOT

The evidence is becoming clear: does ESG 'work'? For *most* ESG practices, unfortunately no.

There are 3 ESG objectives: ① Values-alignment; Financial: 2a outperformance + 2b risk management; ③ Impact/outcomes

1 2b ESG integration (PRI)
- Contribution to financial performance extremely limited or neutral
- Risk tool, but materiality is situational
- Has the industry completed ESG integration?

1 2a 2b 3 Active Ownership / Engagement
- Broadly recognized in academic literature as contributing to better investment decisions & making companies more sustainable
- Enhances corporate governance
- Required by laws / regulations / fiduciary duty (PRI)

Impact investment
- Most impact funds today are impact-aligning, not impact-enabling
- Focus on 'intentionality'
- Increasing regulatory scrutiny

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Blended finance 3
- (Government interventions mobilize private capital; structured finance)
- Small-scale, but growing
- Focus on solving problems, 'additionality'

1 Divestment
No evidence of better risk management, solving societal problems, or contribution to performance (often the opposite)

1 2b Climate Change
- Most climate investment solutions not supported by climate/finance evidence: carbon footprinting, portfolio temperature, net zero initiatives, Paris-alignment; sometimes characterized as 'dangerous'; most don't contribute to climate action
- Increasing awareness of need for public policy (e.g. carbon taxes, regulation)
- TCFD is a good framework; some useful risk management approaches

3 Public Policy
- Government policy 'works' but focus is often on private sector initiatives that signal that government involvement is not needed (e.g. SFDR, taxonomy)

1 2b Disclosures / Data
- SFDR, Taxonomy are *labelling* investments, not changing how investments are made, or redirecting capital (*enabling*)
- Most ESG data is not investment-relevant
- Limited use in risk management
- Supports risk management, but no theory of change

1 ESG Funds
- In the aggregate, do not outperform; individual funds may outperform (but, is it attributable to ESG factors?)
- No contribution to outcomes
- More regulatory scrutiny of financial performance and impact claims

Meanwhile…

Academics & Media
Steady stream of papers & articles analyzing what's 'working' in ESG

Regulatory Scrutiny
"ESG Police" units established by regulators in US, France, Denmark
Increasing scrutiny on ESG / impact claims
First misselling lawsuits, regulatory reviews

ESG Professionals
Are starting to come around to the evidence-based view, speaking up on LinkedIn, in Responsible-Investor, conferences

How to do the stuff that works, well

Active Ownership *but…*
- *Stewardship*: holding corporate management to account, monitoring corporate performance, capital (re)allocation
- Integrated into investment functions
- *Incorporating* ESG, not revolving around ESG

Impact/Blended finance *but…*
- Focus on *enabling investments,* like blended finance (government interventions mobilize private capital)
- Need to help create market to be visible / successful here

Public Policy, *but…*
- Investors supporting governments in creating policies to address ESG, SDG issues, climate
- Proactively contributing to meaningful financial industry regulations

Disclosures / Data, *but…*
- Focus on data and disclosure that *enables* better investment decision-making and active ownership
- Don't confuse quantification with understanding, or with causation

Climate Change, *but…*
- Focus on scenario analysis for risk management; effective active ownership; and supporting governments & effective public policy
- Invest in new technologies, renewable energy, EM infrastructure, e.g. through blended finance

This presents investors with 3 options in terms of ESG strategy:

"Run With The Herd": focus on red/yellow

Pros	Cons
① Safety in numbers ② Business opportunities now ③ Easier to explain	① Greenwashing claims likely ② Not in line with research, facts ③ Possible conflict fiduciary duty ④ Resource-intensive, costly

"Embrace the Complexity": focus on green

Pros	Cons
① In line w/ science & fiduciary duty ② True thought leadership ③ Distinctive ④ Future business opportunities	① Minority industry view,today ② Harder to explain ③ Requires more involvement of investment / risk teams

"Keep Our Heads Down": stay on sidelines

Pros	Cons
① Avoid scrutiny	① Cannot eliminate risks entirely ② No ESG business opportunities ③ Conflict with fiduciary duty? ④ Silent on important industry theme