Rewiring ‘ESG’ in 2023

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In 2022, ESG remained in the spotlight. Given economic turmoil, the war in Ukraine, stubbornly high inflation, shifting investor, political and regulatory sentiment across the globe, the ESG space has been marred with news, controversies, and debates. As sustainable investors, we are so to speak stuck between a ‘rock’ (fund performance & alpha generation) and a ‘hard place’ (evolving regulations and policies). In 2023, we expect the generic term ‘ESG’ to be completely rewired, taking on a whole new meaning well beyond traditional Environmental, Social and Governance criteria.

E - for Evolution, Engagement and Environment

The term ‘ESG’ came under scrutiny during 2022. While in the US, we saw a growing conservative backlash to ESG investing, rising energy and food prices will continue to raise the question of sustainability vs security across the world. But these developments need not be considered as headwinds to ESG investing. It is, on the contrary, the catalyst we need for change. ESG must evolve from a niche strategy to an overarching investment philosophy. In 2023, we expect asset managers, companies and regulators to broaden the scope of ESG and further enforce regulations.

In 2023, we expect a growing focus on engagement and stewardship among investors. Investors need to act as partners with their investee companies in order to generate a meaningful impact on overall returns and portfolio value. A major obstacle to investors effectively deploying their influence as active owners and to delivering long-term value is the limited resources that the investment industry currently dedicates to stewardship. To address this, the Principles for Responsible Investing (PRI) have launched a ‘Resourcing for Stewardship project’ to research and assess the appropriate level of resources that institutional investors should be prepared to dedicate to stewardship activities and to address systemic sustainability issues. The increase in the number of collaborative initiatives being launched to address these issues – PRI Advance (human rights), Nature Action 100 (Biodiversity) – should continue.

The concept of environmental sustainability is no longer synonymous with climate change. It is now commonly accepted that climate action is doomed to fail unless the negative externalities on biodiversity, water, and waste (circular economy) are addressed. The UN Biodiversity Conference in December brought nature into the limelight, while COP27 dedicated specific days to Biodiversity and Water issues. The second and third sessions of the Intergovernmental Negotiating Committee (INC) to develop an international legally binding instrument on plastic pollution will take place in 2023, with an ambition to deliver the document by the end of 2024. We expect more investments to be redirected to natural capital and circular economy strategies, and their interplay with climate transition.

S - for SDGs, Solidarity and Social

The investment community is increasingly seeking to understand the impacts – both positive and negative – it can generate with respect to the UN Sustainable Development Goals (SDGs). Whilst impact investing aims to achieve a positive social return over and above that of a financial return, traditional investing can have positive and negative impacts too. Achieving the UN SDGs is not possible through impact investing alone, and so it is vital that blended finance play a role in achieving those goals. 2023 will likely see an increased recognition of this fact, and we can expect that more financial institutions will be incorporating quantitative SDG analysis as part of their ESG strategies. Some 40% of investors prioritise some form of SDG alignment in their portfolios. Alpha generation can go hand-in-hand with providing healthcare facilities in underserved regions, telecommunication infrastructure in rural areas and clean energy in off-grid communities. Third-party ESG ratings may not necessarily take into account the positive impact a company has/might have on SDGs, and so it is important for asset managers to develop the capability to recognise and identify these gaps.

Both the COP27 and COP15 reiterated the importance of sharing financial responsibility for climate adaptation in the most vulnerable communities (developing countries – Global South) with those countries that have reaped the economic benefits of rapid industrialisation (developed countries – Global North).

COP27 ended with the creation of a 'Loss and Damage fund' to support vulnerable countries. UN Secretary General, Antonio Guterres has been pushing for "a Climate Solidarity Pact, in which all big emitters make an extra effort to reduce emissions this decade in line with the 1.5-degree goal and ensure support for those who need it". The international community is fighting to restore trust with the Global South, which feels somewhat betrayed given that developed nations have not even met the climate finance target of $100bn. Emerging countries with fossil fuel resources will miss out on vital export revenues because of the climate transition, and it is only right that this should be considered in climate negotiations. As we enter the 3rd year of the 'Decade of Action', it is important that public and private financial flows be redirected towards the implementation of transition projects across the globe.

Social elements of sustainable investing have become increasingly important over the last few years. Issues on diversity, equal pay and health & safety are featuring prominently in engagements and shareholder proposals during annual general meetings (AGMs). Safety issues are a key topic for strategically important sectors for the climate transition – such as mining and renewables. With the launch of PRI Advance in December, in 2023 we expect to witness a bigger focus on human rights issues. Within the EU, a new proposed regulation could require all firms with at least 100 employees to report on their gender pay gap every 3 years, and annually for firms with 250 employees or more. Overall and for a same job, women earn on average 13% less than men. We hope that growing interest in these topics leads to more effective engagement and greater transparency among companies and investors.

G - for Greenwashing, Gaps and Governance

With the global emissions gap widening, 2022 saw the beginning of a crackdown on greenwashing, which will likely carry on in 2023. Asset managers in Europe were forced to reclassify funds with the looming uncertainty surrounding SFDR. In November 2022, the UN released a report which offers recommendations on how to prevent and avoid greenwashing, to which corporates and financial institutions alike will have to pay close attention. The UK and EU are independently undertaking a consultation period on greenwashing, beginning this January. The UK's Financial Conduct Authority (FCA) will begin its consultation period on greenwashing on the 25th of January 2023 and publish its findings by the 30th of June 2023. In Europe, the European Supervisory Authority published a 'Call for Evidence' on greenwashing, which aims to identify the key issues, risks and drivers of greenwashing. Responses are due in January 2023, and the final report will be issued in May 2024. In the meantime, more greenwashing accusations can be expected. All companies listed on regulated markets in the EU will begin applying the Corporate Sustainability Reporting Directive (CSRD), which will give asset managers greater clarity on the sustainability performance of companies.

Despite pledges made at COP27 and COP15, overall, the battle to limit emissions to a 1.5-degree increase above pre-industrial levels, is still "moving in the wrong direction". Funding gaps continue to dampen climate action. The global need for green infrastructure alone is roughly $5tn per year, yet only $384bn is currently supplied. In a report by The Rockefeller Foundation in coordination with Boston Consulting Group, it is cited that around $3.4tn in climate mitigation finance is required annually between 2020 and 2025. If China is excluded from calculations, then developing economies also need about $1tn in climate finance per year. However, data suggests that they are currently receiving just 27% of that target. The same is true for biodiversity, for which it is estimated that funding requirements are approximately $800bn per year, versus current estimated global spending of $100bn.

Governance will continue to be a key issue in 2023, but its definition and scope are being revised. Investors are going beyond board structure and independence criteria to demanding more transparency on topics like remuneration, director profiles (age, experience, tenure) and board accountability for environmental and social issues. Executive compensation came under scrutiny during the pandemic when CEO versus worker pay gaps increased exponentially. According to a survey by London Business School, 77% of UK equity investors share the belief that the remuneration of FTSE 100 CEOs is too high. Whilst employee salaries have risen very slowly over recent decades, the remuneration of CEOs has rocketed to 399x that of their employees in 2022, according to Financial Times. Investors and proxy voting advisors are taking a harder line on 'over-boarding' – where a board member or top executive is overcommitted. Investors are increasingly challenging board directors on their companies' sustainability performance and holding them accountable.

Say on Climate proposals have provided a strong new tool for shareholders to make management and boards accountable for the firm's climate risk management strategies and plans. The expectations from both supervisory and executive boards on wider governance matters will continue to escalate.

Alex Edmans, Professor of Finance at the London Business School and a leading author on sustainability topics, wrote last September in his paper entitled 'End of ESG': "ESG is both extremely important and nothing special. Considering long-term factors when valuing a company isn't ESG investing; it's investing." 2022 made ESG integration mainstream. In 2023, we believe 'global sustainable investments' will take on a new dimension. Beyond simply integrating ESG assessments in portfolio construction, investors will be forced to consider the depth and breadth of the impacts of their investments on society and the environment.

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