Balancing Act: Learning from the Best and the Worst of Times for ESG

Key Ideas

- After a period of steadily increasing relevance, ESG investing attracted a lot of attention in 2021.
- This trend was temporarily challenged in Q1, as ESG bêtes noires, such as energy stocks, dominated the markets.
- ESG investing is a compelling long-term discipline, and both the superficially good and superficially bad periods offer valuable lessons on how to implement it optimally.

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It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way—in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.

– Charles Dickens, A Tale of Two Cities

The Best of Times

As the world continues to experience the undeniable effects of rising global temperatures, governments and company stakeholders have slowly begun to address climate change. The Paris Agreement of 2016 established a worldwide framework aimed at keeping the average global temperature rise below 2 degrees Celsius. Since then, much of the globe has moved from seeing sustainable investing as a grand idea to seeing it as a compelling reality — one that affects all of us.

The COVID-19 pandemic went global in 2020 and drew additional attention to how tightly interconnected our civilization is at every level: from how public-health measures in a community can have worldwide implications, to how apparently minor local perturbations of the global supply chains can interact nonlinearly and result in enduring reverberations. At the same time, perhaps not unrelatedly, there was an intensification of social protests, concentrated in the U.S., but represented globally. One positive consequence of all this was the increasingly widespread realization that social and governance concerns really are reasonable considerations when evaluating public companies, further legitimizing the core tenets of ESG investing.

Sustainable Investing Sets Records

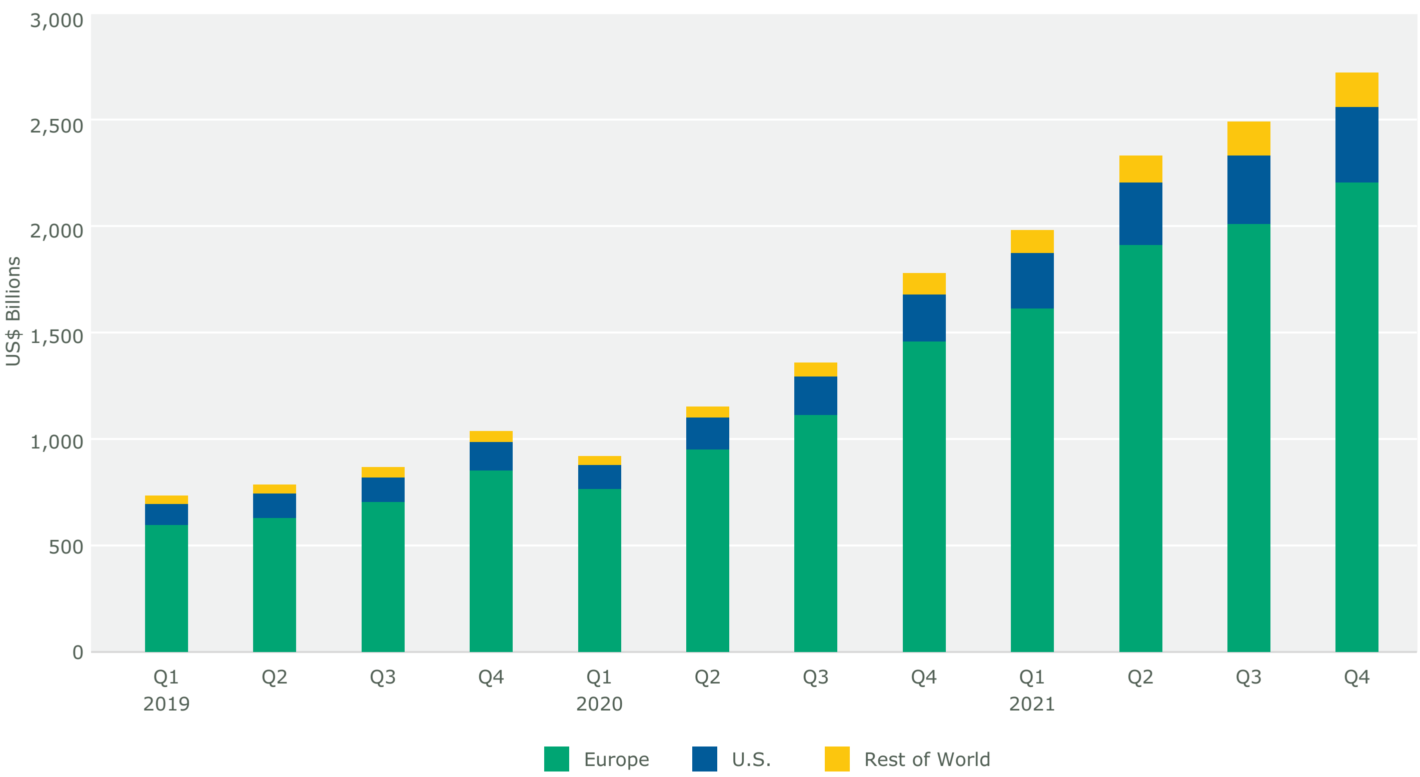
This legitimization has directly led to a level of interest in environmental, social, and governance (ESG) investing that has never been higher. According to Morningstar:[1]

- Global sustainable fund assets expanded by 9% in the fourth quarter to US$2.74 trillion at the end of December 2021 (Figure 1).
- Inflows grew as well, driven by continued investor interest in ESG issues and by facilitating regulation. Investors poured US$142 billion into sustainable funds globally, representing a 12% increase relative to the third quarter.
- Continuing to dominate the sustainable space, Europe accounted for close to 80% of fourth-quarter inflows, while the United States accounted for 10%. Flows clocked in at US$15 billion for Canada, Australia, New Zealand, Japan, and Asia combined.
- Product development remained strong, with 266 new sustainable fund launches globally in Q4 2021. Asset managers also continued to repurpose and rebrand conventional products into sustainable offerings.

FIGURE 1

QUARTERLY GLOBAL SUSTAINABLE FUND ASSETS

Source: Global Sustainable Fund Flows: Q4 2021 in Review, Morningstar, January 2022.



[1] Global Sustainable Fund Flows: Q4 2021 in Review, Morningstar, January 2022.

Regulatory Landscape

The regulatory picture has increased pressure for investment organizations to move toward a sustainable investing model. Last year, the U.S. Department of Labor proposed rules that would permit retirement plan fiduciaries to consider ESG matters in their investment decision-making and voting decisions as shareholders. And in Europe, where sustainable investing is at a more advanced stage of its lifecycle, regulators raised the bar for "sustainable" strategies with a flurry of regulations, including the introduction of the EU Sustainable Finance Disclosure Regulation. The new rules aim to make the sustainability profile of funds more easily comparable to each other and better understood by end-investors.

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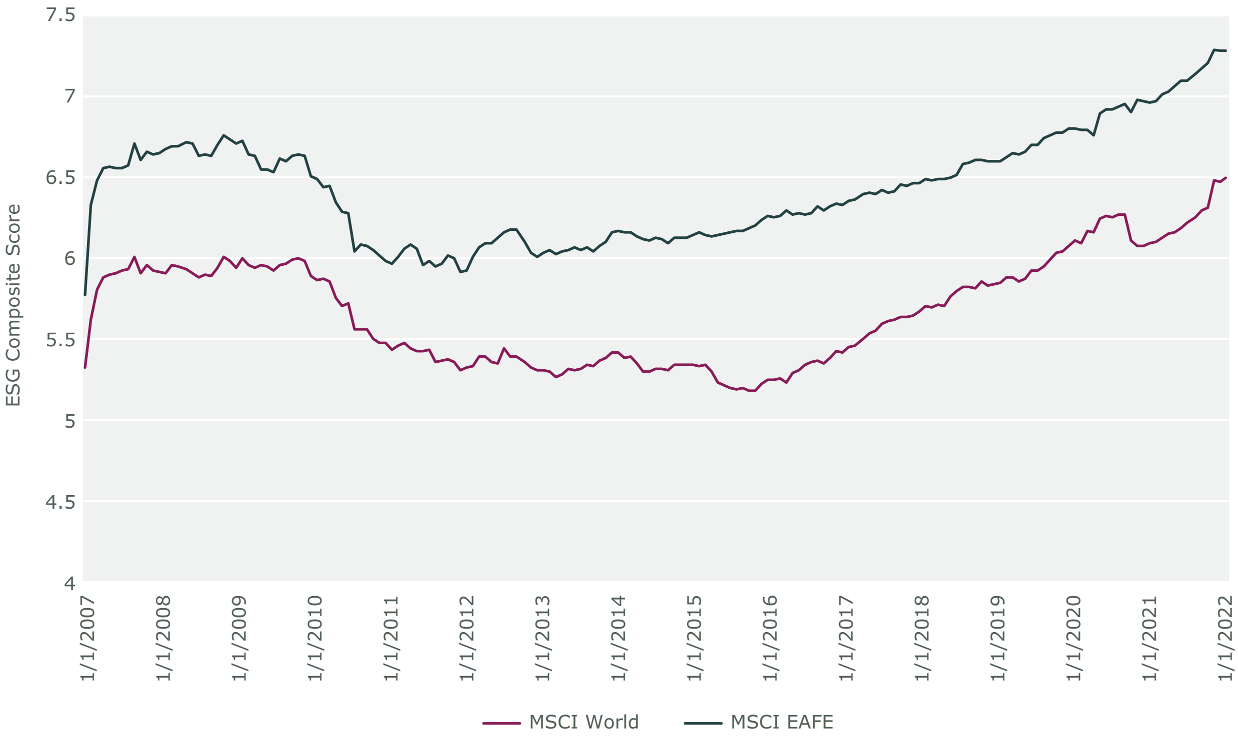
ESG Virtuous Cycle or Grade Inflation?

In the context of this strong demand for sustainable investment strategies in recent years and improving regulatory guidance, it's interesting to note the behavior of index ESG scores, for example the capitalization-weighted average of the composite ESG score as computed by MSCI, which is shown for the MSCI World and the MSCI EAFE Index in the figure below (Figure 2).

FIGURE 2

RISING ESG SCORES

Historical ESG Composite Scores for MSCI World and MSCI EAFE Indexes, January 2007 - March 2022
Source: MSCI.



The chart starts in 2007 when MSCI ESG data first became available, and there's an initial equilibration period of a few years, which can be attributed partly to an increase in the quality of the data, and partly to the normalization following the Global Financial Crisis. After that, we see a consistent period of ESG improvement, which starts earlier and from a higher reference point for stocks outside the U.S.

The natural explanation for this improvement is a virtuous cycle whereby more capital flows to companies with higher ESG scores, which in turn creates an incentive for companies to improve their ESG scores. It's difficult to independently verify how much of that improvement is genuine, but the effect appears to be too consistent and too broad to be completely explainable through greenwashing.

But that was then.

The Worst of Times

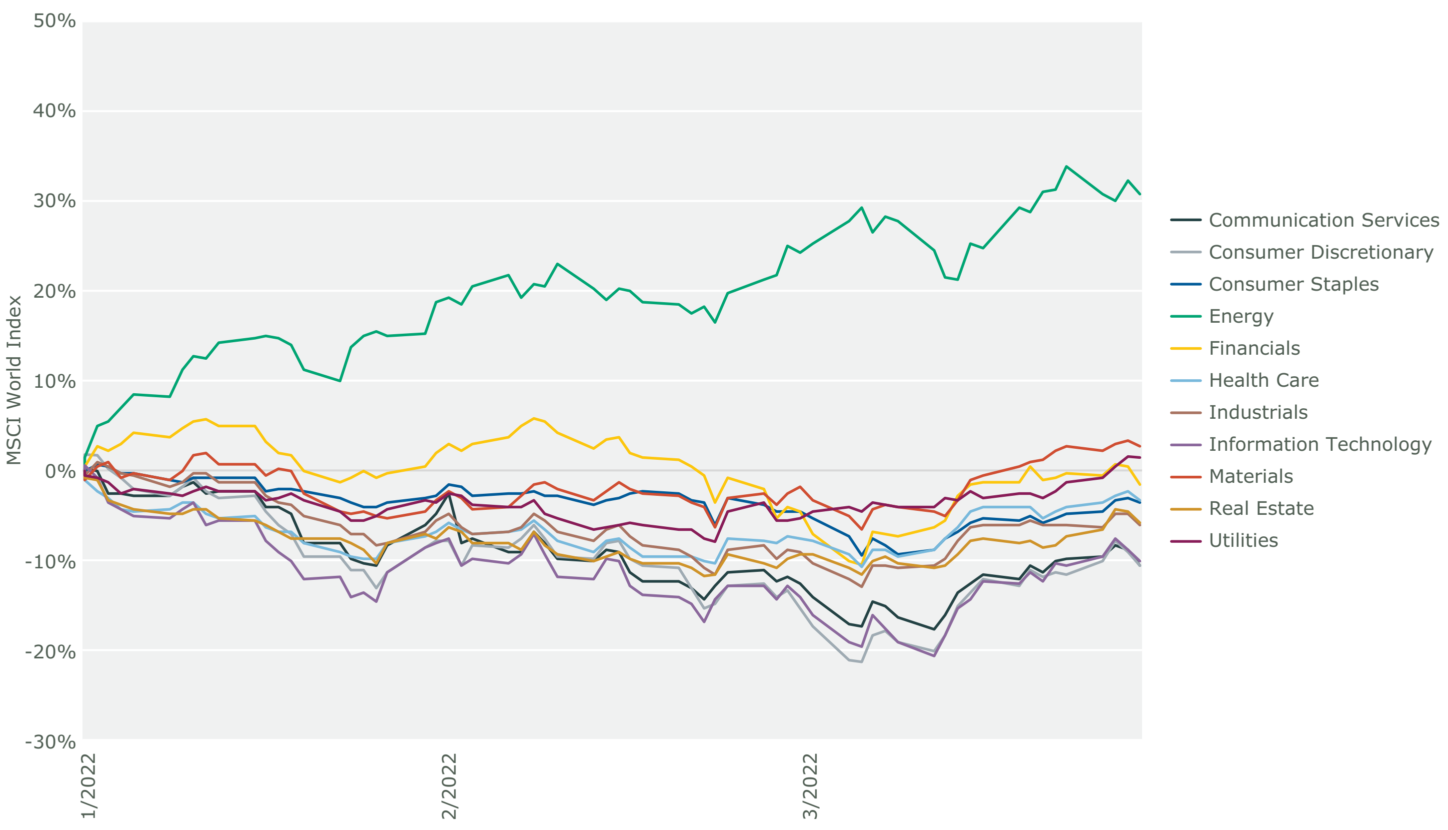
Since the invasion of Ukraine by Russia on February 24th, 2022, the resulting economic and financial fallout has caused some investors to question the continued relevance of ESG strategies. The initial shock appeared to immediately challenge some common assumptions about ESG investing. Further, the ongoing intensification of sanctions by western countries and the resulting reorganization of the global economy is raising concerns about well-established assumptions regarding investment opportunities and goals, including the long-term role of ESG approaches.

The acceleration of energy trends, which originally started after a pivotal point early in the pandemic, has increased the performance gap between the energy sector and the broad market since the beginning of the year (Figure 3).

FIGURE 3

ENERGY SECTOR VS. BROADER INDEX

Cumulative performance of sectors versus the MSCI World Index, January 1, 2022 - March 31, 2022



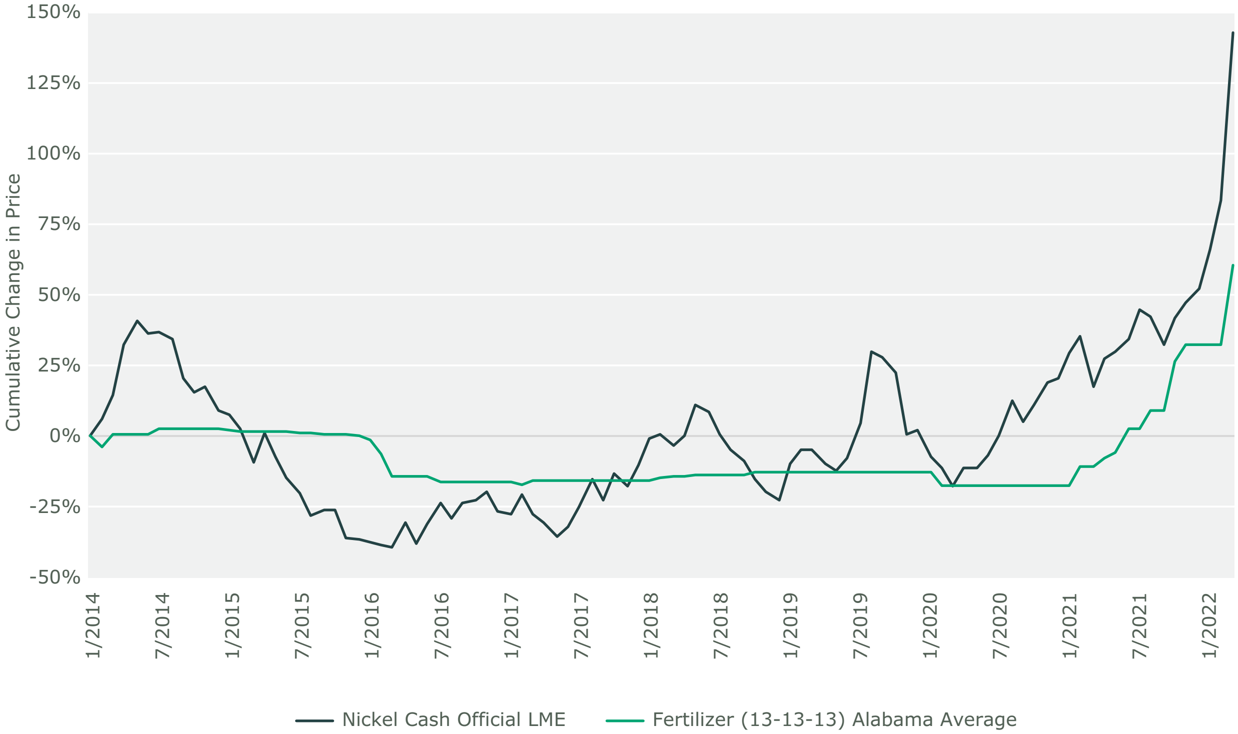
This appears to challenge ESG approaches both by making fossil fuels more economically attractive as a component of equity portfolios, and by making a case for increasing fossil-fuel production in countries that are not controlled by autocratic regimes, through directing capital flow to them. Similarly, non-energy extractive industries such as mining stocks, which are typically unattractive to ESG portfolios, have been presented both as a must-have, high-return asset, and as an investment priority of strategic importance for western democracies (Figure 4). As another argument in the same vein, the Russian invasion has even been used to allege that arms manufacturing also deserves more investment as a bulwark against military aggression.

FIGURE 4

PRICE HISTORY FOR COMMODITIES

January 2014 – March 2022

Source: FactSet.



Surviving the Tale of Two Years

These types of arguments against ESG investing fall apart under even mild scrutiny. The recent historical developments actually strengthen the urgent cases for defossilizing the energy sector and for reducing economic dependence on extractive operations through increased adoption of sustainability practices. Further, it's increasingly clear that, so far, the logistical and technological weaknesses of the Russian effort have been much more decisive than its considerable military assets.

Critical Lesson: Diversification

In terms of potential lessons regarding ESG strategies, especially from the viewpoint of an institutional equity investor, the most crucial consideration is the need to implement ESG approaches through the lens of portfolio diversification. As we've seen in recent months, incorporating ESG considerations into a portfolio usually comes with investment trade-offs. However, the types and magnitude of these potential concessions can often depend more on how you integrate ESG considerations into the portfolio-management process, than on the magnitude of the ESG improvement.

As we've argued in a previous paper, ESG investing is more effective when it uses the benchmark index as a reference point and then exerts pressure in a moderate and positive direction across a broad swathe of stocks, rather than relying on stock-driven approaches, which include exclusion lists or blanket screening, as well as extreme reliance on a handful of stocks to satisfy their ESG goals (Figure 5). In contrast, the portfolio approach helps protect against implementation issues, of which the persistently low quality of ESG data is the most serious. Also, it maximizes the potential impact of individual investors, as it creates incentives for positive change across many companies, as opposed to a handful of ESG investor favorites.

FIGURE 5
ESG IMPLEMENTATION MATTERS

STOCK-DRIVEN EXPOSURES	PORTFOLIO-DRIVEN EXPOSURES
This approach limits the investment universe relative to a benchmark based on specific stock-level ESG ratings. It may not use overall portfolio-level ESG constraints or exposures in the process; instead, it relies on excluding companies with the least favorable ESG ratings or overweighting those with the most favorable ratings as a way to meet an investor's sustainability objectives.	This approach may also incorporate stock-level ESG ratings, but it places emphasis on targeting ESG outcomes at the portfolio level, allowing for a larger initial investment universe. The portfolio-driven approach boosts portfolio-level ESG characteristics above the benchmark, commensurate with investor objectives, while adapting the portfolio to manage the resulting impact to performance and risk.

Managing Complicated Interactions

Portfolio-driven approaches also help manage the nonlinear interaction of many ESG issues, where the resolution of one issue may be effectively suppressed by other interrelated issues. For example, the use of renewable energy sources can be promoted by the large-scale production of batteries, which in turn relies on raw materials that can be challenging to acquire, unless sustainability practices such as effective recycling are more widespread (Figure 6). A diversified, portfolio-driven approach to ESG investing helps advance on a wider front, making progress faster and more consistent.

FIGURE 6
HOW "CLEAN" IS YOUR ENERGY?

Renewables rely on batteries to store clean energy for use when the sun doesn't shine and the wind doesn't blow. Battery storage is essential, but the technology has drawbacks for both humans and the environment. Battery production involves extracting raw materials, mainly lithium and cobalt, which requires large quantities of energy and water. Furthermore, mining operations, particularly in the Democratic Republic of Congo, involve child labor and unsafe working conditions. Balancing these ESG issues may be more challenging for stock-driven approaches.

Managing for Risk Budgets

Further, portfolio-driven approaches manage the higher active risk inherent in ESG objectives by allowing for much greater control of the active weight per sector, country, or other systematic factors, than is possible by an overly concentrated ESG bet. During a period of geopolitical upheaval such as we are currently experiencing, and especially when the transitional regime has an uncertain future duration, it is important to be able to preserve an ESG tilt without exceeding a prudent risk budget.

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ESG Overcrowding

Diversification approaches to ESG also help manage active risk by potentially avoiding ESG bubbles that could occur in isolated companies if they draw unsustainable levels of investor attention. For example, investment in multiple car companies that produce electric vehicles presents a smaller risk than overweighting the most well-known electric-car company, without necessarily compromising on ESG impact (Figure 7).

FIGURE 7
DIVERSIFICATION AT WORK

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ESG-tilt Stability

Stock-driven approaches influence portfolio-driven ESG scores only indirectly since they often give little regard to stocks' absolute level of ESG scores or index weights, and they operate mostly at the initial stage of the investment process. In contrast, a diversified, portfolio-driven approach targets a specific ESG goal and optimizes holdings accordingly, having the full context of each stock's ESG profile and potential contribution to the portfolio – they have direct influence on a portfolio's ESG outcome by design.

Rising to the Challenge

Even though we believe that ESG investing is here to stay, we don't claim that it is going to be completely smooth sailing from here on out. The concerns raised by recent historical developments are easily addressed, but there are genuine mounting challenges that ESG investors are called to address. Looking ahead, we believe there are three main areas where ESG investing is currently facing its greatest challenges: governance, crypto, and fragmentation. These are areas that expose weaknesses in the current approaches to ESG investing, but also represent the greatest opportunities for both meaningful impact and for potentially high investment rewards.

Governance

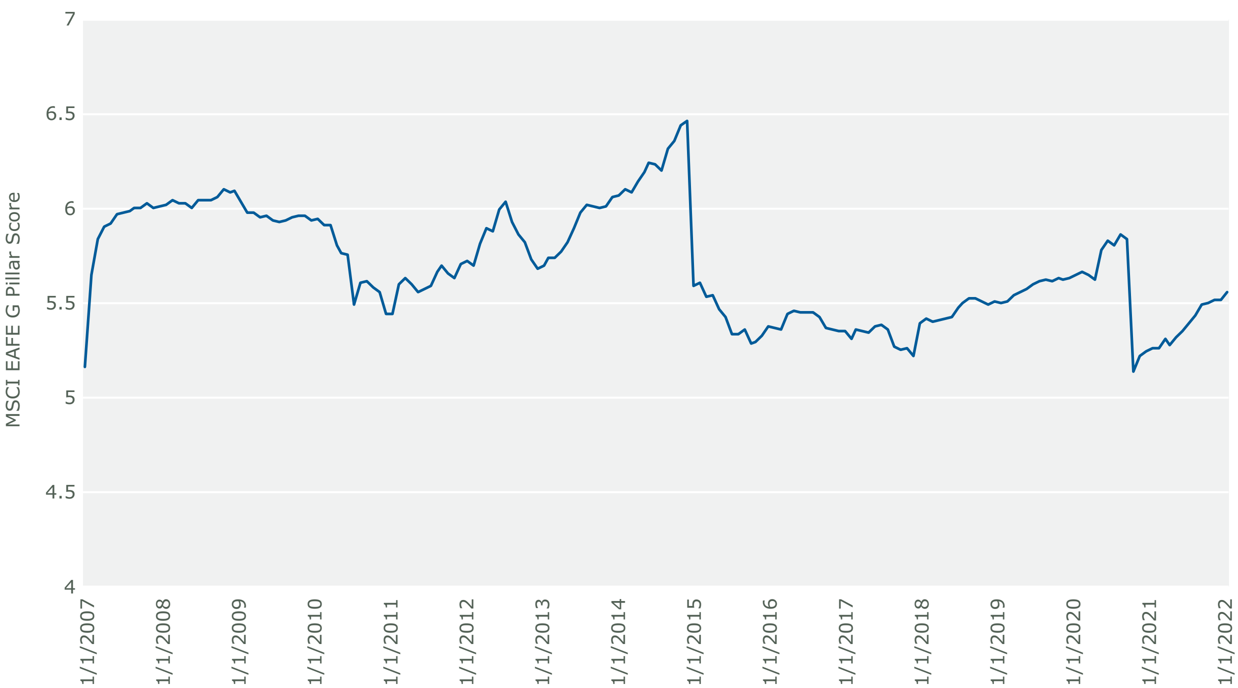
An important area where ESG investors should dedicate more attention is governance. Even though it has traditionally been the most neglected pillar among ESG investors, it is fundamentally as important as the other two, and vital for the validity of the entire approach. For one thing, the reliability of ESG data is necessarily dependent on the quality of the governance of the companies that provide them. For another, governance is the one pillar that appears to be persistently correlated with relative outperformance in most studies of ESG as investment factors, across time, markets, and regimes. This is despite it being the pillar for which reliable data are the hardest to come by. For instance, the MSCI cap-weighted governance score saw a big drop in 2015 due to a dramatic change to the underlying model, not a genuine change in the markets. Irregularities in governance scores suggest that the true underlying alpha signal may even be stronger than past studies indicate.

FIGURE 8

GOVERNANCE SCORE VOLATILITY

January 2007 - March 2022

Source: MSCI.



The recent historical developments help further amplify the role of governance by shedding light on two often neglected considerations. First, in addition to the other reasons for which companies with low governance scores tend to persistently underperform, they are more likely to be subject to economic sanctions and regulatory or even criminal penalties. Second, companies with higher governance scores are more likely to identify and take steps to reduce their exposure to geopolitical risk.

ESG investors have already been putting pressure on companies and regulators to improve the governance of companies, and the corresponding data; this pressure is beginning to pay off, both at the individual-company and the regulatory level. However, there's still a lot of work to be done, especially at the data-provenance level.

Crypto

Cryptocurrencies and their associated ecosystem (e.g., DeFi, NFT, etc.) present a broad-spectrum assault on all pillars:

- Environmental, due to the high and rapidly increasing energy consumption and industrial-level usage of computational resources, including components that rely on valuable raw materials that are difficult to recycle.
- Social, due to their targeting vulnerable social groups, and the high technological and financial cost of diverting resources to potentially negative-sum endeavors.
- Governance, due to the ecosystem's lower transparency and minimal regulation, the incestuous financial structures they appear to engender today, and the ethical challenges they raise.

ESG investors have yet to mount a coordinated response to this challenge. This is partly because technological advancement has generally had a positive impact in ESG causes, and crypto generally, and undeservedly, covers itself with the mantle of technological innovation. This has resulted in investors with limited understanding of crypto considering it as a potentially positive influence. Another reason for the lack of a coordinated response is that crypto is not taken seriously at the institutional level: this may be a mistake, because it has been generating a high short-term cost and is actively interfering with ESG initiatives, e.g., by obstructing the widespread utilization of sustainable energy.

Fragmentation

Perhaps the most material long-term issue that ESG investors face is the proliferation of choices at every aspect of ESG investing, including data sources, ratings, investment approaches, regulatory frameworks, etc. This large variety was to be expected in the early stages of ESG investing; it is even desirable to the extent that exploring different approaches makes it easier to identify the ones that are more effective in practice sooner rather than later. However, as this proliferation of ESG flavors continues, it is increasingly becoming counterproductive.

To take one example, the apparent embarrassment of riches for ESG data presents a recurring test for investment managers: if they forgo one of them, they might miss valuable information that complements aspects that can help them meaningfully improve their models. If they do not forgo them, they will incur an economic and analytical cost to obtain and digest it, while they will also often find that the data are redundant or useless (due to the data's coverage, reliability, or materiality). This is a far cry from most other types of financial data, which are both standardized in format, mandated by regulators, and easily available.

The establishment of ESG standards at every level of investing is only beginning, and it will require uncommon levels of coordination and good faith, but it's also the area that will have the greatest impact in helping to move ESG investing to the mainstream.

Conclusion

Like any successful investing program, sustainable investing is a long game. The importance of committing to a consistent, repeatable process is essential to both investing and meeting the world's sustainability challenges.

Indeed, earlier persistent action toward sustainability practices would have had the potential to reduce our dependence on fossil fuels and mitigate the spike in energy prices this year. But the lesson here is less about today's particular challenges and more about how to address future ESG challenges in your portfolios.

Again, like most investing, diversification can help. We believe a portfolio-driven approach to ESG investing offers investors a sensible way for managing ESG trade-offs. A portfolio-centric implementation seeks to mitigate the impact of the complex interactions between ESG factors and ESG overcrowding while maintaining prudent risk budgets and consistent ESG scores.

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