Responsible Investment
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AEGON **INSIGHTS**

The death of ESG is greatly exaggerated

The past few weeks has seen a senior academic, a prominent UK politician, and a high-profile hedge fund manager all variously pronouncing the death of ESG. To paraphrase Mark Twain following the premature publication of his obituary, reports of ESG's demise are greatly exaggerated.

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As with many inflammatory arguments, much of the headline grabbing comes from misinformation mixed with vitriol. For example, the hedge fund manager in question reportedly claimed that ESG and 'woke capitalism' are the result of the failure of fund managers to ensure proper governance in investee companies. This is an intriguing view given what the 'G' in 'ESG' stands for.

The evolution of ESG

So where does the ESG investing industry stand today? Well, the landscape has evolved significantly since I started in the industry over two decades ago. Rather than abruptly dying, it could be characterised as maturing nicely (a bit like me). ESG funds were once based on avoiding certain industries, thereby aligning with the 'ethical beliefs' of investors. Since then, ESG has gathered momentum as a way of investing and there is now a diverse range of investment solutions to suit the needs of investors. Arguably it really came of age in 2020, when there was a lot of attention on what companies were doing to respond to the global pandemic. Performance of many ESG funds was exceptionally strong and helped banish any lingering doubts that investing in companies doing positive things could lead to outperformance. As a result, assets in ESG strategies jumped significantly and they became part of the investing mainstream.

Over the past two years, performance has been more challenging. This has largely been down to a combination of external factors, such as interest rates, inflation and the conflicts we have seen around the world. Taken together, they have formed a headwind for the stock prices of many companies exposed to prominent ESG themes. All investments, however, go through cycles and ESG is no different. It is vital that we remember that these ESG themes involve investing in long-term solutions to structural problems and should be viewed through that lens.

Strong demand for ESG-themed investments

So, has this recent underperformance and the noise of the anti-ESG agenda impacted demand for ESG investing? A recent Gallup survey found that 69% of UK people did not want their pension savings invested in companies that harm the environment, while 70% do not want to be invested in companies that treated workers, suppliers or the community poorly. Furthermore, data by Morningstar showed that sustainable funds globally continued to attract net inflows in Q3, in contrast to the outflow seen for the overall fund universe.

A global outlier is the US, where sustainable fund flows have been negative. Much of the rhetoric in the US is driven by protectionism from states that are heavily reliant on fossil fuels for employment. We see politicians getting involved and some asset managers being barred from managing state money due to their stance on climate change. Oddly, this sometimes involves the very states that are feeling the most tangible impact of climate change. In some quarters, ESG investors were even being blamed for the likes of the Silicon Valley Bank failure, which shows how ridiculous some of the claims have become.

Politicians backing down

Another recent factor that has fuelled the flames of the anti-ESG debate has been the unwillingness of some politicians to stick to their pledges made at COP 26. The past few weeks has seen the UK government roll back its net-zero commitments, Sweden missing targets, and the US dithering over its role in a proposed 'loss and damage' fund to rectify the impact of climate change.

ESG integration now mainstream

There was always going to be some resistance to the growth of ESG, as it challenges some long-held beliefs in how investments should be managed. The naysayers seem to believe that fund managers should stick to traditional analysis and consider only a company's revenues, costs and profits in their investment decisions, and this is where an important distinction should be made.

While the funds mentioned above cater for individuals seeking to invest in an ethical or sustainable manner (by having an objective more than purely financial return) there are other funds that are 'unconstrained' by these considerations and are seeking to maximise returns without an overlay. Most of these funds are 'ESG integrated', that is they take ESG factors into account when they are financially material to the prospects of the company.

Recent history is full of examples where ESG factors were material to a company's prospects. The Deepwater Horizon disaster killed 11 people and caused longstanding ecological damage in the Gulf of Mexico, but led to a halving of the share price of BP. It is difficult to argue that an energy company's approach to safety is not something that should be considered when looking at the investment case.

Similarly, when slave labour practices were uncovered in fashion retailer Boohoo's supply chain, the share price halved and numerous distributors turned their backs on the company. This issue has very recently resurfaced for Boohoo, showing that such risks are often not a one-off event. Clearly, these material ESG factors had a very real financial impact on the companies in question and, in this sense, considering such factors is just part of good, thorough investment analysis.

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Performance is cyclical

In today's fast-moving world, we all too often seek instant gratification, and investment markets are as guilty of that as any. It is surely no coincidence that the anti-ESG backlash has emerged just as market rotation has, in the short term, hampered the performance of many prominent ESG themes, while also boosting areas that ESG funds simply cannot go. Add to that unhelpful government policy actions and some very high-profile incidences of 'greenwashing', and you can see why confidence in ESG investing has been shaken.

It is, however, important that we differentiate between baseless, headline-grabbing soundbites and hard facts. Despite the rumoured death of ESG, people are still directing capital towards this area.

Investments are cyclical, and unfortunately many ESG themes have been in the wrong part of the cycle for the past few years. But cycles turn, and investing with an ESG mindset is good investment practice. We should all remember this, whatever the headlines suggest.

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