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INVESTING BEYOND ESG: THEMATIC SUSTAINABLE INVESTING

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Investing Beyond ESG: Thematic Sustainable Investing

The term 'ESG', whilst an important introduction to sustainable investing, is too broad – investors must now focus on applying specific thematic sustainable investment approaches.

Executive Summary

The summer of 2022 has borne witness to extreme weather events across the globe with parts of California, Pakistan, India, Europe, Africa, and China all suffering from the devastating physical impacts of climate change. Addressing climate change has become the defining issue of the era, with this sense of urgency further driven by warnings from UN scientists that the window to elude otherwise unavoidable increases in multiple climate hazards is closing fast[1]. Set against this backdrop of extreme weather, societal urgency, and finite time, it would be logical to assume that the momentum behind ESG Investing has never been so strong. This sentiment however is far removed from the current reality.

The ESG community has faced a backlash in 2022 with scrutiny emerging from across the political and economic spectrum. Investors, regulators, and politicians have directed their criticism at a sector they view to be in certain cases overly virtuous, ineffective, and inherently subjective. With ESG facing such a retaliation questions have arisen as to the merits of focusing on sustainable investing. The answer is simple: climate change presents systematic risks to global economic structures and actors across all industries and sectors. The legal, regulatory, and consumer pressures on companies to achieve carbon neutrality by the middle of the century have grown massively. These pressures are becoming tangible financial issues, highlighted by the fact that S&P Global estimate that over 90% of the world's largest companies will have an asset financially exposed to extreme climate risks by 2050[2]. In this environment it is Foresight Capital Management's view that the most successful future companies will be those that are positioned to succeed in both a decarbonising and a decarbonised global economy.

This paper outlines that not only should the ESG backlash have been expected, but that it is also healthy for the industry. The paper does however highlight that the notion of ESG investing must evolve too. Investors must move away from an inexact definition of ESG investing supported by a range of unstandardized issues and instead focus on specific pre-defined thematic issues that will allow companies to remain impactful and competitive in an era that is above all dedicated to eliminating the global economy's greenhouse gas emissions. The paper will focus on the concept of

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[1] Portner, H. and Roberts, D., 2022. Climate Change 2022: Impacts. Adaption, and Vulnerability. *Working Group II Contribution to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change*, p.13.
[2] Ritchie, G., 2022. [online] https://www.bnef.com/news/1082339. Available at: <https://www.bnef.com/news/1082339> [Accessed 15 September 2022].

‘double materiality’ – the process of not only assessing the sustainability of a company’s business operations, but also the impact of their goods and services on the environment – as an important lens through which to analyse a company’s suitability for sustainability-minded investors. Focusing further on using double materiality as an investment tool, the paper will outline the relevance of real assets in sustainable investing and their role in managing both current and future physical climate risks. The paper will also touch upon important debates within the real asset sustainable investment space, most notably the contrasting views held over the merits of ‘greening’ portfolios Vs ‘greening’ assets. Finally, the importance of stewardship as a key pillar of any sustainable investment strategy will be reviewed. The ultimate conclusion to the paper will be that as the market evolves beyond traditional conceptions of ESG, sustainable investing must focus on the impact of regulatory, technological, and social changes which will make thematic sustainable investment even more vital for analysing future market valuations[3].

Evolution Of The ESG Market

At its core ESG investing has an easily digestible approach to assessing potential material impacts that emerge from environmental factors, social issues, and corporate governance practices. ESG investing is based on the understanding that by managing risks and opportunities associated with long-term economic, social, and environmental trends, companies will have the best chance to prosper over the long run. This broad swathe of approaches has helped fuel rapid growth in the ESG investment universe over the last decade. The past five years have witnessed a large increase in capital flows towards products labelled under the ESG umbrella. The Global Sustainable Investment Association assert that global ESG AUM has risen from $22.8 trillion in 2016 to about $35 trillion in 2022[4]. This trend is only set to continue with Bloomberg Intelligence estimating that global ESG AUM is set to climb to $50 trillion by 2025[5]. These estimates however depend upon what people define as ‘ESG’ and in that caveat the pressures that this investing universe has recently been under are laid bare.

The inherent broadness of ESG has catalyzed a subjectivity to the sector resulting in the term meaning different things for different people. Many strategies have emerged under the broad concept of ‘ESG investing’, with those terms often repeated including responsible investment, sustainable investment, and ethical investment. These terms have often been used interchangeably and efforts are now being made to standardise their meaning. With the term ESG having so widened as to lose some of its

[3] Quinson, T., 2022. [online] BloombergNEF. Available at: <https://www.bnef.com/news/1060953> [Accessed 15 September 2022].
[4] Global Sustainable Investment Review 2020. [online] Available at: <http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf> [Accessed 16 September 2022].
[5] Kishan, S., 2022. An ABC on ESG and the Kinds of Backlash It's Facing: Quick Take. *BloombergNEF*, [online] Available at: <https://www.bnef.com/news/1082255> [Accessed 16 September 2022].

meaning, the threat of greenwashing – the practice of companies and funds exaggerating the environmental benefits of their actions – has risen precipitously. Ratings agencies have capitalized on this growing demand for ESG information, yet the binary and unstandardized nature of their scores has also received backlash. Correspondingly therefore, the finance industry has been accused of "sprinkling ESG fairy dust[6]" on its products to make them more palatable in this socially and environmentally conscious era.

Where Do We Find Ourselves Today?

The first half of 2022 saw inflows into ESG ETFs shrink 14%[7] with notable tailwinds including the Russian invasion of Ukraine, soaring inflation, and apprehensive market sentiment dampening enthusiasm for the sector. Furthermore, booming energy and faltering tech shares (the former largely excluded from ESG portfolios and the latter heavily represented) also left ESG funds and ETFs liable to underperformance[8]. ESG's perennial problem of being made up of three distinct categories potentially at odds with one another was also exposed by the omission of Tesla from the S&P 500's ESG index in May[9] due to labour and safety issues. The optics of a company so clearly aligned with global decarbonisation not making an ESG index were poor and led to Elon Musk denouncing the concept. Attempts to neatly package together broad 'ESG' issues off the back of wide labelling and terminology have therefore resulted in ESG finding itself on the backfoot. Understanding therefore that ESG is inherently subjective, it has become vital to accurately define how to incorporate ESG into fundamental investment analysis.

Foresight Capital Management asserts that there is no such thing as an 'ESG stock'. Rather, the investment team focuses on the thematic trends (for example, the energy transition) that provide the foundation of a sustainable investment approach. These are then used as a framework by which to assess the risk/return characteristics of companies and the opportunities or threats their operations face in a decarbonising global economy. ESG investing has historically attempted to align 'ESG companies' with ratings that would suggest stronger future performance. By contrast, investors must now begin to analyse how companies are positioned to take advantage of thematic trends that are emerging as the world prioritizes net-zero. This positioning must be married to financial drivers that will impact the fundamental investment case for a company. Examples include but are not limited to questions relating to revenues and risk profiles of specific companies. Investors must frame their

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[6] Kishan, S., 2022. An ABC on ESG and the Kinds of Backlash It's Facing: Quick Take. *BloombergNEF*, [online] Available at: <https://www.bnef.com/news/1082255> [Accessed 16 September 2022].
[7] Bloomberg Intelligence, 2022. *Global ESG 2022 Midyear Outlook*. Bloomberg Intelligence.
[8]Kirk, S., 2022. ESG must be split in two. *Financial Times*, [online] Available at: <https://www.ft.com/content/4d5ab95e-177e-42d6-a52f-572cdbc2eff2> [Accessed 19 September 2022].
[9]Greifeld, K 2022. *ESG's Crown Is Slipping, and It's Mostly Fund Industry's Fault*. Bloomberg Businessweek.

analysis around these fundamentals and assess, for example, how a company's provision of goods and services that look to decarbonise highly emitting sectors will impact their market share, their pricing power, or indeed create new markets to enter into. Conversely, an investor would also have to assess how the risk profiles of companies that externalize their negative impacts will be impacted through potential changes to cost of capital, the emergence of contingent liabilities, and industry divestment risk.

Assessment of how these asset price drivers will be impacted by the internal and external operations of a company will help forecast their future performance. To take advantage therefore of the investment opportunities arising from the transition to net-zero, a thematic sustainable investment approach that looks to identify positive emerging trends and which also uses investment approaches such as 'double materiality' will be required.

Incorporating Double Materiality Into Thematic Sustainable Investing

Many ESG-focused investment approaches currently assess the internal operational performance of a company yet omit the crucial assessment of the impact of their goods and services. By contrast, a double materiality approach focuses on a company's operational footprint whilst also assessing the environmental and social impacts of the products and services that company provides. Research by MSCI on the top 20 largest ESG funds found that 'Information Technology' was the largest sector allocation for most ESG funds, with Alphabet being the most commonly held stock followed by Microsoft, Adobe, and Apple[10].

Common Holdings by GICS Sector[11]

Name	GICS Sector	ESG Rating	# Funds (Top 20)	Average Weighting (%)
Alphabet Inc	Comm. Services	BB	12	1.93
Microsoft Corp	IT	AAA	9	5.09
Adobe Inc	IT	AA	8	1.25

[10] MSCI ESG Research LLC, 2021. *The Top 20 Largest ESG Funds - Under the Hood*. [online] MSCI ESG Research LLC, pp.1-17. Available at: <https://www.msci.com/documents/1296102/24720517/Top-20-Largest-ESG-Funds.pdf> [Accessed 19 September 2022].

[11] Ibid, pp.9

Apple	IT	BBB	7	5.68
Nvidia	IT	AAA	7	1.67

Whilst companies such as Microsoft, Adobe, and Apple have wide-reaching operational climate and social targets, their products will not lead to the decarbonisation of the global economy. Their inclusion within ESG funds therefore highlights the difficulties presented by the broad concept of ESG investing. A company like Adobe, with its verified science-based emission reduction targets and plans to commit to 100% procurement of renewable energy by 2035[12], is clearly an environmentally and socially responsible company. However, its fundamental service of developing computer software products should make sustainability-minded investors question whether it should hold a weighting in a portfolio looking to allocate capital to environmental or social solutions. Thematic sustainable investing therefore must go beyond analysing internal operational performance against ESG criteria and look to invest into companies that have sustainable operations embedded into their long-term strategies but who are also defined by their innovative products and services which seek to address key environmental or social issues. The importance of adopting a double materiality approach to sustainable investment, above all when focusing on 'green' investing, is seen particularly within the infrastructure and real asset space.

Infrastructure such as efficient power and communication networks, effective water and sewage systems, and functioning transportation systems is the essential backbone to modern economies and societies. Vital to both climate mitigation and adaptation, the availability of green and resilient infrastructure will determine whether we remain dependent on fossil-fueled power, whether we travel in climate-friendly ways, and whether increasing extreme weather events can be dealt with effectively. However, companies that own and operate real assets will naturally be more carbon intensive than many companies within the investment sectors such as 'Consumer Discretionary' that are popular in the largest ESG funds. MSCI's research on the top ESG funds found that toy-marker Hasbro and sports apparel company Nike were held in 7 out 20 of the largest global ESG funds[13]. By contrast, the largest ESG funds had almost no allocations to the energy sector[14]. The impacts of these allocation decisions are made starker by the fact that over the next three decades the energy sector's

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[12]Adobe, 2021. *Adobe Corporate Social Responsibility Report 2021*. [online] p.13. Available at: <https://www.adobe.com/content/dam/cc/en/corporate-responsibility/pdfs/Adobe-CSR-Report-2021.pdf> [Accessed 19 September 2022].
[13] MSCI ESG Research LLC, 2021. *The Top 20 Largest ESG Funds - Under the Hood*. [online] MSCI ESG Research LLC, pp.1-17. Available at: <https://www.msci.com/documents/1296102/24720517/Top-20-Largest-ESG-Funds.pdf> [Accessed 19 September 2022].
[14] Ibid.

required investment will be £3.5 trillion per year[15]. This statistic serves to highlight another inherent tension within ESG investing; the contradictions between 'greening' portfolios (creating portfolios that have low carbon footprints) and 'greening' assets (holding securities in more carbon intensive sectors which are vital for the low-carbon transition). Whereas ESG fund managers may look to tilt their portfolios based on metrics such as carbon intensity, applying a double materiality lens when investing in real asset owning securities allows investors the opportunity to manage and improve the impacts of assets that are vital for the net-zero transition[16]. It is apparent therefore that thematic sustainable investing provides the flexibility required to allocate capital towards companies moving from 'brown' to 'green'. With thematic sustainable investing looking to finance the transition to a net-zero world rather than simply create a 'green' portfolio, the role of active engagement becomes vital.

Active Engagement In An Era of Environmental Responsibility

MSCI's research outlined that 45% of 2020's top ESG funds were passive investment strategies[17]. Passive ESG funds have faced many of the same tailwinds that have slowed ESG investing's momentum in 2022. Implicitly, when investors choose a particular index provider, they are aligning with the provider's ESG approaches and philosophy in terms of raw data acquisition, analysis, and weighting. The diversity of approaches and opaque interpretation of data means that ratings that differ markedly from one index provider to another. Tesla, having already been mentioned in this report, provides another applicable indicator of how the ESG ratings of companies can vary significantly between ESG providers. Having received a high score from MSCI based on its contribution to low carbon technologies, a rival ESG ratings provider - FTSE - who rated only the emissions from the company's factories, awarded Tesla a near zero score. These differing scores were reflected in very different weightings across respective ESG indices, with Tesla making up 3.52% of the MSCI US Low Carbon SRI Leaders index yet only 0.35% of the FTSE USA ESG Low Carbon Select Index[18]. Unstandardized ESG ratings processes and indices therefore play a defining role in how passive ESG investors make their investment decisions and lessen the investors' scope to align with emerging thematic trends and catalyse positive impact.

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[15] Carney, M., 2021. *Value(s): Climate, Credit, Covid and How We Focus on What Matters*. 1st ed. London: Harper Collins, p.287.
[16] Ibid.
[17] MSCI ESG Research LLC, 2021. *The Top 20 Largest ESG Funds - Under the Hood*. [online] MSCI ESG Research LLC, pp.1-17. Available at: <https://www.msci.com/documents/1296102/24720517/Top-20-Largest-ESG-Funds.pdf> [Accessed 19 September 2022].
[18] Eckett, T. (2021). *Tesla and the ESG conundrum*. Available at: https://www.etfstream.com/features/tesla-and-the-esg-conundrum/

Active engagement refers to the interactions between investors and investees to improve practices and reflects the intention to put an asset manager's stewardship responsibility into effect. In contrast to passively tracking ESG indices, active engagement is an approach that is universal and can be applied to a company no matter where it is on its transition pathway. The technique also permits asset managers to shift their time horizons and take a longer-term approach to issues such as the climate transition[19]. The depth to which investee companies both monitor and address their climate risks and opportunities is an increasingly important investment consideration. Companies must consider the risks of environmental change on the goods and services they provide, whilst they must also consider the impacts of their business on the environment. Put quite simply; if a prospective or investee company's operations are exposed to climate-related risks, they may be neither a good nor an impactful investment. Active engagement must therefore be a key pillar in any thematic sustainable investment approach. Engagement with holdings, specifically those in more carbon intensive sectors that are vital to the green transition, will be paramount to help deliver real solutions to the climate emergency.

What Next For Sustainable Investing?

As the military maxim goes, 'no plan survives first contact with the enemy'. ESG-aligned investing philosophies have been maturing for decades and at their current rate of growth will represent half of all professionally managed assets by 2024[20]. The sector clearly represents an investable universe that investors wish to have available to them and, rather than heralding its demise, ESG's recent trial by fire will place the concept on the path towards major improvement. Added regulatory focus will expose greenwashers who have co-opted ESG for marketing purposes and force capital to flow towards funds that have clear, specific, and measurable environmental or social aims. Furthermore, notions of ESG investing increasing shareholder returns will have to be quantified by the marrying of E, S and G components with company fundamentals.

The motives behind the inexorable rise of sustainable investing are well-meaning and vital. Addressing the climate crisis is the defining issue of our generation, and investors cannot afford to slow the movements of capital towards environmental and social solutions. The window to act is finite and shrinking; to hit a 1.5°C objective we must halve emissions every ten years, if we wait another four years the challenge will be to halve them every year, and if we wait eight more years our carbon

[19] Hvidkjær, S. (2017). *ESG investing: a literature review*. Available at: https://dansif.dk/wp-content/uploads/2019/01/Litterature-review-UK-Sep-2017.pdf
[20] Taylor, T. and Collins, S., 2022. *Ingraining Sustainability In The Next Era Of ESG Investing*. [online] Deloitte. Available at: <https://www2.deloitte.com/uk/en/insights/industry/financial-services/esg-investing-and-sustainability.html> [Accessed 21 September 2022].

budget will be entirely gone[21]. The movement away from opaque notions of ESG investing towards thematic sustainable investment strategies will ensure that portfolios are created that have a deep grounding in climate science, overlay climate-analytical lenses on social issues, and fundamentally impact the real economy through the products and services of underlying holdings.

Conclusion

Lazy labelling and terminology have forced ESG investing onto the backfoot in recent months. Whilst not all of the backlash against ESG investing hits the mark, it must not be conflated with active thematic sustainable investing. Whereas the former looks to achieve strong risk-adjusted returns by investing into companies that ostensibly perform well against pre-defined metrics, the latter seeks to capitalize on long-term transformative industrial or societal trends. Successful sustainable investment must assess which industries and companies are positioned to seize the opportunities that the decarbonisation of the global economy presents. This thematic approach, aided by the concept of double materiality and active engagement to drive sustainable value creation, will help investors identify which companies are positioned to succeed long-term. The consensus is clear: climate change is here, its impacts are tangible, and the risks are global. Mainstream finance must be mobilized to deal with the climate tragedy on the horizon and defining and streamlining sustainable investment will be paramount to achieving this goal.

[21] Carney, M., 2021. *Value(s): Climate, Credit, Covid and How We Focus on What Matters*. 1st ed. London: Harper Collins, p.239.

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