ESG IN INVESTMENT MANAGEMENT

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What is the current status of ESG investment?

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WHAT IS THE CURRENT STATUS OF ESG INVESTMENT?

According to The Investment Association's (IA's) ESG Global Survey of 2019, there was not one survey respondent who imagined a future whereby "75% or more of an investor's portfolio would integrate ESG by 2021." However, nowadays, 22% of the investors surveyed in the IA's ESG Global Survey of 2021 state that investors integrate ESG into at least 75% of their portfolios, and this number will continue growing in the years to come.

Further to this, it is observed that brand and reputation have overtaken returns as the primary driver of ESG, with 59% describing it as the main driver, compared to 45% who said that improved long-term returns were their main driver.

By November of 2021, ESG-focused funds raised a record $649 billion, a figure that dwarfs the $542 billion and $285 billion raised in 2020 and 2019, respectively. As things stand, ESG funds account for 10% of fund assets worldwide. Moreover, of the current $6.1 trillion in ESG funds, it's estimated that 59% of this money is held in Europe, the Middle East and Africa, meaning that ESG is going beyond the traditional geographical regions usually associated with it.

During the discussions at the World Economic Forum's Davos Agenda 2022, major players were clear in stating that Environmental, Social and Governance standards are coming for everyone. The suggestion is that even industries that do not want to partake will be forced to adopt ESG. Incorporating ESG into Investment Management is fast becoming a necessity rather than a mere whim.

As things stand, there are two main ways regarding how ESG is being integrated into investment management. The first is Integrated investment teams, where Portfolio managers and analysts do ESG analysis and integrate it into their decisions. The second is a dedicated ESG team that conducts ESG analysis, integrating investment teams into their investment strategy. Given that two teams are involved in the latter scenario, communication is of the essence for the result to be satisfactory. For this reason, a third possibility is the inclusion of integration specialists, which help the ESG team integrate their findings with the investment team's strategy.

In April of 2021, the European Commission adopted a package of measures related to sustainable finance. The ultimate aim of these measures is to enable investors to have more information that would allow them to make more sustainable decisions when investing.[8] Although the Non-Financial Reporting Directive (NFRD) had been introduced some years back, in the European Commission's own words, "there is ample evidence . . . that the information that companies report is not sufficient",[9] and the new proposals, therefore, seek to remedy this.

The Commission's text proposal for the Corporate Sustainability Reporting Directive notes that "users will benefit from better access to comparable, relevant and reliable sustainability information from more companies", thereby reducing risks and increasing financial flows to companies that have positively impacted people and the environment.[10] As a result the people's fundamental rights will also see a positive impact.[11]

The Corporate Sustainability Reporting Directive also amends existing rules and extends the scope of the current NFRD to all large companies and companies listed on the markets, barring micro-enterprises.[12]. This directive will require auditing the reporting information while introducing detailed requirements and standards relating to ESG reporting.[13] Furthermore, companies will also be required to "digitally tag" their reported information so that the information becomes machine-readable.[14]

Given the current trends, ESG investment in the post-Covid era promises to be a lucrative industry, with investors looking beyond the rate of return and towards other considerations such as matters related to environment and governance. Further to this, it is also observed that technological developments will make it easier for investors to accurately measure and report ESG metrics in the months to come.[15]

Covid-19 has been described as "the major turning point for ESG investing".[16]. Although on the environmental sphere, climate targets were put on the backburner for economic considerations, it is envisaged that these policies will be at the very top of the agenda.[17] When it comes to social considerations, it is observed that the pandemic also highlighted widespread inequality between people of different social classes and nationalities.[18] Moreover, in times of crisis, the true value of good governance becomes more apparent – as happened during the Covid-19 pandemic.[19] Given the events that the world has been through over the past 24 months, ESG investment in the post-covid scenario is only envisaged to accelerate.

INCREASED DEMAND FOR ESG

In recent years, the conversation relating to ESG has been moving from compliance to competitiveness.[20]. At The Davos Agenda 2022 Summit, Chief Executives agreed that "ESG has helped companies become more attractive to investors, customers, and prospective employees." [21] Frans van Houten, Royal Philips's CEO, stated that while ESG did not serve to reduce profitability, it serves to build up customer loyalty,[22] something that is increasingly becoming important in today's volatile world.

On the investor side of things, demand for ESG has been soaring. A 2021 Investopedia and Treehugger reader's survey found that 58% of the respondents reported a growing interest in ESG.[23] 64% of millennials believed that ESG principles would be the industry standard in the future. In contrast, only 52% of Gen X and 42% of the Boomer Generation agreed with such a statement.[24]. Seeing this, it becomes evident that ESG will become more and more critical in the future.

PERFORMANCE OF ESG FUNDS

Further to the increasing interest in ESG, companies with a positive ESG score tend to outperform companies with a poor ESG score. This statement is backed by data, with statistics from 2021 showing that more than 50% of "environmental, social and governance-linked funds outperformed the S&P 500" in the first months of 2021.[25] Between the 31^{st} December 2020 and 17^{th} May 2021 the S&P 500 increased by 10.8%, these funds rose between 11% and 29.3% over the same period.[26]

ESG funds have proven to outperform non-ESG funds on a long term horizon over periods of three, five and ten years.[27]. The annualised returns stood at 10.59% over the last three years, 10.03% over the last five years, and 7.5% over the last ten years.[28] These statistics continue proving that investor appetite is moving towards ESG inspired funds.

CONCLUSION

Both investor appetite and legislative changes within the European Union and elsewhere will make it difficult for companies not to integrate ESG within their investment strategies.

Firms that focus on ESG obtain a better return than those that don't. Compliance and competitiveness are making ESG a necessity. With this in mind, it is difficult not to conclude that companies that have not invested in ESG will do so soon, and those that have will continue to increase their investment.

CONTACT US

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