pi ESG CLUB

Institutional investing has changed. Sustainable strategies are no longer considered niche; there is a strong argument that they have become mainstream, especially for long-term investors.

In response, fund managers are launching sustainable-themed funds that target issues such as equality, climate change and water conservation. This change in approach is partly the result of pressure from pension scheme members, but it is also being driven by regulators with pension schemes having to show how they are protecting savers from climate change. The government banning new petrol and diesel cars on the UK's roads from 2030 and announcing plans to launch a sovereign green bond shows how attitudes are changing.

Because ESG investing is now a major consideration for pension schemes, we have assembled a panel of asset managers and consultants to discuss some of the biggest issues of environmental, social and governance standards.

Welcome to *portfolio institutional's* ESG Club.

Members

Catherine Douglas is director of ESG at Morrow Sodali, a consultancy

REPORTING SOCIAL IMPACT IS DAUNTING, BUT CANNOT BECOME A 'HEAD IN THE SAND' MOMENT

In the grand scheme of things, ESG is still a new area of focus for investors and stakeholders, and social impact, in particular, can be hard to define. This leads to a suspicion of under-reporting and inaccurate disclosures from companies of all sizes. Social and governance issues are also inexplicably linked though challenges such as executive pay and living wage commitments, and boards worldwide are realising they have serious work to do to bring the S in line with the E and the G.

As we have seen with environmental reporting demands, disclosure requirements and frameworks are evolving rapidly. Companies and investors now know they not only have a mountain to climb, but they must also climb it at speed.

Even forward-thinking firms are in danger of falling into familiar traps along the pathway to transparency and compliance. One such pitfall is the production and publication of large amounts of data without a clear narrative, which can lead to confusion among investors and stakeholders. This is often a knee-jerk reaction to stakeholder demands. While detailed data can offer real value, it can often confuse and turn stakeholders off when presented in an unorganised way without a clear narrative and roadmap.

Equally, firms opting for concise reporting methods can create different concerns for stakeholders. Short reports without high level insights and disclosures can be mistaken for a reluctance to engage and share the inner-workings of an organisation. This is especially true in relation to social reporting – a broad field containing issues magnified during Covid-19.

As we emerge from the pandemic, consumers and investors are more motivated than ever to support companies they believe are committed to a 'just and green' transition. Social impact commitments and reporting around topics like working conditions, pay, sick leave and supply chain transparency are under more scrutiny than ever.

There's no shortcut here – this is a huge challenge. Even defining what falls under social impact is difficult. Social factors affect a business' employees, customers and suppliers, and are often considered to be less tangible than environmental and governance issues where clear frameworks are in place. This lack of precision contributes to why social impact is often poorly measured, and without measurement it's impossible to implement, track and, most importantly, make improved social impacts.

In a 2019 paper, MIT labelled the lack of standardisation in ESG scoring 'aggregate confusion'. In the three years since it was published, the world of environmental reporting has been rightly turned on its head as companies seek to curb their carbon emissions.

Social, however, has been left behind. Progress has been slow and a lack of cross-industry consensus on reporting means many companies are unsure of what progress looks like.

These factors have conspired to create a confusing quagmire with no clear path out – companies need to report data quickly but are also under pressure to adhere to a framework which has not been built and are wary of the perils of 'washing' – falsely reporting positive progress. Data needs to be robust but concise, conveying a strong narrative and reassuring stakeholders that claims and goals have been built on the strong foundations of accurate data.

There are positives, however. Thanks in part to industry-wide efforts on environmental reporting, investor relations are changing for the better. Now more than ever, companies are willing to engage openly with investors, regulators and stakeholders to define these frameworks. The companies now leading the way are engaging with activist shareholder groups – something which would have seemed surprising just a few years ago.

An event hosted by Morrow Sodali saw panellists from the FRC, Rio Tinto, the Church of England Pension Fund and ShareAction discuss how to establish clear reporting requirements for companies. I was struck by the frank and open discussion and collaborative approach. Efforts to improve environmental reporting has shown what can be achieved through cohesive action in short periods of time, and it's heartening to see this spirit being applied to social reporting, too.

As the net tightens around how social impact is measured and assessed, some companies may fear the additional scrutiny and avoid putting real thought into how they report their efforts in the field. That would be a mistake. Forward-thinking companies are using this moment to play an outsized role in how their sector defines the social in ESG. Policy red lines are being drawn by regulators now, and any new legislation will only increase the importance of actionable social data. What's more, a better understanding of this data will help companies make better strategic decisions.

ESG SCORES: NOT HIGHLY RATED

Sustainability scores diverge hugely, making it difficult for investors to assess a company's ESG profile. *Andrew Holt* reports.

A study has found a significant divergence in ESG scores from six prominent rating agencies, which has big consequences for investors.

This is the main finding of a report – *Aggregate Confusion: The Divergence of ESG Ratings* – published by academics from the Massachusetts Institute of Technology (MIT). The team investigated the divergence of ESG ratings based on data from six prominent agencies: KLD, Sustainalytics, Moody's ESG, S&P Global, Refinitiv and MSCI.

They found that ESG ratings on the same company can vary substantially, with these disagreements having a number of important consequences, warned the report.

Primary failure

First, such a divergence in scoring makes it difficult to evaluate the ESG performance of companies, funds and portfolios, which is the primary purpose of ESG ratings.

Second, ESG rating divergence decreases companies' incentives to improve their ESG performance. "Companies receive mixed signals from rating agencies about which actions are expected and will be valued by the market. This might lead to under-investment in ESG improvement activities *ex-ante*," the report read.

Third, markets are less likely to price firms' ESG performance ex-post, that is after actual returns have been achieved and the ESG performance may be fundamentally value-relevant or affect asset prices through investor tastes. "However, in both cases, the divergence of the ratings disperses the effect of ESG performance on asset prices," the report added.

Fourth, the disagreement shows that it is difficult to link CEO compensation to ESG performance. The report said: "Contracts are likely to be incomplete, and CEOs may optimise for one particular rating while underperforming in other important ESG issues – that is, CEOs might hit the target set by the rating but miss the point of improving the firm's ESG performance more broadly."

ESG challenge

Finally, the divergence of ratings poses a challenge for empirical research, as using one agency versus another may alter a study's results and conclusions. "The divergence of ESG ratings introduces uncertainty into decisions taken based on them and, therefore, represents a challenge for a wide range of decision-makers," the report said.

It presents a challenging picture for investors, who are consistently wanting to show their commitment to ESG. But how can they do so convincingly when the scoring situation is such a contradictory mess?

For all of this, the report concludes that ESG ratings can still be some use. "ESG rating divergence does not imply that measuring ESG performance is a futile exercise," the report said.

"However, it highlights that measuring ESG performance is challenging, that attention to the underlying data is essential, and that the use of ESG ratings and metrics must be carefully considered for each application," the report added.

Ken Pucker, an ESG and sustainability senior lecturer at the Fletcher School at Tufts University in Massachusetts, is much more critical – and has long identified this as a problem. "ESG rating firms take self-reported data from companies on their corporate social responsibility [CSR] activities, add their own information and weightings, and mix it in a cauldron to come out with a rating for a company.

"A problem is garbage in, garbage out," Pucker added. "The reporting is not complete, results are mostly unaudited, and they are not comparable, so ESG ratings often use bad data that's unaudited, extrapolated and interpolated."

Just one

The report recommends how investors could obtain a better ESG scoring picture. "Investors could reduce the discrepancy between ratings by obtaining indicator-level data from several raters and then imposing their own scope and weight," it said. But this would be a time consuming for investors and not easy to undertake.

The paper presents a second option for investors to consider. "Alternatively, investors might rely on one rating agency after convincing themselves that scope, measurement and weight are aligned with their objectives."

The paper adds another recommendation: "A taxonomy of ESG categories would make it easier to contrast and compare ratings."

To be clear

The MIT report concludes on calling for greater transparency on behalf of rating agencies.

"First, ESG rating agencies should clearly communicate their definition of ESG performance in terms of scope of attributes and aggregation rules.

"Second, rating agencies should become much more transparent with regard to their measurement practices and methodologies. Greater methods of transparency would allow investors and other stakeholders, such as rated firms, NGOs and academics to evaluate and cross-check the agencies' measurements."

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DUAL-CLASS SHARES: ASSET OWNERS FIGHT BACK

A group of asset owners have come together to fight the ongoing march of dual-class shares to ensure that their voices are heard, finds *Andrew Holt*.

Global asset owners and the US association of public, corporate and union employee benefit funds known collectively as the Council of Institutional Investors (CII) have come together to create the Investor Coalition for Equal Votes (ICEV) to fight against unequal voting rights at listed companies.

Steering the initiative is Railpen, the £37bn UK railways pension scheme, along with the Minnesota State Board of Investment.

Joining them is the New York City Comptroller's Office, the New York State Common Retirement Fund, Ohio Public Employees Retirement System and the Washington State Investment Board.

The group's prime motivation is to prevent further enabling of dual-class share structures – without strict mandatory time-based sunset clauses – in the US and UK.

Share concern

The founding ICEV members have expressed their concern that differential voting rights dilute the ability of public shareholders to positively influence company management and hold them to account where necessary.

Although many new public companies embrace equal voting rights, public shareholder rights have been eroded among a minority of debuting companies in recent years across several countries, as company founders seek to secure disproportionate control and policymakers seek to encourage firms to list in their jurisdictions.

In the first phase of the initiative, ICEV will undertake a campaign with pre-IPO companies and their advisers, as well as policymakers, commentators and index providers in priority jurisdictions.

This will take place through engagement with private and public market participants as well as in policy forums.

Commenting on the launch of ICEV, Caroline Escott, senior investment manager at Railpen and ICEV's chair, said: "At a time when policymakers increasingly recognise the value of effective investor stewardship to achieving good member outcomes, it's vital that the shareholder voice is heard by company management.

"Voting is an important part of the stewardship toolkit, but dual-class share structures without automatic time-based sunset clauses mean long-term investors are trying to influence with one hand tied behind our backs.

"We are delighted to be working with the CII, a vocal and long-standing champion of corporate governance, and some of the world's leading pension funds to make the case for equal voting rights at portfolio companies," Escott added.

"The issue is fundamental to the ability to engage with, and hold companies to account on, material risks and opportunities, and we hope that the work of ICEV will mark a turning point in the dual-class share structure debate."

Hear my voice

The group is expected to include additional asset owners over time – with the potential of like-minded asset managers joining.

ICEV plans to open dialogue with key market participants and policymakers, emphasising the importance of the proportionate shareholder voice to effective stewardship and long-term sustainable company performance.

The creation of ICEV ties-in with Railpen's objective of making one-share, one-vote, one of its central engagement and voting priorities going forward.

Some big-hitting companies have gone the down dual-class structure route, including Google, Facebook and Snap, because of the amount of control it gives founders in overseeing the company.

Amy Borrus, CII's executive director, added that indefinite control is alluring to any founder contemplating an IPO. "So it's incumbent on investors to communicate early and together about this long-term corporate governance trainwreck. We are pleased to be partnering with Railpen as co-leaders in this campaign, as this issue is increasingly global," she added.

Legislation push

This effort complements CII's current draft legislation in the US that would require stock exchanges to bar listings of new dual-class companies unless they have seven-year sunset provisions, or if each class, voting separately, approves the unequal structure within seven years of the IPO.

"We will look to coalition members for their continued support in advancing the legislation," Borrus said.

ICEV carries some real clout collectively managing assets worth more than $1trn (£820bn) on behalf of nearly five-and-a-half-million members.

In the UK, companies with dual-class share structures can now list on the main market, following a rule change last year.

The move came as the structure was already being used on exchanges in New York and Hong Kong, which was seen as giving them a competitive advantage over London.

The change could also be seen as part of a broader push by chancellor Rishi Sunak to make London a more appealing destination for global investors and companies post Brexit.

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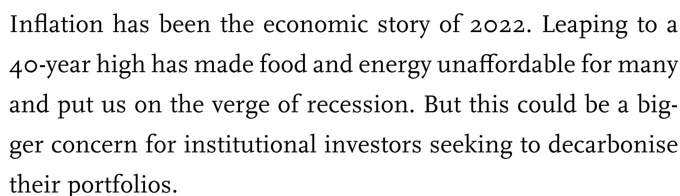
ESG: GREENFLATION



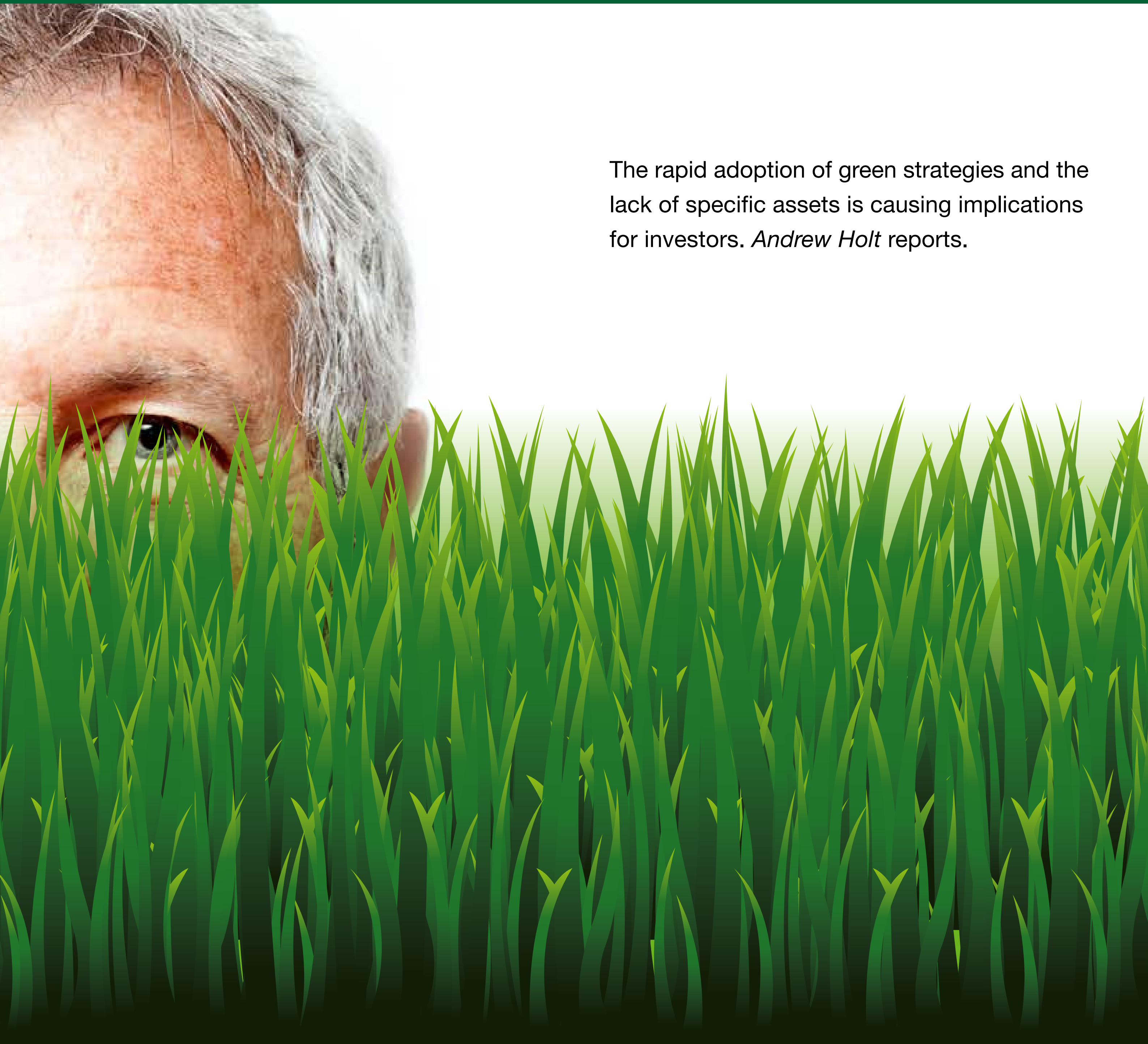
Inflation has been the economic story of 2022. Leaping to a 40-year high has made food and energy unaffordable for many and put us on the verge of recession. But this could be a bigger concern for institutional investors seeking to decarbonise their portfolios.

The invasion of Ukraine and economies still suffering from the impact of Covid have pushed up the cost of living, on top of that making the world greener and reducing inequality is another driver of inflation. In short, greening the world could potentially lead to what has become known as "greenflation".

This has implications for pension schemes and insurers who have committed to building sustainable portfolios amid a supply-demand imbalance which has pushed up the price of assets with a high ESG profile.

Madeleine King, co-head of global investment grade research at Legal & General Investment Management (LGIM), believes that greenflation is a problem for which there is no short-term fix. "It is definitely an issue and there are many aspects to it," she says. "Certain commodities being in short supply is not going to be alleviated anytime soon. Arguably, it is only going to get more difficult."

And some aspects of greenflation stand at the door of investors themselves. "You have a certain pool of green assets to invest in and a growing pool of investors who want to invest in them. It is a basic supply and demand problem – with more people wanting to invest than there are assets to invest in," King says. "So naturally, the prices of those assets have been driven up. The value of something considered purely green is arguably inflated."



The rapid adoption of green strategies and the lack of specific assets is causing implications for investors. *Andrew Holt* reports.

Same positions

This raises problematic questions about the market and how it works in terms of ESG investing, King says. "The market environment around ESG incentivises everyone to be invested in pretty much the same positions. Which is never a healthy environment. A regulatory system – with slightly unrealistic ESG standards – and a climate that encourages everybody to put the same trade on is ultimately not a healthy one for the financial markets," she says.

It is a concern shared by Désirée Lucchese, an ESG data and UN Sustainable Development Goals expert. "Capital flows and heightened interest in ESG funds have caused an increase in valuations of highly coveted stocks," she says. "These flows have not been adequately matched by availability of underlying investable assets. For years, green bond issuance of externally reviewed, certified or verified bonds have also been over-subscribed."

Lucchese, therefore, declares greenflation a negative scenario. "We are undergoing the greatest inflationary storm of all times; we are talking about escalating inflation with a bite," she says.

This will see greenflation combined with climateflation, which is where food crops and key commodities fail to reach market, and fossilflation where energy supply-demand comes under pressure. "These inflationary shocks mean that they will unexpectedly add to current and future price pressures," she says.

Deflationary scenario

But Alex Bernhardt, global head of sustainability research at

BNP Paribas, presents a different picture. "Greenflation is a transitory problem," he says. "The long-term effect of the transition to a greener, more sustainable economy that is less depending on fossil fuels is deflationary. Renewable energies over the longer term are going to be much more deflationary given they do not require ongoing fuel input costs.

"The challenge in the short term as we transition to a future greener economy is there are inflationary pressures that could arise on inflation from higher fossil fuel prices and higher prices in commodity markets needed to support the energy transition like copper and lithium," Bernhardt adds. "It will be particularly challenging if we do not invest adequately at the same time in building the green infrastructure necessary to replace fossil fuels. So it is important in the transition that all the people around the top tables responsible for this are aligned to that goal."

Lower level

Eric Nietsch, head of ESG Asia at Manulife Investment Management, also has the short-term implications of greenflation in mind. "Inflation of any kind is a problem for investors, especially fixed income investors. When it comes to greenflation, we have to think about whether the transition is contributing to inflation."

Here Nietsch cites some data that asserts a short-term greenflation picture, and a less stressful picture at that. "If we look at the value of commodities that are consumed globally, that has increased to $15trn (£12.2trn) from about $7tn (£5.7trn) during the past year, due to the Ukraine shock. That's about 7% of global GDP.

We are undergoing the greatest inflationary storm of all times; we are talking about escalating inflation with a bite.

Désirée Lucchese, an ESG data and UN Sustainable Development Goals expert

"If we were to compare that to a $50 carbon price being applied across all commodities globally, Citi estimates that would be about $2.5trn (£2trn). So that potential level of greenflation is only a third of the level of inflation from the Russian/Ukraine shock. It is likley even less than that – because that $2.5trn can be spread over time compared to the inflationary pressures that have happened with a single year."

Such numbers suggest a greenflation situation is not as problematic. "It is manageable. There is a time horizon aspect to it," Nietsch says. "If we try to think about greenflation and take a step back to look at the bigger picture, the implications of reducing greenhouse gasses by 2050 are massive.

"And many estimates state that it will require up to $5trn (£4trn) of investment annually – so it's probably not an understatement to say that this will reshape the global economy.

"That could create inflationary pressure, especially during the next 10 years when there is the capex going into new infrastructure," Nietsch adds. "But once that infrastructure is built, it will probably be deflationary after about 2030."

And any inflation in the meantime is something that could be kept under control, Nietsch says. "And even though it might be a little inflationary over the next decade, it is likely to be at a level that is pretty manageable. If we put that in the context of the annual investment that will be required for the transition, which creates a huge amount of investment opportunity for asset managers to participate in," he says.

Peter Mennie, global head of ESG integration at Manulife Investment Management, highlights a different angle to the greenflation scenario. "From a political perspective greenflation is a challenge. It obviously is important if we are going to successfully address climate change to retain popular support for the risks that faces."

And with the picture evolving over the coming years, Mennie admits that investment managers have a role to play in showing investors where the best places to invest will be, as greenflation takes some form of hold, even temporarily.

"In the ESG investment spectrum you have everything from ESG integration all the way through to impact products," Mennie says. "The onus is on us as investment managers to be as transparent as we can about the products and when they are likely to outperform and underperform. So when the asset owner is making their asset allocation decisions they understand that backdrop and how, and what, will work," he says.

Counterfactual case

To the many potential problems presented by greenflation one should also present a counterfactual of what life would be like if we did not take the transition road, Nietsch says. "The World Economic Forum estimates that climate change could lower global GDP by 11% in a 2-degrees scenario by 2050 and up to

The market environment around ESG incentivises everyone to be invested in almost the same positions.

Madeleine King,
Legal & General Investment Management

18% in a 3.2-degrees scenario relative to a world without climate change. And that would be even higher in Asia," he says. "So that could end up being either deflationary or inflationary depending on whether it materialises as a supply or demand shock. But we can agree that either way, the priority should be on avoiding that level of economic loss in the first place," Nietsch adds.

Whatever the likely worse-case scenario, greenflation inevitably presents a challenging picture for investors. Bernhardt has some interesting advice on how investors can make the most of the situation. "You can play the commodity angle, invest in commodity producers, ideally the most sustainable ones, or more interestingly, invest in low carbon solution providers," he says. "Increasingly more companies are developing new technologies to address decarbonisation challenges. And investors are providing capital for these companies to do things to scale. Embracing sustainable investment processes is the best thing to do to address greenflation causes in the real economy and related portfolio effects.

"What we are seeing in our portfolios in the investment landscape is that the energy transition presents a whole host of risks and opportunities, and as asset managers we can strive to avoid those risks and take advantage of those opportunities."

A rethink

King says though concerns about greenflation could present a rethink of LGIM's approach to ESG. "We may have to rethink if every fund needs to be 100% sustainable. I would argue, not every one of our clients wants that. Some will, and that's fine."

On investor trends in a greenflation environment, Lucchese offers some recommendations. "When we focus on greenflation, long-term investors certainly need to pay attention to how macro-trends are translating into local market dynamics and who the leaders are going to be out of robust strategic positioning in the short and medium term," she says.

King says a problem for investors is they are bound by ESG regulation, which, of course, could be creating greater greenflation problems. "Looking at this from the position of an investor, I would argue that the way regulation is positioned and moving right now is only going to make matters worse," she says. "Everyone is incentivised to chase the same small number of super green companies to invest in. And the demand for more to be as green as they can be is growing."

It raises questions for pension funds as well, says Lauren Wilkinson, senior policy researcher at the Pensions Policy Institute. "While greenflation is unlikely to cause pension investment strategies to backtrack on ESG progress, rising costs and limited supply of the raw materials needed for the creation of renewable technologies are likely to further complicate decisions about how best to allocate investment in order to meet targets and mitigate risks," she says.

Biggest scope

King challenges such conventional ESG investment thinking. "You do not need every company to be perfectly green and tick the taxonomy box today. But you need everyone to improve and transition across the climate path. It is here where we should be concentrating – on those with the biggest scope for change."

This leads to a more compromised and less idealistic ESG approach to avoid the problems posed by greenflation: with investors currently chasing the same green investments. "I think in the UK there is time for the green definitions to be a lot more practical than the EU taxonomy," King says.

"Hopefully in the UK we can get the regulation to be a little less restrictive," she says. "There needs to be some compromise if we are to construct sensible portfolios for our clients. You do not just want to let anything into an ESG fund. You want to have standards. But you do not want those standards to be so high that nobody wants to launch an ESG fund."

The piling into green investments, which in turn is boosting greenflation is also having a worrying impact on returns. "From an investor point of view the returns you can expect to generate from purely green assets is typically much lower than it was in the past," King says.

A point highlighted by Lucchese. "We are in for a sobering adjustment of market returns expectations and business transformation," she says. These are worrying sentiments for investors." But Lucchese adds that it is not all doom and gloom. "Darkness is defined by light, after all, and there is an upside to this: a new economics story." On this reading, greenflation, in all its various outlooks, may well be worth it in the long run.

Lloyd McAllister is head of ESG research at Newton Investment Management

FINDING NET ZERO

What measures are necessary to achieve net-zero carbon emissions?

Under most scientific projections around climate change, it is anticipated that global carbon emissions will peak around 2030, at a level that is around 16% higher than it is today, as the growth of emerging markets outstrips the reductions in emissions made by developed markets. This path is at odds with what most scientists agree is needed if we are to limit the worst effects of rising global temperatures.

On a historical and cumulative basis, the modernisation of the western world has caused most of the emissions, but from a forward-looking perspective, the population and wealth growth in emerging markets, in India and China in particular, is where much of the future concern lies.

As wealth increases, people buy increasing amounts of energy-hungry items – from fridges to cars. While some of the energy required to support those goods will come increasingly from renewables, we expect that the bulk will continue to be derived from fossil fuels, at least over the next 10 to 20 years. Thus, while the burden of historic emissions lies with the developed world, balancing the improvement of living standards in Asia and Africa with a reduction in carbon emissions presents a significant challenge over the next two to three decades. The International Energy Agency has released a 'net zero scenario' which sets out some of the necessary (and quite radical) conditions it believes will be necessary to achieve net zero in the most cost-effective way. Several key points stand out:

- No new oil and gas fields or coal mines to be approved
- Electric vehicles (EVs) to make up 60% of the global market by 2030
- Net-zero electricity to be achieved globally by 2040

EVs currently represent around 9% of new car sales and clean energy supplies around 35% of the grid globally, but these are at least areas where progress is being made; we know that in areas such as cement, shipping, long-distance aviation and trucking many of the technologies required to produce effective, affordable and scalable solutions don't yet exist.

The transition to a low-carbon energy scenario also re-quires significant investment. The world currently spends around $2trn (£1.trn) per year on its energy system, and economists estimate that it will require around $4trn (£3.2trn) of annual investment to achieve net zero, significantly more than current levels of investment. When weighed against annual GDP, the cost for the US alone has been estimated at around $1.6trn (£1.2trn).

At Newton, we are trying to play our part. We have joined the Net Zero Asset Managers initiative and have aligned ourselves with an independent methodology produced by the Science Based Targets initiative. Through the latter, we are committing to having 50% of the financed emissions of the companies we invest in on behalf of our clients tied to credible net-zero plans by 2030, with the aim of reaching 100% by 2040.

We will seek to meet these headline targets via a range of transparent measures around investments in climate 'solution providers', engagement with fossil-fuel com-panies to support their energy transition, and active stewardship activities.

While the 2030 and 2040 milestone targets might still seem some way off, we are making investment deci-sions today that we believe will aid our progress along the way. First, we are stepping away from areas we deem to be unacceptably risky, such as new coal mines, new coal-fired power stations, and speculative or high-cost oil projects. These are also areas carrying the high-est regulatory risk, as well as being at greater near to mid-term risk of substitution by cleaner energy sources.

We also focus on selective, well-managed opportunities around energy-transition metals like copper, EV infrastructure or supply chains, and clean energy.

Just because something is 'green' doesn't necessarily make it a good investment, but we expect to see a grow-ing number of investment opportunities in the energy-transition area over the coming months and years. If a company is well managed, executes well and operates in a stable regulatory environment, it is more likely to offer greater green-growth opportunities in the future.

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