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ESG Investing

Overview, recent developments, key drivers, and main challenges

Introduction

In recent years, we've witnessed a significant increase in ESG-mandated AUM over the last few years. The report provides an overview of the current state of ESG investing from a global perspective.

Initially, the report highlights the framework under which ESG investing is defined, outlining its 3 main factors: environmental, social, and governance. The analysis moves on to cover the current state of affairs in ESG investment and recent developments. Furthermore, we highlight the 4 key drivers of ESG investing, with a focus on the regulatory driver. Finally, we present the main challenges currently facing ESG investing.

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ESG investing assesses the environmental, social, and governance factors of an investment instead of focusing solely on a company's financial performance

Environmental Factors

- Climate change and carbon emissions
- Resources
- Pollution
- Biodiversity
- Energy efficiency
- Waste management

Social Factors

- Gender and diversity
- Employee engagement
- Community relations
- Human rights
- Labor standards
- Health and safety

Governance Factors

- Business ethics
- Executive pay
- Board diversity and structure
- Corruption
- Political lobbying and donations
- Whistleblower schemes

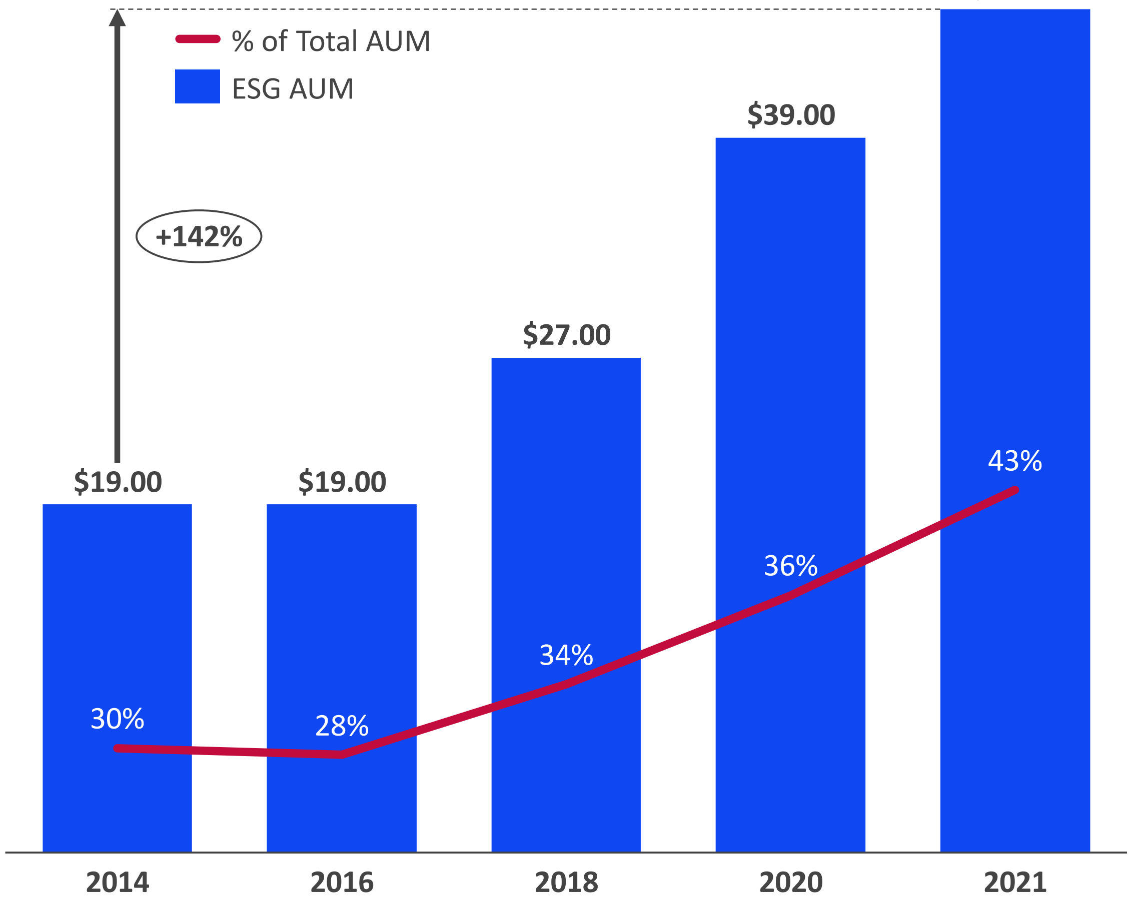
Sources: Web and press search

ESG-mandated AUM witnessed significant increases globally, both in absolute terms and relative to total AUM

- ESG assets under management (AUM) are dominated by equity funds
- The dominant ESG investment strategy is ESG integration
- ESG AUM grew substantially in the last 10 years.
- By 2020, institutional investors made up 75% of all investors.
- Europe and the United States make up more than half of global AUM.
- In MENA, 44% of issuers and 33% of investors indicated a higher interest in ESG investing, according to the 2020 MENA Sustainable Financing and Investing surveys conducted by HSBC.
- In Latin America, since 2020, Chile, Brazil, Ecuador, and Mexico have issued bonds linked to environmental or social issues to raise funds.
- Doubts are surfacing about the future of ESG investing. These doubts are highlighted by the Russo-Ukrainian War.

ESG mandated assets under management (USD Trillions, % of total AUM)

Source: Deloitte



Sources: *Deloitte, GSIR, Statista, HSBC, ECLAC,*

ESG funds vary in terms of types and approaches

These funds showcase the variations among the top ESG funds globally

	Parnassus Core Equity Fund	Vanguard FTSE Social Index Fund	iShares Global Clean Energy UCITS ETF
AUM (2020)	USD 22.94 Bn	USD 10.87 Bn	USD 6.52 Bn
Type	Active Fund	Index-based Fund	Index-based ETF
Location	United States	United States	Ireland
MSCI ESG Rating	A	BBB	A
Approach	• Excludes companies that generate significant revenues from several sectors, including weapons and fossil-fuel-related activities • Invests in companies with positive ESG profiles	• Excludes Companies that operate in or derive threshold amounts of revenue from activities such as tobacco, alcohol, and nuclear power • Excludes stocks that do not meet certain labor, human rights, and anti-corruption standards	• Focuses on companies operating in clean energy production or the provision of clean energy equipment • Excludes companies generating carbon emissions beyond specified thresholds

Sources: MSCI, Parnassus, Vanguard, and iShares

ESG investment drivers 1/2

The growth in ESG assets under management has been driven by several factors in the last few years, including:

- Increasing concern about environmental and social issues
- Push by regulators and policy makers
- The performance of ESG investments
- Minimizing risk exposure

Increasing concern about environmental and social issues

- According to a 2019 Morgan Stanley study, 85% of individual investors were interested in sustainable investing.
- Concerns about environmental and social issues is high among millennial investors.

Push by regulators and policy makers

- Regulators and stock exchanges across the world are introducing policy changes and financial products.
- In 2020, 25 stock exchanges required ESG disclosures, an increase from 2 exchanges in 2009.

Sources: Morningstar, Fidelity, BlackRock and Mckinsey

ESG investment drivers 2/2

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The performance of ESG investments

- Investors have turned towards ESG investments to leverage their financial returns, particularly in the long run.
- A study by Morningstar in 2020 covering 745 European sustainable funds indicated that they outperformed their non-sustainable counterparts over a range of periods reaching up to 10 years.

Minimizing risk exposure

- ESG-related risks have significant impacts on companies' market values.
- In the short run, revenues and profits decline after worker safety incidents and waste or pollution spills. In the long run, investors are concerned about climate change-related risks.
- In its marketing for ESG funds, BlackRock highlights the decreased investment risk on par with the decreased climate risk.

Sources: Morningstar, Fidelity, BlackRock and Mckinsey

ESG regulations are a key driver of the increase in ESG investments. 2022 witnessed the introduction of diverse and significant related regulations

Amendments to the "Name Rule"

Body: Securities and Exchange Commission (SEC) **Status:** Proposed **Date:** May 2022 **Geography:** United States

The proposed amendments to the Investment Company Act "Names Rule" would require funds with ESG-related terminology in their names to invest at least 80% of their assets in holdings that comply with the language used in their naming.

Environmental Disclosure Requirements

Body: Securities and Exchange Commission (SEC) **Status:** Proposed **Date:** March 2022 **Geography:** United States

The proposed rule would standardize and improve public companies' climate-related disclosures. The proposed rule covers GHG emissions disclosures, governance disclosures, and other qualitative disclosures (e.g., how climate change would impact the business and the availability of a climate transition plan).

EU Taxonomy Regulation/ Article 8

Body: European Commission **Status:** Implemented **Date:** January 2022 **Geography:** European Union

The article aims to increase transparency in the market and curb the effects of green washing. It requires issuers meeting specific size and financial criteria to disclose information on the extent to which their economic activities and operations are environmentally sustainable according to EU taxonomy.

Sources: CSSF, Deloitte, SEC, and S&P

The Russian invasion of Ukraine highlighted the challenges already faced by ESG investing and raised calls for the rethinking of the concept

Disruptions in energy markets

The war in Ukraine has led European countries to turn to fossil fuels to decrease their dependency on Russian gas.

The opportunity cost of not investing in oil and gas companies is increasing, making conventional funds more lucrative.

A notable impact is BlackRock's announcement that it will vote against shareholders' resolutions pursuing a prohibition on new oil and gas production.

Raised interest in defense expenditures

For years, investors shied away from defense companies as part of their ESG policies. A shift in attitude toward the defense industry has led investors to rethink their stances.

The compatibility of investing in defense companies with ESG has been brought into debate.

SEB, the Swedish bank, has allowed 6 of its funds to invest in the defense sector since April 2022.

Greenwashing allegations

Concerns are growing regarding ramped-up greenwashing practices across the industry through inaccurate representations of ESG factors.

Authorities are starting to combat the phenomenon, with measures such as the crackdown on Deutsche Bank by German authorities in 2022.

The war also highlighted the magnitude of investments by companies with high ESG scores in the Russian economy.

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