June 2023

The future of ESG after the bear market

Passive Investing 2023

create | Xtrackers by DWS

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Foreword

The end of the era of cheap money and the resulting downward correction in equity prices has coincided with the rise of ESG investing. But while stock markets are inherently cyclical, the trend towards ESG investing appears to be here to stay. ESG has fundamentally changed the way we invest, and the results of the latest Xtrackers by DWS sponsored report shows pension fund managers are embracing this change.

Certainly, the challenging market conditions of last year impacted ESG strategies in particular ways. The war in Ukraine turbo-charged the fossil fuel sector, for example, to the relative detriment of ESG-tilted investments. While being underweight in energy and defence stocks, ESG portfolios also tended to be overweight in tech stocks with good ESG ratings, which registered price falls in response to aggressive interest rate hikes.

At the same time, however, geopolitical uncertainty has focused minds on the 'S' and the 'G' parts of ESG. The ability of ESG to identify opportunities and risks traditional financial analysis fails to reveal – especially in the area of climate risk – is becoming increasingly recognised. More and more clients expect their managers to invest expressly in line with their individual ESG goals.

The tectonic shift to sustainable investing is therefore set to endure, with the majority of pension plans surveyed continuing to believe ESG factors remain critical to long-term risk management and value creation.

At Xtrackers by DWS we are committed to being part of this ongoing progress.

Thank you for your continued interest, and thank you also to CREATE-Research, for producing another insightful report, marking five years of collaboration with Xtrackers by DWS.

Simon Klein
Global Head of Xtrackers Sales, DWS

Acknowledgements

"The pessimist complains about the wind,
the optimist expects it to change,
and the realist adjusts the sails."

William Arthur Ward
American motivational writer, 1921-94

ESG investing has been advancing rapidly into core pension portfolios since the 2015 Paris Agreement on climate change. It came of age in 2022 in the face of two unexpected challenges: the savage market rout and the strong political backlash in the US.

What next? That is the question that has now come to the fore.

This is the subject of the first of two 2023 pension surveys in a research series that started in 2018.

It shows how pension plans are responding to these challenges, while they advance into a geopolitical climate of radical uncertainty where energy security and affordability have raced up national policy agendas.

The survey provides a timely perspective on the future of ESG investing after its first major setback.

As always, my foremost thanks go to the 148 pension plans who participated in an electronic survey. Many of them have been supporting our annual surveys since this series started. They have helped to create an impartial research platform on key asset allocation trends in the global pension industry.

Grateful thanks also go to DWS for sponsoring the publication of this report without influencing its findings in any way. This arms-length support has helped to deliver fresh insights into the evolving ESG landscape, as governments, regulators and various coalition bodies are reshaping the ESG agenda in different regions.

I would also like to thank IPE for helping to carry out the survey and to its editor, Liam Kennedy, for his wise guidance and unstinting support throughout this series.

Finally, I would like to thank four colleagues at CREATE-Research: Anna Godden for desk work, Lisa Terrett for survey management, Naz Rajan for survey analysis and Dr Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors or omissions, I am solely responsible.

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Executive summary

Key takeaways

- The ‘shock and awe’ anti-inflation measures from key Western central banks ushered in a savage bear market in 2022. ESG investing got messy as oil, gas, coal and controversial weapons made big profits due to geopolitical tensions sparked by the war in Ukraine.
- The majority of pension plans’ ESG portfolios underperformed because of their ill-timed sector bets: underweight in energy and defence stocks that soared, while overweight in tech stocks that crashed after steep hikes in interest rates.
- Other factors were at work too. They included the abrupt end of the longest bull market in history, a political backlash against ESG investing in the US and data challenges around ESG that added to investors’ nervousness in times of severe market stress.
- However, a significant minority of the surveyed pension plans met their return targets. Some even exceeded them. Their pragmatic approach did not exclude energy and defence stocks but relied on their stewardship activities to achieve their sustainability goals.
- The underperformance of 2022 is considered a temporary setback, not an irreversible trend. After all, most investment strategies are cyclical and self-correcting: they go in and out of fashion, with periodic ebbs and flows in capital markets.
- Irrespective of their recent experiences, the majority of survey participants continue to believe that ESG factors remain critical to value creation. The current travails are seen as the birth pangs of a better model of ESG investing that will pay off over time.
- Three in every five survey participants believe that ESG investing is not a bull market luxury but a foundational trend. The majority expect the share of ESG investments to increase in both their total as well as their passive portfolios over the next 3 years.
- The turbo-charged globalisation of the past 40 years has created many negative externalities that are reshaping the risk–reward profiles of listed and unlisted companies. These remain obscured while corporates are not mandated to declare them.
- The tectonic shift to sustainable investing will continue, but with one big difference: the increased burden of proof on whether ESG works. It has become more complex and nuanced. The end is not in question, but the means of getting there is changing.
- The new ESG disclosure regulation in Europe is driving the much-needed transition from the old principal–agency model of engagement to the stewardship model that promotes a stronger mutuality of ESG goals between pension plans and their portfolio companies.

“The history of societal progress is punctuated by innovation, regulation, improvisation and periodic setbacks. That applies to ESG too.”

An interview quote

ESG investing under the spotlight

A temporary blip or a big reversal?

This question came to the fore as capital markets turned ultra-volatile in 2022 and ESG portfolios trailed their return targets after outperforming for the past 8 years.

The backdrop was marked by seismic shifts that are now all too familiar: soaring inflation, aggressive hikes in interest rates, the Russian invasion of Ukraine and deadly extreme weather events in countries as diverse as China, Nigeria, Pakistan and the US.

Indeed, commentators talked about a ‘polycrisis’: where disparate shocks are cross-cutting in ways that ensure that the whole is greater than the sum of its parts.

Together, they unleashed a savage bear market that hit the good, the bad and the ugly indiscriminately. ESG was no exception.

The market carnage seemed to ignore new policy breakthroughs, charting fresh pathways towards progress on, for example, climate action. Examples include the European Union’s border adjustment taxes, the US’s Inflation Reduction Act, which channels billions into green energy and the agreement at COP27 on rich nations setting up a loss-and-damage fund to assist energy transition in developing nations.

Yet, ESG remains at a crunch point. Some 19 Republican-led states in the US have been pushing back against its perceived ‘woke’ or politically motivated decisions agenda.

For example, Texas passed a law preventing the state from contracting with companies found to be boycotting oil and gas. Florida updated its rules to ban pension funds from building ESG factors into their investing strategies.

The unexpected confluence of these events begs the question: is ESG investing just a bull market luxury, fuelled by central banks’ super easy money policies since the Global Financial Crisis of 2008, or is it a durable trend?

Accordingly, this year’s DWS/CREATE-Research global pension survey pursues four issues:

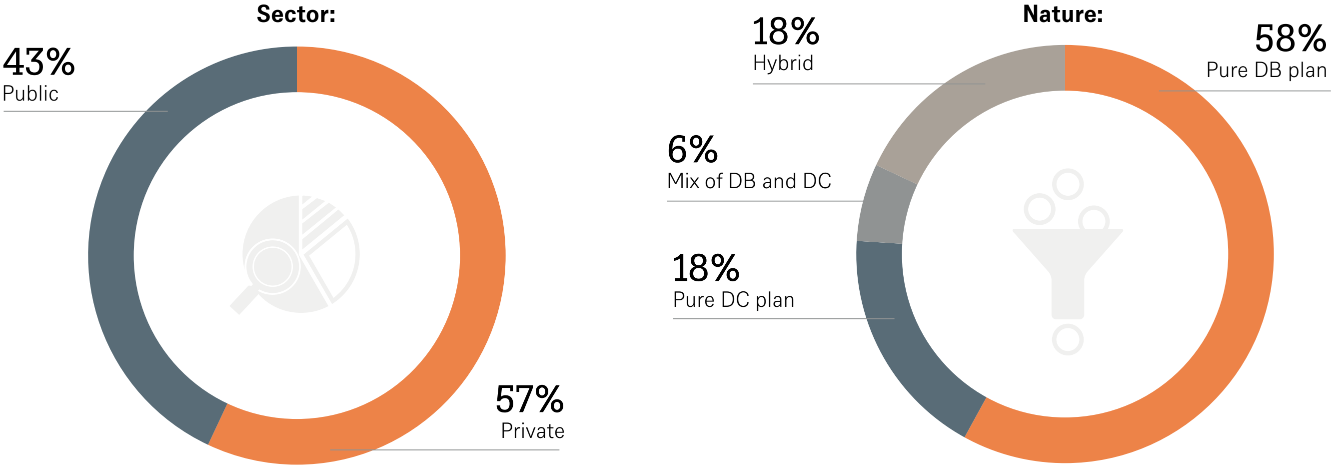
- How did pension plans’ ESG investments perform against their chosen market cap index as well as the rest of the portfolio?
- Was it generalised market-related factors or idiosyncratic factors that contributed most to ESG’s underperformance in 2022?
- What is the share of ESG funds in pension plans’ total investment portfolio and index funds portfolio?
- How are these shares likely to change over the next 3 years and what will drive them?

The survey involved 148 participants in Europe, Australasia and North America, with a total AuM of €1.7 trillion. The survey was augmented by structured interviews with senior executives in 20 participating organisations. Their background details are given in Figure 1.0. The survey provided the breadth, the interviews the depth and insight. The rest of this section presents the survey highlights and our four key findings.

Figure 1.0

Which sector does your pension plan cover and what is the nature of your plan?

% of participants



Source: CREATE-Research Survey 2023

Survey highlights (% of participants)

ESG performance in the 2022 bear market

58% Failed to meet their chosen cap-weighted market index

42% Achieved performance that kept up with or exceeded their chosen cap-weighted market index

52% Failed to keep up with the rest of their non-ESG portfolio

48% Achieved performance that kept up with or exceeded the rest of their non-ESG portfolio

Role of market-related and idiosyncratic factors in underperformance

59% Attribute underperformance to the bear market caused by a structural rise in interest rates

56% Attribute underperformance to a regime shift from QE to QT in central bank policies

60% Attribute underperformance to underweight position in energy stocks that soared

58% Attribute underperformance to overweight position in tech stocks that tanked

Current share of ESG in portfolios and future growth

56% Have more than 20% of their total portfolio allocated to ESG investing

46% Have more than 20% of their passive portfolio allocated to ESG investing

58% Expect ESG allocations to rise in total portfolio over the next 3 years

51% Expect ESG allocations to rise in passive portfolio over the next 3 years

Main findings

1. Ill-timed sector bets hit ESG performance

ESG investments underperformed in the 2022 bear market on two traditional measures: a chosen cap-weighted index and the return on the non-ESG part of pension portfolios. Their choice of measures reflects the fact that the practice of having a target return on ESG investments as part of top-down strategic asset allocation is slow to evolve.

The story is the same when judged against two separate measures (Figure 1.1). Taking them in turn, 58% of our survey participants reported that they failed to hit their chosen cap-weighted index, 20% met that index and 22% did better than the index (left chart).

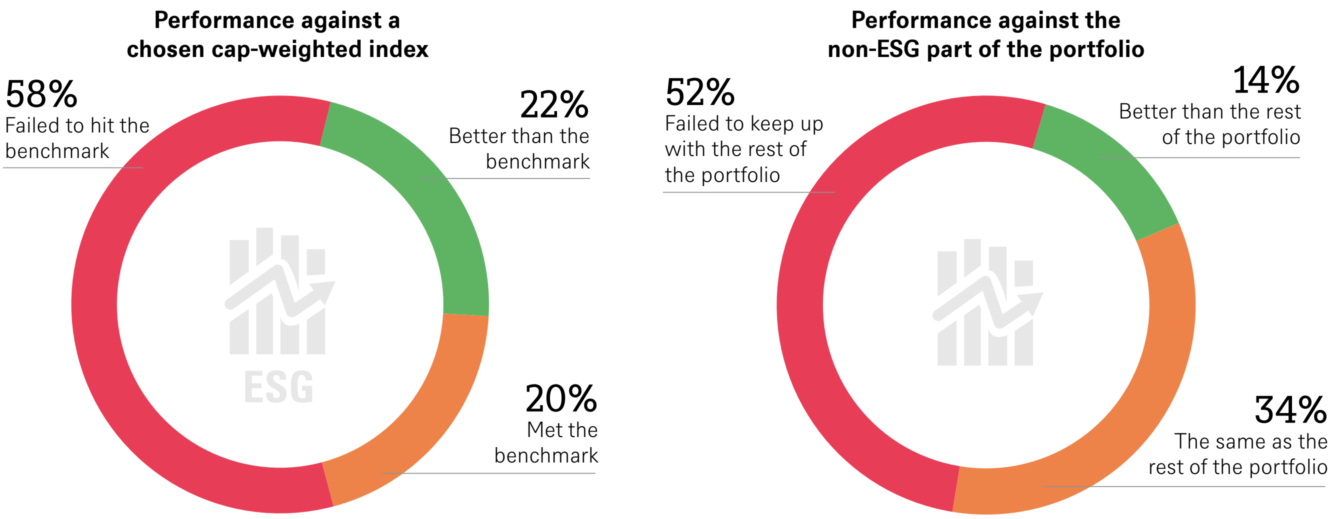
By a different measure, when performance is compared with the rest of the portfolio, 52% failed to match it, 34% were able to match it and 14% managed to outperform it (right chart). Thus, for the majority, ESG investments struggled to live up to expectations in their first serious brush with severe market turmoil. On the positive side, though, for at least 40%, ESG investing either met or exceeded their two benchmarks.

These findings are nuanced. There are two sets of causes: immediate and basic. The first set is covered here and the second in the next subsection. The immediate cause of underperformance was ill-timed sector biases in underlying portfolios. The conventional energy sector was a terrific investment in 2022 – up 67% – making it the star performer in the S&P 500. It soared in the middle of the last decade, nose-dived in 2019 and then roared back in 2022 in the wake of the Russian invasion of Ukraine: all in line with some 11 pronounced energy cycles since 1967. Also, the exclusion of controversial weapons companies from the portfolios meant that they missed out on the big bounce in defence stocks caused by the Russian invasion.

Figure 1.1

How did your pension plan's ESG investments perform with respect to your chosen performance measures in 2022?

% of participants



Source: CREATE-Research Survey 2023

"ESG suffered a big setback, as oil, gas and weapons made big money from the war in Ukraine."

An interview quote

Those survey participants who failed to beat their two chosen measures of performance are best classified as purists. They were underweight in fossil fuel, in line with their net zero goal as per the 2015 Paris Agreement. They believe that the transition to a low-carbon future is real, as shown by rising investment in renewables, as we shall see in Section 2. Besides, energy stocks will lose their glamour again as Europe succeeds in sourcing its fossil fuel needs from other regions outside Russia. As for the defence sector, the outlook remains cloudy due to uncertainty around the resolution of the Ukraine war.

Another immediate cause of underperformance was the overweight position in growth stocks, especially the tech sector. Its companies had long held two advantages for investors.

First, the prolonged era of low interest rates had hitherto vastly inflated the present value of their future income streams, driving their stocks into the stratosphere. Their appeal was all the more alluring in the light of academic evidence that, since the 1950s, roughly 5% of such stocks have driven net wealth creation in the US.

Second, the companies in question have also had high ESG ratings due to their overemphasis on human capital and community involvement. Both active and passive portfolios have been overweight in such companies. On the flip side, these stocks are exposed to higher market drawdowns, since rising rates always overly shrink future earnings. A good example is Amazon. Between 1997 and 2020, it suffered three drawdowns of over 50% – the largest being a fall of 93% in the 2000 dot.com sell-off.

So much for underperformance by ESG purists. We now move to another group, classified as pragmatists. Their investments either met their chosen benchmarks or exceeded them, for two reasons.

First, they envisaged that the rise in interest rates would cause a long overdue rotation from growth to value stocks, traditionally covered by energy, banks and materials. Value was a relative outperformer in 2022, thanks to an inflationary environment and rising interest rates that have usually favoured value over growth factors. This left them overweight in the energy sector.

Second, such opportunism was justified by their policy of actively engaging with 'dirty' companies rather than divesting them from the portfolio. For them, divestment simply shifts the ownership of the stocks, with no discernible impact on corporate behaviours. Some of the pragmatists also invested in energy infrastructure in private markets that aim to promote energy transition, while avoiding fossil fuel producers.

Irrespective of their experiences in 2022, purists and pragmatists report that ESG factors have shown positive or neutral performance across sectors over extended periods in the past. They also believe that energy transition and social progress is not something that will happen over a couple of years but is a pervasive trend that will eventually pay off. In the meantime, pension plans are becoming ultra-demanding on two key aspects: transparency and outcomes (Case study 1a).

Case Study 1a

The burden of proof is increasing

Our ESG investments took a big hit when the market boom ended abruptly in 2022. Until then, returns were in line with expectations, while aiming to make a difference to people, planet and profits. But the bear market showed all too clearly that they are not immune to short-term volatility. In hindsight, two sector biases played a big role: our underweight position in the energy sector and an overweight situation in tech stocks. Going forward, the setback has focused attention on two key aspects of ESG investing.

One is portfolio transparency. We have stepped up the disclosure requirements from our asset managers. These not only cover the thinking that goes with their approach to ESG, but also the risk models they use, the quality of data they rely on, the criteria underpinning their stock selection, their stewardship activities and, above all, their regulatory compliance.

The EU's Sustainable Finance Disclosures Regulation (SFDR) has had teething problems around the ambiguity on what 'sustainability' actually means. But it remains a powerful device for tackling greenwashing by requiring full disclosure on key issues like greenhouse gas emissions, the gender pay gap and boardroom diversity. These help to look beyond short-term volatility and capitalise on long-term structural trends that can deliver good risk-adjusted returns. That is what we remain focused on.

Another key aspect is outcomes. We now expect our portfolio companies to adopt a range of credible outcome metrics and report on them regularly. Our asset managers now know that the burden of proof has increased: we expect our ESG mandates to be invested expressly in line with delivering our goals.

A Swedish pension plan

2. Rocky markets and political backlash were the cause

When identifying the basic causes contributing to ESG underperformance in the 2022 bear market, the survey duly distinguished between market-related factors that overwhelmed all investment styles and strategies and idiosyncratic factors that were specific to ESG (Figure 1.2, left chart).

It emerges that both sets of factors were at work, but market-related factors was cited by the majority of survey participants (51%), followed by idiosyncratic factors (27%), followed by both sets of factors (22%).

Figure 2.1 in Section 2 details the factors under two headings. Taking them in turn, more than one in every two survey participants singled out four market factors: the structural rise in inflation due to Covid-19 and the Ukraine war (64%); the unwinding of the last decade's artificially inflated boom in securities prices (62%), the structural rise in interest rates in key economies to control inflation (59%) and a regime shift as central banks went from quantitative easing to quantitative tightening (56%).

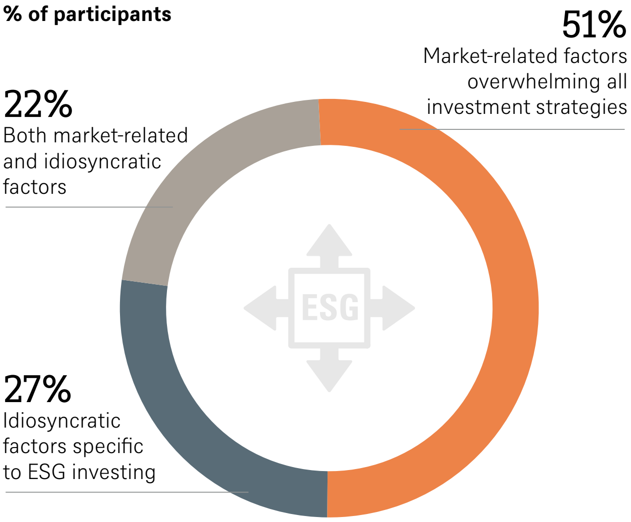
Moving on to idiosyncratic factors, at least one in every two participants singled out four factors, as shown in Section 2: ESG's underweight in oil stocks (60%); political backlash against ESG investing in the US (59%); ESG's overweight in tech stocks (58%); and lack of clarity on the impact of ESG on the ground (49%).

This lack of clarity, in turn, reflected a host of challenges around ESG data and metrics as well as the slower pace of the necessary response from governments and regulators in the past. Examples include the ambiguity around the term sustainability in the EU's Sustainable Finance Disclosure Regulation and the uncertainty around mandatory disclosures of ESG risks in the US.

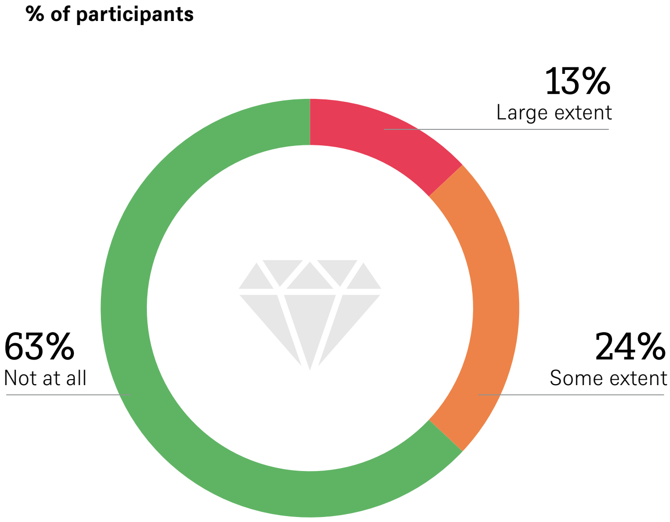
As described here, both sets of factors are interrelated to a large extent. It was the generalised market collapse that sparked the sell-off, which

Figure 1.2

Overall, which set of factors have had most influence on the performance of ESG investing in the bear market of 2022?



To what extent has ESG investing just been a bull market luxury that cannot withstand volatile markets going forward?



Source: CREATE-Research Survey 2023

was accentuated by idiosyncratic factors that had remained in the background while market conditions were benign. This applies especially to the lack of meaningful data, which has long remained a fundamental challenge to ESG investors. So far, few companies can disclose sufficient reliable data on the vital concept of double materiality.

It enjoins asset owners to look beyond the impact of ESG risks on their portfolios to understand how their investee companies' operations affect the social, economic and environmental systems around them. The concept requires a raft of non-financial information, which has been slow to materialise so far.

That apart, the political backlash against ESG in the US has unnerved pension plans inside and outside the US (Case study 1b). They are caught in the crossfire of rising political disputes, as are the top two global corporate proxy advisors – Glass Lewis and Institutional Shareholder Services – over their guidance tied to climate and social goals.

However, Republicans hoping to quash ESG investing in state capitols are, in turn, starting to face blow-back at state level. Bankers Associations in states such as Indiana, Nebraska and North Dakota have opposed any legislation that would work to the detriment of ESG investing. Also, Democrat-led states are pressing asset managers to uphold their ESG commitments despite criticism from their political opponents. Thus, battle lines are being drawn in the latest culture war in the US. The future of ESG is likely to be settled in the US courts. Pension plans worry that this backlash may force them to ignore investment factors that they regard as material for sound investing.

These developments have not dented our survey participants' views, but they have made them more vigilant (Figure 1.2, right chart). When asked whether ESG investing has just been a bull market luxury, 63% say 'not at all', 24% say 'to some extent' and 13% say 'to a large extent'.

Case Study 1b

Woke, Inc is under siege in America

Choppy markets hit the performance of ESG funds in 2022. But their politicisation in the world's biggest pension market was also a factor. While European governments have been setting formal targets for diverse boards and climate action, US politicians are engaged in a battle over the very soul of ESG investing.

On one side, some 20 Democratic states are making demands for fuller disclosure of ESG factors at corporate level and filing lawsuits against energy companies that fail to live up to their promises.

On the other side, ESG investing is under attack from right-wing groups that think it is entirely politically motivated. A band of Republican states have blacklisted asset managers for promoting ESG funds and neglecting their fiduciary duty by sacrificing the financial interests of end-investors in pursuit of 'questionable' political aims.

While the two sides have been trading blows, a group of conservatives have sued the Nasdaq stock exchange for requiring companies to have a set minimum of women and ethnic minorities as board members.

States like Florida and Texas have instructed pension plans under their jurisdiction to avoid ESG investing. It is likely that such pension plans could be hit by lawsuits if they suffer losses as a result.

In March 2023, Congress passed a resolution that nullified the Department of Labour's rule permitting the use of ESG factors in retirement plans. But President Biden has vetoed the measure. Thus, battle lines are drawn in America's latest culture war.

ESG investing is suddenly a riskier proposition. We still plan to divest all our fossil-fuel holdings by 2030 and switch to green energy. But you can't ignore politics for too long.

A US pension plan

The supporters of ESG investing adopt a holistic view. They see the rise of globalisation over the past 40 years as a double-edged sword. It lifted over 700 million people out of poverty in emerging economies; but as unintended side-effects, it also caused a hollowing out of middle-class jobs, rising income inequalities, rapid environmental degradation and rising market concentration, all contributing to the rise of populism in the West.

These externalities are reshaping the risk–reward profiles of listed and unlisted companies. The political backlash described above would have been far less vociferous if corporates had been mandated to document the inherent risks in their financial statements. These risks are existential; yet they are largely ignored in the 'war on woke'.

3. ESG is coming of age

As shown in the previous two subsections, rocky markets and political pushback mark a new phase in the evolution of ESG investing. Yet, our survey participants remain committed to reducing their exposure to financially material environmental, workplace and corporate governance risks. They see the current travails as the birth pangs of a better model of ESG investing.

It is clear that there is already a critical mass of assets in pension portfolios. In the total portfolio, 56% have allocations in excess of 20% and 30% have allocations in excess of 30% (Figure 1.3, left chart). The corresponding figures for the passive index funds portfolio are 32% and 12%, respectively (Figure 1.3, right chart).

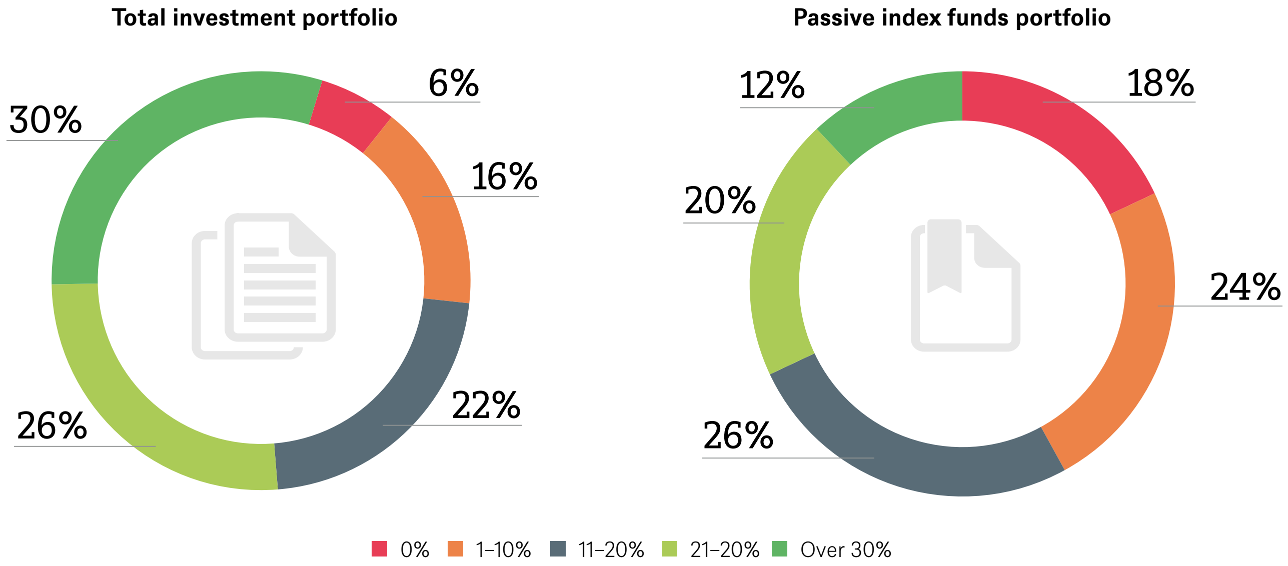
They reflect a cultural shift now in progress around the expanding scope of the fiduciary duty of pension plans. They are becoming increasingly explicit that earning a financial return is not the only goal they have for their investments. They want their investments to benefit the wider world as well.

"If US officials in Republican states could see an accurate representation of ESG risks in company accounts, they might well change their minds."

An interview quote

Figure 1.3
What is the approximate share of ESG funds in your pension plan's two investment portfolios currently?

% of participants



Source: CREATE-Research Survey 2023

In the US, ESG integration into portfolios is mostly about mitigating reputational and financial risks while chasing investment opportunities. This is why the Securities & Exchange Commission is promoting ESG disclosure so that investors can make informed choices.

In Asia Pacific, on the whole, pension investors currently trail behind their European counterparts in addressing ESG risks and opportunities. The exceptions are Australia, Japan and New Zealand. They are making progress in areas such as governance oversight, performance incentives for their asset managers and disclosure of their voting policies.

Europe, in contrast, has extended ESG disclosure requirements well beyond carbon, and asset owners are enjoined to implement the concept of double materiality: the risks faced by companies and, in turn, companies' impacts on outside stakeholders.

Accordingly, new actionable pathways are emerging under impact investing that channel ever more capital into solutions that meet the environmental and social needs of businesses and society. The solutions are designed such that financial outcomes and societal impacts are two sides of the same coin. In the last decade, impact investing only really existed in the venture capital stage of new start-ups. Now, it has gone beyond single asset class and includes actively managed private debt, private equity, public equity and infrastructure, among others. It has also advanced into passive portfolios, as shown in our 2022 report *Impact Investing 2.0.*

In the passive space, index funds are witnessing innovation via customised indices or new strategies overtly focused on climate change, like the EU's PACT benchmarks. For their part, ETFs have evolved in three distinct stages. They started out offering cheap and accessible beta returns. Then they followed precision exposure, such as thematic funds and smart beta, leading to a proliferation of ESG funds in this space. Finally, we are seeing the rise of actively managed ETFs, with granular ESG goals that have a high tracking error. This evolution has advanced furthest in the US due to tax advantages linked to ETFs.

The lack of meaningful data remains a headache for ESG investors. Security issuers do not always disclose sufficient data or do not do so effectively, posing measurement challenges in the absence of mandatory reporting. That ensures that the ESG ratings from external rating agencies have severe limitations. They have to use proprietary methodologies and varying weights for ESG components, both of which are rarely disclosed.

Research by MIT's Sloan School of Management found that the correlation among the top six agencies was 0.61 on average, compared with 0.99 for mainstream credit. The implied mismatches make it hard to make an 'apples with apples' comparison for ESG funds from different providers.

Worse still, vagueness around the term 'sustainability' in the EU's taxonomy has led to a wave of fund downgrades from Article 9 (dark green) to Article 8 (light green), and from Article 8 to Article 6 (absence of sustainability). InfluenceMap, a London-based non-profit body, found that more than 70% of funds promising ESG goals fell short of their targets in 2021. Globally, though, standards are steadily being introduced that will help to narrow the scope for misrepresentation. Notably, the International Sustainability Standards Board is introducing new ground rules for companies

Case Study 1c

No level playing field in regulatory requirements and reporting

Unlike our southern neighbour, ESG investing remains popular in Canada. But progress has been held back by the absence of nationwide regulation on the integration and reporting of ESG factors into the investment process. While the law permits pension investors to take such factors into account, it is far from clear whether that is a fiduciary obligation.

This ambiguity is due to the fact that there are five federal and 21 regulatory agencies, each with its own version of the rules, and each using inconsistent language. Hence some pension plans believe that ESG is part of their fiduciary duty and others don't. In a federal state, provincial regulatory bodies enjoy a large degree of autonomy. But this is not our only problem.

Canada was one of the early adopters of carbon pricing, despite its role as a big oil producer. Both political parties continue to espouse the benefits of carbon pricing as part of the programme to reduce carbon consumption in line with the net zero goal. Details on how that would affect the price motorists and households pay are unclear, as is how the resulting revenue would be used. Anything that raises the cost of living is a contentious issue. Voters also want to see a border adjustment tax that ensures that our domestic industry is not hit by cheaper imports from countries where there are no carbon taxes. It is essential to avoid this 'free rider' problem, if we are to have a credible approach to climate change. That requires action on the home front too: for example, households are encouraged to use electric vehicles but, as yet, there are no nationwide charging stations. Long queues are inevitable.

A lot needs to happen on the ground before ESG investing can live up to its promise.

A Canadian pension plan

"From its current midlife crisis, ESG will be morphing into a more credible form of investing."

An interview quote

reporting on sustainability. Even so, differences in regulation within countries with federal structures remain a problem (Case study 1c).

Overall, ESG investing is, rightly, under intense scrutiny as commercial pressure and ambiguous definitions increase the risk of greenwashing. This much has become evident with the publication of the 2022 report from the non-profit US SIF Foundation. By merely adopting a modified methodology and reporting, it has nearly halved the size of the US sustainable investment universe to USD$8.4 trillion in 2022, compared with USD$17.1 trillion in 2020. A similar phenomenon occurred in the EU after the SFDR regime beefed up its disclosure rules.

4. Strong tailwinds will continue for ESG investing

For investors, the war in Ukraine abruptly transformed the positivity of COP26 into despondency at energy shortages. But our survey participants believe that the Russian invasion will also be the massive external shock that will spark a step-transition towards a low-carbon future by exposing the out-and-out risks of energy dependency on Russia.

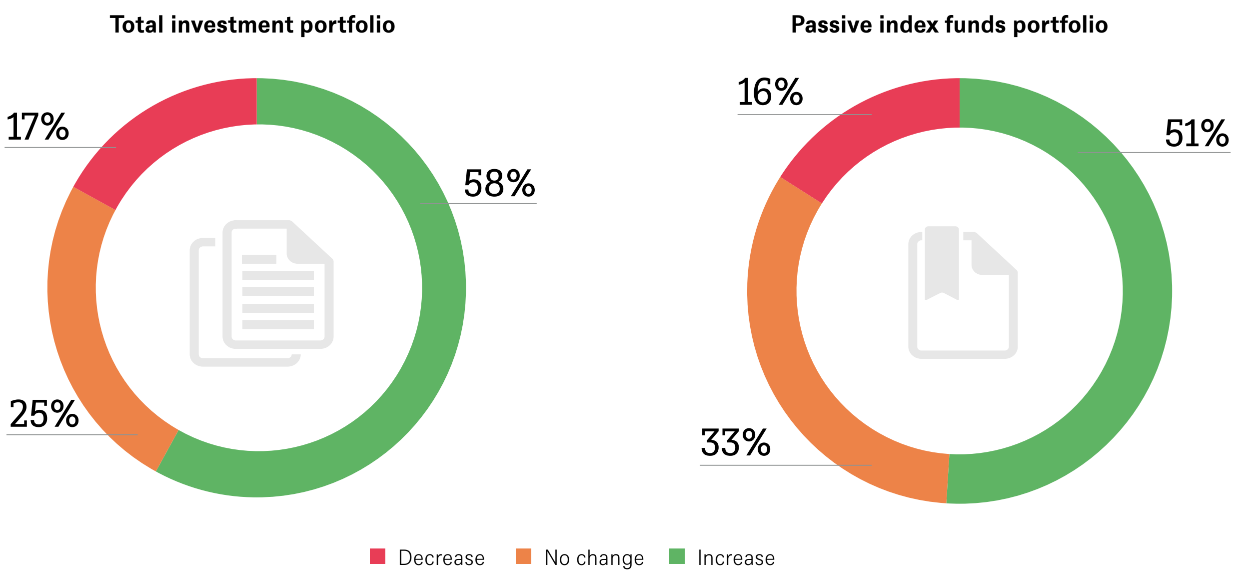
The survey asked how the share of ESG funds is likely to change over the next three years in the two portfolios. In the total portfolio (Figure 1.4, left chart), 58% expect it to increase and 17% expect it to decrease, leaving 25% expecting it to remain unchanged. The corresponding figures for passive portfolios are 51%, 16% and 33% (right chart).

As Figure 2.2 in Section 2 shows, at least one in every two survey participants singled out four growth drivers behind this assessment.

The first centres on new regulations on fiduciary duty (62%). Following the global financial crisis, regulators in key regions like the EU, Scandinavia and the UK legally required pension plans to pursue ESG goals as part of their fiduciary duty, as we saw in the previous subsection. The traditional 'shareholder first' model of capitalism has been challenged by the newly emerging stakeholder model. Advocacy groups such as Climate Action 100+ and the United Nations Principles for Responsible Investment (UNPRI) are attracting

Figure 1.4
How is the share of ESG-related funds in your portfolio likely to change over the next three years?

% of participants



Source: CREATE-Research Survey 2023

more and more members. Indeed, the litmus test now used by pension plans is whether their asset managers embrace these frameworks and others such as the Operating Principles for Impact Management.

The second growth driver is the rising role of stewardship aimed at promoting the ESG agenda, as shown in Figure 2.2 in Section 2 (60%). Stewardship is now firmly equated with long-term value creation. Before the 2015 Paris Agreement on climate action, engagement with investee companies was based on the traditional principal–agency model, where pension plans and corporate managers sought to pursue their own agendas to the point where there were clear conflicts of interest. The stewardship model, in contrast, seeks to minimise such conflicts by having a common agenda based on mutual interest. This progress has been made possible by the EU's Corporate Sustainable Reporting Directive 2022 and 2022 Climate and Investing Reporting in the UK. Not only do they treat ESG as a part of the fiduciary role, they also enjoin pension plans as well as their portfolio companies to report regularly on progress on the ground.

The aim is twofold: firstly, to augment the current infrastructure of data, skills and technology with shareholder activism that targets real-world outcomes at scale; secondly, to gain an information edge on how the ESG agenda is being implemented in ways that can help target alpha returns. Either way, via engagement, the aim is to invest in companies with a virtuous trajectory, as opposed to those exposed to controversy.

The third growth driver is a heightened search for good long-term returns as capital markets enter an extended era of low returns after a halcyon decade of stellar returns (53% in Figure 2.2 in Section 2). For their part, pension plans are becoming more selective in the companies they hold: ones where they can apply shareholder pressure to promote the ESG agenda and avoid those whose core business could not exist in a post-carbon world.

Their focus is on strategic hard-to-abate sectors that are both essential and high emitting. They include agriculture, chemicals, cement, oil, gas, conventional power, steel and transportation. Their successful decarbonisation is essential for meeting net zero ambitions, while delivering wider goals such as economic growth, financial stability and an orderly climate transition.

The final growth driver is the fresh policy momentum from governments and regulators in key regions (51%). In 2022, as described in Section 2, three pieces of legislation in the US made nearly USD$500 billion of public money for energy transition. This could treble if the private spending generated by it is included. China and India are investing huge sums in green energy. REPowerEU envisages substantial investment in renewables and a phase-out of fossil fuels in the EU, and Japan has adopted its Green Transformation (GX) plan. Indeed, 2022 was a milestone for decarbonising the world's energy system. It was the first year when investment in energy transition equalled global investment in fossil fuels, according to BloombergNEF. It was also a year in which, despite severe market dislocation, ESG-related ETFs in Europe still managed to attract annual inflows of €78.4bn, according to Investment Week (12-01-2023).

The regulatory push has come from the EU's SFDR, although it needs further clarity on 'Level 2', which requires asset managers to provide detailed disclosures to justify the categorisation of their funds, the reporting of which is carried out as per Articles 8/9 of SFDR.

Overall, the direction of travel is clear for public policy and investment regulation, but progress will remain piecemeal for now (Case Study 1d).

"Bad news should not mean minimising good."

An interview quote

Case Study 1d

GFANZ shows why ESG investing will remain a nonlinear journey of fits and starts

One of the highlights of COP26 in 2021 was the launch of the Glasgow Financial Alliance for Net Zero, covering around 500 financial institutions, which raised hopes that finance would play a critical role in climate action by leveraging the USD$130 trillion at its disposal. So far, however, only a tiny fraction of that sum has been forthcoming.

One reason is the Ukraine war creating an energy trilemma: environment, security and affordability. European governments have been forced into balancing conflicting needs in the short term by stepping up the demand for fossil fuels from sources outside Russia. Another reason is that a key voluntary body, the Finance Sector Expert Group, has been dissolved. It was meant to set standards for the finance sector and membership criteria for financial institutions for the UN's Race to Zero group.

For its part, Race to Zero has delayed plans to create a new accountability framework designed to track the net zero progress of financial institutions.

The reason is that binding restrictions on fossil-fuel finance proposed by Race to Zero could potentially expose institutions to litigation risks from having misled their customers when setting their own net zero targets. In particular, US banks have come under attack from Republican politicians for neglecting their fiduciary duty for the sake of a 'woke' agenda.

This has forced GFANZ to follow a broad-church strategy: to allow its sectoral suballiances to have their own governance structures. Thus, the path to net zero has innovations here and there and is fraught with twists and turns.

A UK pension plan

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2

ESG performance in the bear market

What will drive future allocations?

There are two sets of contributory factors behind the underperformance of ESG investing in the 2022 bear market: one covering external market-related forces that have little to do *per se* with ESG and other covering factors inherent to ESG.

However, taking a three-year forward view, interest in ESG investing will continue to grow. The key drivers will be fresh progress on the regulatory and policy front, growing interest in active stewardship and an intensified search for good returns.

1. Causes of underperformance

Figure 2.1 sets out two sets of forces that contributed to the underperformance of ESG funds in the 2020 bear market.

The upper panel covers the macro factors that caused market turmoil, hammering all investment styles and strategies – ESG included – indiscriminately. The turmoil was triggered by the abrupt aggressive policy reversal by central banks, as inflation soared during 2021-22 to a 40-year high. Our survey identified three principal contributory factors. One was the structural rise in inflation due to two fat-tailed events: Covid-19 and the war in Ukraine (64%).

The second was the resulting rate hike blitz by central banks (59%). The third was the severe policy tightening by central banks when inflation surged with the outbreak of the war in Ukraine. The policy reversal marked a regime shift: from quantitative easing to quantitative tightening (56%), bringing to an abrupt end the artificially inflated boom in asset prices (62%). So far, this episode has appeared to follow the 'shock and awe' playbook of Paul Volcker, who jacked up Fed policy rates to nearly 16% in the early 1980s as stagflation took hold in the US.

The 2022 market collapse also exposed some of the current design faults in ESG strategies that accentuated underperformance. These are shown in Figure 2.1, lower panel. If they had not remained untackled, ESG performance in 2022 would have been better. For ease of analysis, they can be grouped in three clusters.

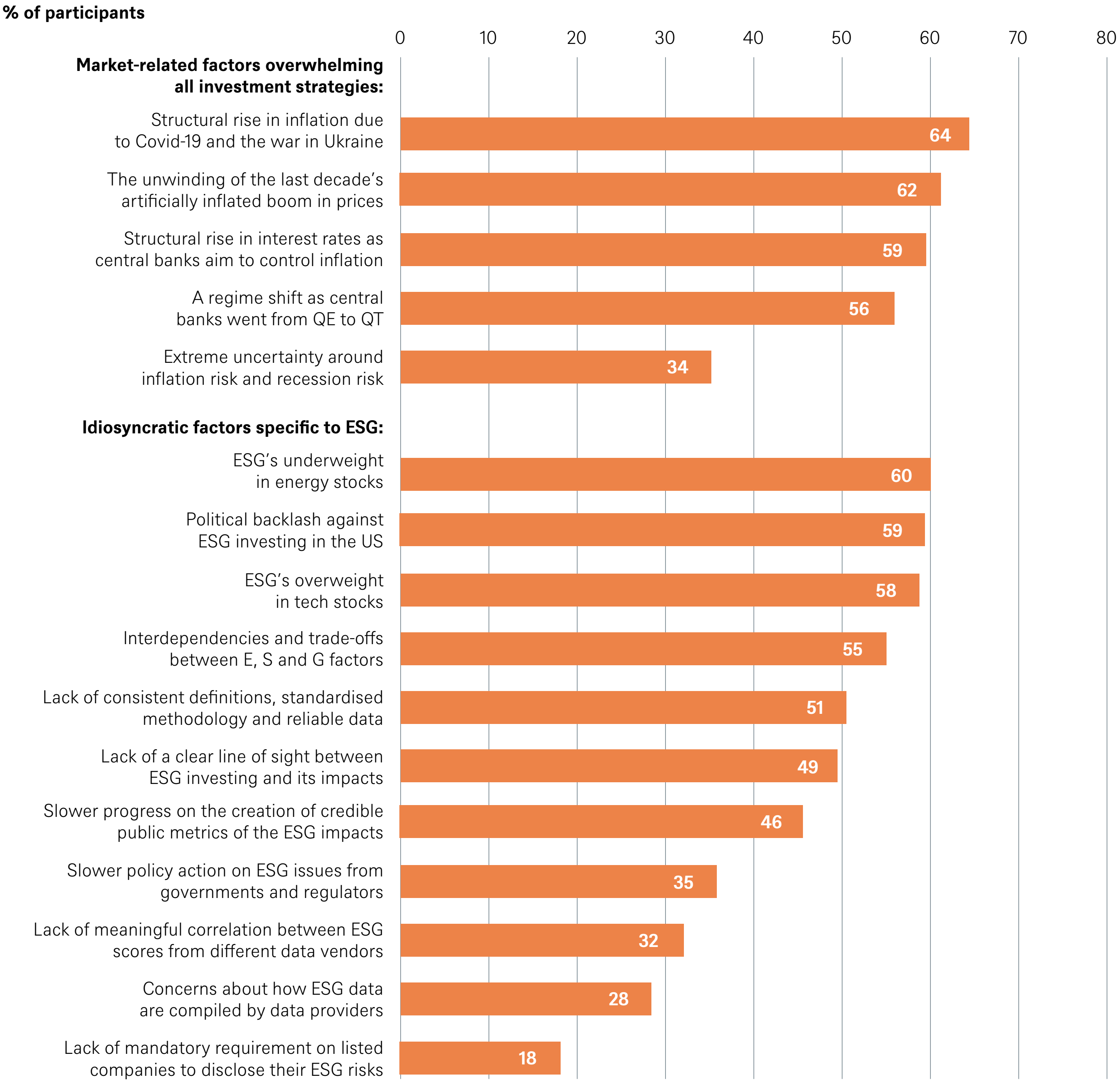
The first covers sector biases in our survey participants' portfolios as seen in Section 1: some were underweight in energy stocks (60%) and some were overweight in tech stocks (58%). Both worked against ESG performance.

The second cluster covers two political factors. One is growing political backlash against ESG investing in the US (59%). The US market holds nearly 60% of the world's total pension assets. It is currently tied up in legal knots over ESG. This has been exacerbated by the lack of a clear line of sight between ESG investing and its real-life impacts on the ground (49%). These points are covered in Case Study 1b in Section 1. Another political factor is interdependencies and trade-offs between E, S and G factors (55%), causing an extra layer of complexity. Trade-offs involve tough political choices between climate action and its social impact caused by stranded assets, as fossil fuel reserves are left in the ground well ahead of the end of their economic life.

The third cluster covers data issues. There are two noteworthy factors here. One is the slower evolution of consistent definitions, standardised methodology and reliable data (51%). The other is slower progress on the creation of public metrics of the ESG impact (46%).

The crux of the problem is that there is no universal acceptance of what constitutes a 'good' company in real life. Governments, therefore, shied away from mandating listed companies to provide the necessary data. This meant that a common language and the mental models necessary for a widely agreed statistical framework around ESG investing was slow to evolve. However, Article 173 of the French 2017 Transition Law was a game changer. It required mandatory carbon reporting for listed companies as well as pension plans. Other European jurisdictions followed suit,

Figure 2.1
What were the contributory factors behind adverse performance?



Source: CREATE-Research Survey 2023

"Underperformance is a temporary setback, not a permanent reversal."

An interview quote

as the EU launched its taxonomy and other initiatives that are now coming into effect. But the problems have not yet gone away (Case study 2a).

Case Study 2a

Data problems raise all manner of doubts about ESG in times of market turmoil

ESG investing will always have detractors, in the absence of consistent taxonomy and reliable data. Understandably, this absence elevated the role of rating agencies. There was a sense that they were filling a gap because corporate disclosure was low and voluntary. Where it prevailed, it was self-selective and self-serving: only metrics that seem to enhance the corporate image were reported.

The influence and reach of rating agencies has since grown to the point where they have come to the attention of the SEC in the US and the FCA in the UK. The SEC is currently considering whether they should be reclassified, from data providers to investment advisers, and duly brought under the remit of the 1940 Investment Company Act.

This is because rating providers are forced to make judgement calls on a host of ESG issues, as listed companies in key jurisdictions were only recently mandated to provide the relevant data. But even if the data were available, rating providers are still left to make subjective calls on what weights to accord to each of the three ESG pillars and their numerous subcomponents, so as to condense them into a singular metric. No wonder the correlation between rating providers of the same companies in the same universe is so low. Worse still, providers are also expected to predict how their estimated singular metric is likely to fare in future, so as to provide a snapshot of future ESG leaders and laggards. ESG ratings remain a messy and opaque pyramid of assumptions, riddled with data gaps.

Hence, when markets come under stress and your ESG funds are hit, you begin to doubt whether the current infrastructure of data is viable for developing strong conviction about ESG investing.

A German pension plan

2. Strong tailwinds are likely from regulatory and policy initiatives

As we saw in Figure 1.4 in Section 1, allocations to ESG investing are likely to grow, as the search for good long-term risk-adjusted returns intensifies. After all, all investment strategies are cyclical: they go in and out of fashion, with periodic ebbs and flows in capital markets.

That much is clear from three sets of mutually reinforcing growth drivers that are now jointly seeking to boost ESG investing and its impacts.

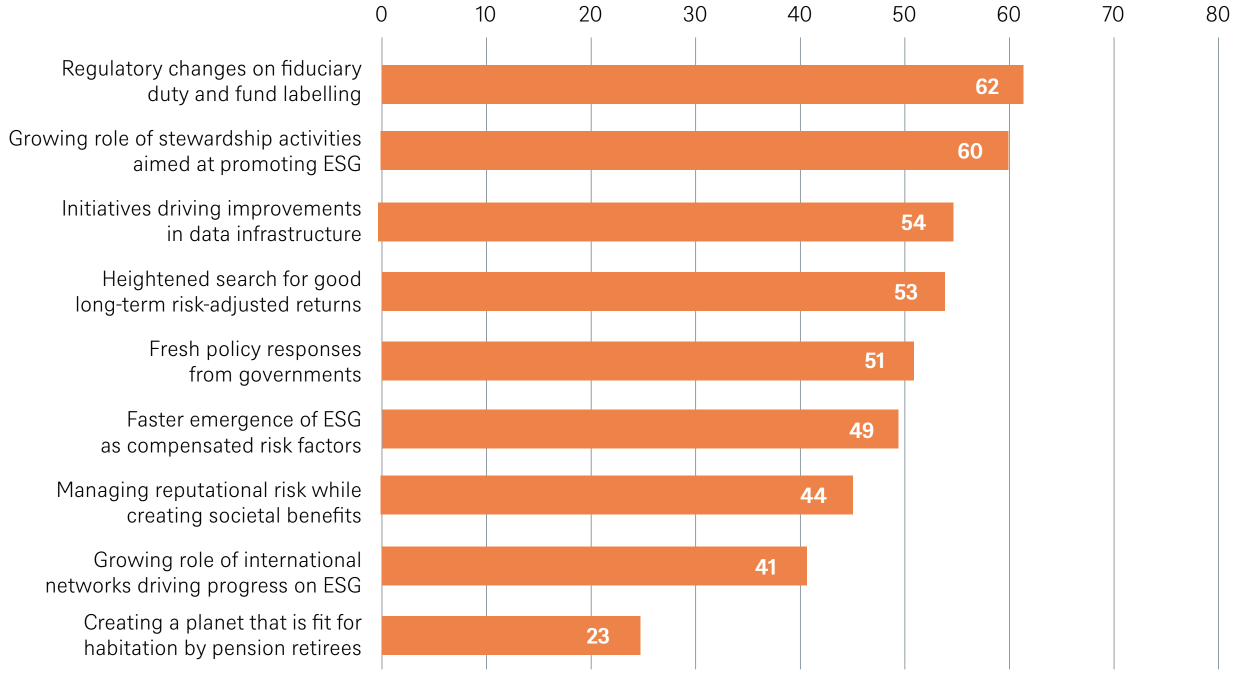
As Figure 2.2 shows, the first and most important set covers the recent regulatory (62%) and policy changes (51%).

Progress on the regulatory side is most evident in the EU. For example, detailed disclosure requirements came into effect in January 2023 under the SFDR; as did mandatory reporting on taxonomy alignment metrics for non-financial companies. Also, opinions on the first set of draft European Sustainability Reporting Standards have been submitted to the European Commission. Finally, consultations on greenwashing and fund names have received feedback and are awaiting decision. By the end of Spring 2023, the European Commission is expected to have given a clearer interpretation of the definition of what 'sustainable investment' means under SFDR, so as to avoid a repeat of the abrupt and disruptive downgrades in funds under Article 8 and Article 9 at the end of 2022 (Case study 2b).

Figure 2.2

Which factors are or will be driving interest in ESG investing over the next three years?

% of participants



Source: CREATE-Research Survey 2023

As for progress on the public policy side, three pieces of recent legislation, envisaging nearly USD$500 billion investment in green energy in the US, stand out: the Infrastructure Investment and Jobs Act, the Chips and Science Act and the Inflation Reduction Act. By tripling climate investment, together they are targeting economic sectors that have the highest GHG emissions, according to the World Economic Forum.

But that is not all: other regions are also stepping up to the plate. India and China are hugely expanding their capacity in renewables; while the REPowerEU signals policy intent to build more renewables and decrease dependence on fossil fuels. Japan has its Green Transformation (GX) programme, a 10-year roadmap for decarbonisation. Indeed, the International Energy Agency's World Energy Outlook for 2022 contends that the war in Ukraine could be a historic catalyst, ushering in a new era of cleaner and more secure energy. No wonder central banks and other prudential regulators are now under increasing pressure to better protect the financial system from climate shocks. Multilateral development banks, too, are encouraged to use blended finance, or use public or philanthropic funds, to de-risk private investment projects around ESG.

These changes focus on the environmental pillar of ESG. But progress is also evident in the social pillar, as shown by the 2023 German Supply Chain Due Diligence Act. It requires covered companies to carry out human rights and environmental audits to uncover risks, establish grievance mechanisms and remedy problems. Another example includes the tighter enforcement of laws in the US, aimed at restricting the import of goods believed to be made in whole or in part by child labour. For its part, the EU is also pushing through its own Human Rights and Due Diligence Directive that will force large companies to check whether their suppliers use slave or child labour, or pollute the environment.

"Although the direction of travel on regulatory and policy issues is clear, progress will remain incremental."

An interview quote

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Case Study 2b

Regulatory and policy progress are slow since they require a delicate balancing act

Recent regulatory progress on ESG disclosures for listed companies as well as policy changes at government level are welcome. We are always glad when they come and disappointed that they are so small. This applies especially to climate action. The world is fast exhausting its carbon budget and the chances of meeting the totemic 1.5°C climate goal are getting vanishingly small by the year.

Thus far, across the ESG space, the official response has come in small steps, not giant leaps. Mature democracies outside Scandinavia have been obliged to contend with fickle public opinion. Australia's 2014 reversal of its carbon levy after an 'axe-the-tax' election campaign is one example. Another is France's backpedal on energy tax rises forced by the gilets jaunes (yellow vests) protests in 2018-19. In both cases, what was billed as an environmental policy was perceived as a revenue grab.

In the West, periodic elections mean that politicians find it easy to kick the issue into the long grass rather than demand sacrifices from the electorate. After all, the net zero goal requires steep hikes in carbon pricing for all citizens and inflicts hardships on local communities by creating stranded assets. Between 60 and 80 percent of the world's carbon reserves will have to be left in the ground if the Paris goal is to be met. Regulators and governments are thus forced to perform a delicate balancing act that relies on incremental solutions to what is an existential threat.

As investors with multidecade liabilities, we have to accept that, while the direction of travel is clear, progress on ESG will be a matter of a few enlightened initiatives here and a few innovations there, with periodic setbacks in between – as marked by the political backlash in the US and the Ukraine war. That is what the history of great human endeavours shows.

An Australian superannuation fund

Moving on to the second set of growth drivers, progress on the data front is clear: 54% of survey participants anticipate that the identified advances in regulatory and policy areas will serve to accelerate improvements in the data infrastructure. The growing role of international networks like Climate Action 100+ and the UNPRI will remain at the forefront of progress on the data front (41%). Influential bodies such as the European Financial Reporting Advisory Group, the US Securities and Exchange Commission, the UK Financial Conduct Authority, and the newly formed International Sustainability Standards Board have now put forward concrete proposals on disclosure standards for ESG risks that are likely to have a material impact on businesses. These are expected to be adopted by 2024. Their overall aim is to enhance consistency and transparency on ESG-related issues and mitigate the risk of misrepresentation. Investors will be better able to compare corporate performance on risks and opportunities.

Moving on to the final set of drivers, there is expectation that the progress identified above will intensify the search for good long-term risk-adjusted returns (53%) by helping stewardship activities (60%) that will serve to ensure a faster emergence of ESG as a compensated risk factor (49%). Some also see the drivers as helping investors to manage reputational risk while creating societal benefits (44%).

3

Trade-offs within and between individual ESG pillars

What benefits are being targeted by ESG investing?

As pension investors climbed the learning curve of sustainable investing after the 2015 Paris Agreement, they placed varying emphasis on the three separate pillars of ESG. Currently, environmental ranks first, social second and governance third. Interdependencies and trade-offs between them are dealt with via a more activist form of stewardship and engagement, as well as thematic investing.

Currently, ESG investing targets a mix of overlapping goals: risk-adjusted returns, a double bottom line, a more defensive portfolio that minimises fat-tail risks, better diversification and lower portfolio volatility. Overall, their approach curtails risks and seeks opportunities to deliver good financial as well as societal outcomes. However, the double bottom line goal remains fine in theory but challenging in practice.

1. Trade-offs and interdependencies

As Figure 3.1 shows, in ESG investing currently, the environmental pillar is ranked number one (cited by 47% of survey participants), followed by the social pillar (33%) and then the governance pillar (20%). Successive annual COPs organised by the UN since the Paris Agreement have focused investor attention on the existential risks from global warming. In turn, the Covid-19 pandemic and Black Lives Matter protests worldwide have elevated the importance of the social pillar to the point where ESG pillars are no longer viewed as mutually exclusive.

Indeed, their trade-offs and interdependencies have become all too obvious lately as the war in Ukraine has pitted elements within the S and E pillars against one another. It has raised two dilemmas: first, whether it is ethical to invest in a weapons manufacturer whose products end up in the hands of Ukrainians trying to defend themselves against Russian aggression; and second, whether fossil fuel companies should no longer appear on exclusion screens, as they strive to plug the energy shortfall caused by the war.

Such contradictions also cut across the pillars. For example, the net zero goal will serve to save the planet but at the expense of local communities whose livelihoods have long relied on fossil fuels. Social media companies are another example. They are trying to create a diverse workforce while rejecting widespread concerns that uncensored material on their platforms affects children's wellbeing as well as the fabric of democratic institutions.

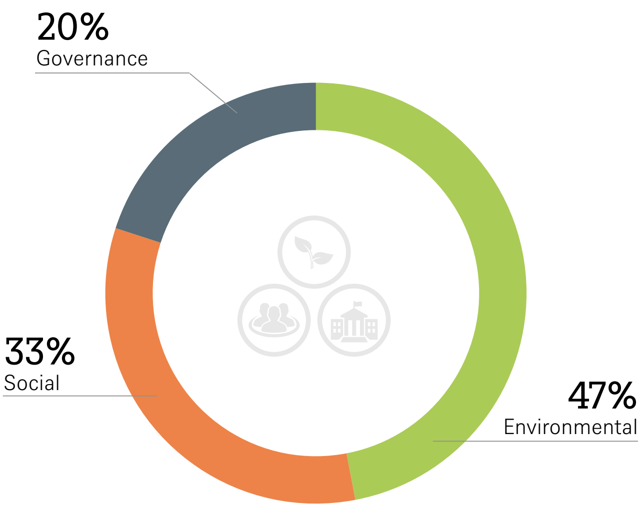
But individual ESG pillars can also generate positive spill-over effects via interdependencies: investing in biodiversity can improve human health, economic wellbeing and a well-functioning earth system. Also, good corporate governance can help set high standards for the E and S pillars.

Thus, an acronym like ESG can conceal as much as it reveals. Yet, there is not much support for decoupling the pillars among survey participants. After all, bundling them under a catch-all concept has given ESG strong legitimacy and attention among policy makers and investors alike.

Figure 3.1

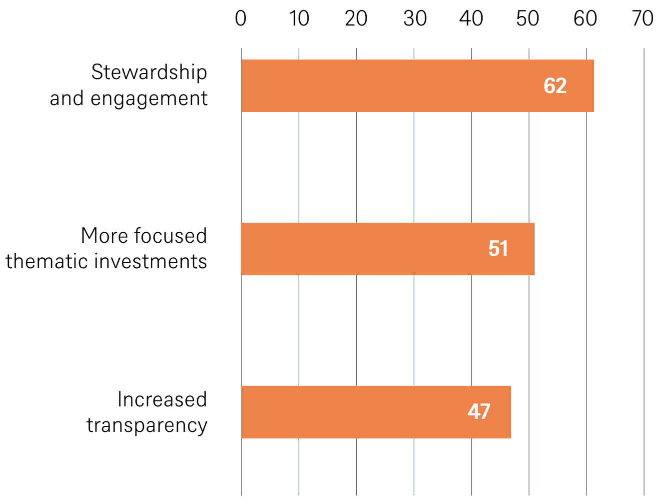
Which ESG component do you consider to be the single most important one?

% of participants



How do you intend to address the interdependencies and trade-offs between E, S and G factors?

% of participants



Source: CREATE-Research Survey 2023

To counter the resulting challenges, our survey participants rely on three avenues (Figure 3.1, right chart): stewardship and engagement is the most favoured (62%), followed by thematic investments that focus on granular themes (51%), followed by increased transparency around how a chosen theme is playing out (47%).

Ideally, it would make sense to pinpoint subject areas of interest to investors to enable portfolios to focus on them and avoid harm in other areas. But the current state of disclosures is not so mature across all areas. Pension investors are still grappling with the complexity of trade-offs within and across the 17 different Sustainable Development Goals, with a total of 169 targets. Hence their focus is on stewardship and engagement (Case Study 3a). They are seen as a more constructive way to encourage companies to handle the trade-offs by adopting a more balanced approach to ESG.

The membership of various international coalitions such as PRI, Climate Action 100+, and the Institutional Investors Group on Climate Change are viewed as a valuable resource for improving the effectiveness of shareholder activism in forcing oil supermajors to adopt the net zero goal. Indeed, some pension plans are now backing a lawsuit against Shell that alleges that its board is mismanaging climate risk and breaching company law. Similarly, Volkswagen now faces legal action by a coalition of pension investors accusing the German carmaker of refusing requests to answer questions about its private lobbying activities on climate change.

2. ESG investing is converging with fundamental investing

When asked which outcomes are currently targeted by their ESG investing, our survey participants identified five benefits that fall

"It's better for the planet to encourage and engage with high-carbon polluters. Divestment only moves the problem from one portfolio to another with no net gain."

An interview quote

Case Study 3a

Shareholder activism is becoming a risk management tool

We only invest in companies where we believe shareholder pressure can maximise value for us and wider society. We avoid companies that have no future in the post-carbon world. So far, this selective approach has not been easy. It has long suffered from the rhetoric–reality gap. The rhetoric holds that corporate boards are stewards acting solely in the interests of capital owners. The reality is that these boards just see themselves as agents and capital owners as principals, with the accompanying conflict of interest.

This principal–agency model has turned engagement into a box-ticking exercise. The new ESG disclosures requirements in the EU, especially Sustainable Finance Disclosure Regulation, will reveal whether the boards of listed companies are acting as real stewards of capital, or simply as markers of their own homework.

We try to steer them towards impactful forward-looking activities: such as strategic planning, CEO succession and oversight of all enterprise risks and opportunities, especially those related to ESG. Such activities can help the company create a viable future, while delivering financial and societal benefits.

Of course, we are mindful of 'reporting fatigue'. That's why we seek to develop a relationship of mutual trust with the boards, so as to have a clear idea about how our ESG agenda is being implemented in reality. It also allows us to influence the boards on tackling various thorny trade-offs between the E, S and G pillars.

At the same time, we are also quick to vote against the election of those board directors who do not support our ESG agenda and we do not shy away from divesting our holdings, if all else fails.

A Dutch pension plan

into two sets (Figure 3.2). Some of them overlap but all of them are consistent with the tenets of fundamental investing that rely on analysing the key financial and non-financial ratios to estimate the true value of a business over a defined time horizon.

The first set centres on returns. Good risk-adjusted long-term returns top the list (62%). A subset of these survey participants are also targeting a double bottom line: doing well financially and doing good socially (48%). There are regional differences.

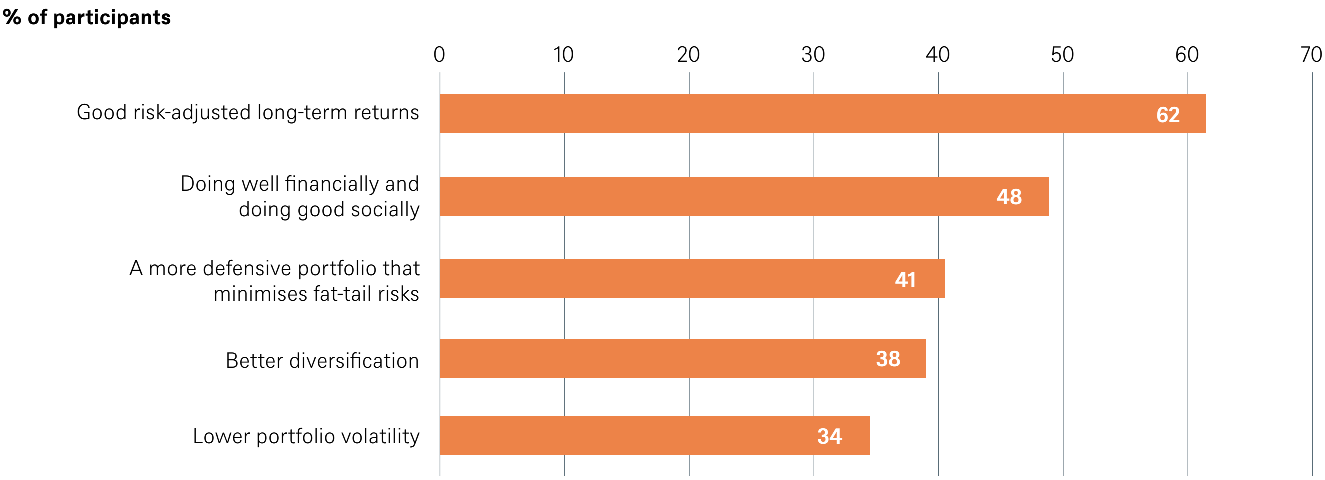
In the US, ESG investing is mostly about mitigating reputational and financial risks and detecting investment opportunities. It is consistent with the Securities and Exchange Commission's approach, now reaching the end of the consultation stage, towards promoting climate risk disclosure as useful for investors.

In Asia, China is leading the charge on regulation so as to meet the country's pledge to peak carbon emissions by 2030: the only country in the world to have such a target.

In Europe, regulators use a carrot and stick approach. Carbon prices are three times higher, thanks to the Emission Trading System and higher fuel taxes generally. Additionally, ESG disclosure requirements extend well beyond carbon footprint and centre on the concept of double materiality – risks faced by companies and the impacts of the companies' own actions on outside stakeholders. Unsurprisingly therefore,

Figure 3.2

Which benefits are your pension plan targeting with its ESG portfolio?



Source: CREATE-Research Survey 2023

the notion of double bottom-line resonates more widely within European pension plans compared with their US peers – as does the idea that ESG is now a compensated risk factor. Indeed, it is already correlated with traditional quality and low variance factors in many regions.

However, the emphasis on double bottom-line is a major departure from conventional investing and is forcing European pension plans up a steep learning curve (Case Study 3b).

Part of the problem stems from the confusion around what ESG investing is about for two sets of players. For pension investors, it means delivering environmental and societal goals on top of decent financial returns.

Portfolio managers, in contrast, think in terms of risks and opportunities that have a bearing on corporate bottom line. They have yet to develop the expertise to assess how their chosen companies make a positive difference in normative areas like human rights, vibrant communities and employee satisfaction – all varying between cultures as well.

Turning to the second set of benefits (Figure 3.2), these include: a defensive portfolio that minimises long-horizon fat-tail risks that are hard to model statistically since they have no precedents (41%); better portfolio diversification (38%) and lower volatility (34%).

The aim is to reduce portfolio exposure to dynamic risks such as climate change, societal upheavals and governance lapses that can be highly material to corporate performance.

After all, analysing a firm's past financial reports is akin to driving a car using only the rear-view mirror. The past is not a guide to the future, especially after cataclysmic events like the pandemic and the Russian invasion.

So, pension investors are looking forward by factoring in change, especially as markets are beginning to price in ESG risks that cannot be captured by existing backward-looking risk models based on past price behaviours. The aim is to prudently pre-empt ESG risks rather than be forced into panic mode when they materialise. The benefits identified in Figure 3.2 are being pursued through a variety of strategies.

"Risk management in ESG is about predicting and managing forward-looking volatility."

An interview quote

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Case Study 3b

The double bottom line proposition is tough to deliver

Double bottom line outcomes require us to make judgement calls around trade-offs in three areas: selectivity, intensity and implementation. There is considerable ambiguity in each of them to the point where unintended greenwashing becomes inevitable.

The first area enjoins us to choose between investing in all three pillars of ESG or being more selective and focusing on a particular pillar or its individual components. Currently, our interest is centred on biodiversity and global warming in the E pillar and human rights and workforce diversity in the S pillar. We are conscious of the inherent trade-offs that make it hard to estimate the double bottom line on a net–net basis. Selecting investments for non-financial gains is hard: the investment industry has yet to coalesce around measures that capture them.

The second area is intensity. Along the familiar spectrum of capital, put forward by the Impact Management Project, it measures the amount of risk-adjusted returns, if any, that we are willing to sacrifice for a specific positive societal outcome. This means differentiating between ESG factors that boost financial returns and those that do not. For portfolio managers, it is essential to have a North Star that codifies non-financial benefits because 'doing good socially' forces managers to make value judgements.

That leads to the third area, implementation. We have to decide whether we want to reward companies that currently score well on some chosen metrics in the hope that they will continue to attract capital or invest in companies that are likely to go from being ESG laggards to ESG leaders and are duly rerated by markets over time.

There are no ready solutions. ESG remains a journey of experiential learning for pension investors like us.

A French pension plan

In fixed income, the emphasis is on green bonds and social bonds. Transparency around the use of proceeds links outcomes with specific ESG goals. In equities, the emphasis is on resilient high-quality, well-run companies with good consistent return potential, admired brands and pricing power backed by strong balance sheets and a secular growth story that is less exposed to fluctuations in macro variables like interest rates, inflation and economic growth.

In private markets, the emphasis is on sustainability-linked loans used to finance specific ESG projects. Typically, they reward improvements in metrics measuring greenhouse gas emissions with reductions on a loan's interest margin. Similarly, private equity investments are also being used to decarbonise portfolios by reducing emissions from individual assets, and by carbon capture or removal technologies.

In passive portfolios, the weighting of companies in the indices is also based on the extent to which they adopt science-based targets and partly on whether companies are using recognised standards for climate reporting, as defined by the Task Force on Climate-related Financial Disclosures.

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