ESG IS **EVOLVING**

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ESG is evolving; but not in a way that simplifies matters for asset owners or managers.

The concept has always meant different things to different people, encompassing harm avoidance, recognising threats to business-as-usual from external changes and highlighting the need for better corporate disclosure. Some view ESG as picking "good" companies or avoiding "bad" ones, while others emphasise the need for all companies to consider environmental, social and governance risks, regardless of sector. The consensus is that better disclosure of relevant information enables improved decision-making by investors and policymakers. However, relevance varies between entities, which raises the question: Who decides?

Background

ESG enthusiasm peaked around 2021 amid the Covid-19 pandemic, as the world grappled with life's fragility and climate risks became more prominent. Many investors and commentators used "ESG" and "green transition" interchangeably, though they mean different things.

The 2021 COP26 Climate Conference in Glasgow saw the creation of the Glasgow Net Zero Financial Alliance, with global financial giants declaring support. ESG-related products and fund flows increased as companies embraced the trend. Some even claimed it could deliver superior short-term returns, which seemed plausible in 2020 and 2021 with low energy prices and high technology share prices. Some firms engaged in outright "greenwashing" by overstating their products' environmental friendliness.

Backlash

Subsequently, a significant backlash against ESG has emerged. The Russian invasion of Ukraine reminded the world of its reliance on fossil fuels, hurting ESG strategies not invested in this sector and emphasising energy security needs. Perceptions of weapons manufacturers shifted as their products were seen in some corners as important to defend democracies.

In the US, ESG has become entangled in culture wars, with high-profile Republican politicians deriding it as "wokeism". According to a UN PRI Policy Briefing, 37 states introduced over

160 pieces of legislation to limit or discourage ESG information use by asset managers and owners. This trend could escalate to the Federal level after the November election outcome.

Asset managers are caught in the middle.

Some US-based companies have toned down ESG messaging, wary of it becoming a political football, and there have been some high-profile withdrawals from initiatives like GFANZ and Climate Action 100+.

In contrast, European regulatory pressure favours stronger ESG application and disclosure.

Morningstar data shows that most ESG fund and ETF inflows came from Europe, peaking in 2021. Inflows decreased in 2022 and 2023, with US investors pulling capital from these funds in the latter half of last year. Total ESG fund assets were estimated at nearly $3 trillion at the end of 2023, with over 90% in Europe.

Asset managers now face diverging regulatory landscapes across the two largest fund management markets. This could lead to companies offering different product sets for each market. Questions arise about whether offering ESG and non-ESG versions of the same product is fence-sitting or a client-centric response to diverging demands, and whether asset managers should make big, potentially controversial decisions for asset owners without explicit mandates.

Strong ESG credentials alone may not win goodwill anymore, as illustrated by the Baillie Gifford case, where two major UK book festivals dropped the firm as a sponsor due to pressure from authors about the firm's links to fossil fuel investments. (Baille Gifford has been a PRI signatory since 2007 and has a dedicated ESG function, headed by a partner, that works with its investment teams.)

The South African context

In South Africa, greater ESG principle implementation by companies and investors. However, the country faces the additional complexity of conflicting "E" and "S" factors due to its reliance on coal for electricity generation. Renewable energy use has grown rapidly since President Ramaphosa liberalised power generation, but Eskom remains the largest producer, primarily using coal.

The Just Energy Transition Partnership (JTEP) aims to support South Africa's shift away from coal, with billions pledged by rich countries. However, progress has been challenging, with the government proposing delays in decommissioning some of Eskom's oldest power plants for reasons of energy security.

What do our managers say?

When compiling this Responsible Investing report, one of the questions we asked our managers was whether the ESG pushback described above has influenced their thinking. The answers were wide-ranging, as might be expected, but the underlying message remains that asset managers are committed to incorporating ESG risks and thinking into their investment processes.

One global equity manager answered simply:

"No. We have been consistent in our responsible investment approach."

In contrast, a large South African manager highlighted that the ESG controversies present an opportunity to improve processes.

"Yes, the controversy/pushback has provided us with insight to some of the fears and hesitancy that exist with regards to ESG integration in investment-decision making. In doing so we are able to address as far as possible these concerns. For example, the issue of data disclosure from investee companies has meant that, when engaging with companies, we are intentional about requesting relevant disclosure of data in their reporting suite. The concerns around ESG rating companies having differing ratings have resulted in us creating our own scoring methodology."

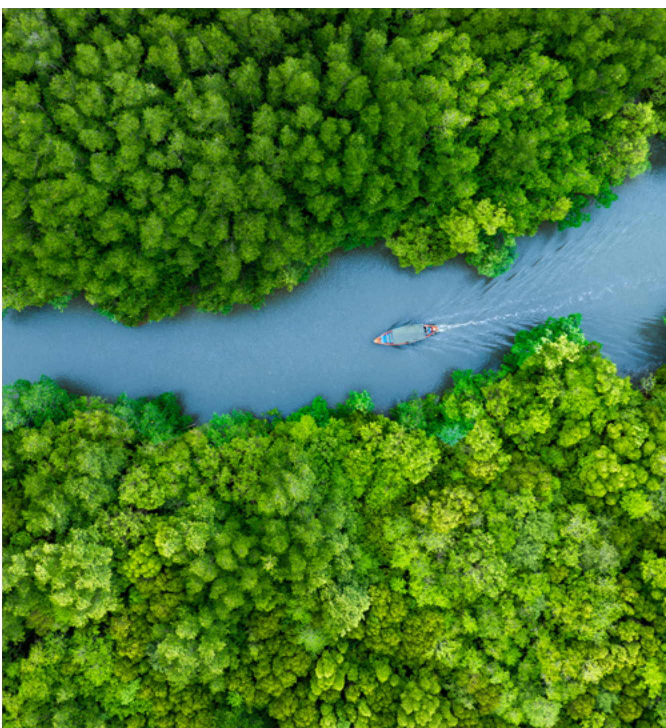
Others are clearly grappling with the various nuances. A large Cape Town-based manager argued that the benefits of

integrating ESG into day-to-day investment analysis remains very important:

"A broader information set allows a richer understanding of companies and their potential future success or failure. ESG analysis also considers the externalised costs of business that are imposed on broader society because of the risk that those externalities may in due course be internalised. We believe that failing to consider long-term investment value drivers which include ESG issues in investment practice is a failure of fiduciary duty."

Similarly, a local equity manager reiterated that it applies ESG considerations not primarily for its own sake, but to ultimately enhance risk-adjusted returns for investors. By implication, it is not the ESG label that counts, but the outcomes for clients.

"We take sustainability and ESG considerations very seriously, but have as our primary motive great risk-adjusted investment returns for our clients. Therefore, we consider long-term sustainability issues in our fundamental modelling of cash flows and the risk discount rate applied to them in valuations. We are very active investors on behalf of our clients and do engage vigorously with companies our clients own, with a view to reducing sustainability risks and costs to the benefit of our clients. The nuance here is that we are not doing this for sustainability outcomes in themselves, but for the economic benefit of our clients. With that motive in mind, we would say over the long term we have been effective in being stewards for our clients."



One of the large (and high profile) global managers we invest with argued that more needs to be done to engage with clients on ESG, rather than communication only going in one direction:

"We stand firm in our belief that investors and companies that take a forward-looking position with respect to climate risk and the low carbon transition will generate better long-term financial outcomes. However, as a leading asset manager, we know we need to address the misinformation in the marketplace. That's why we are engaging with stakeholders and ensuring clarity in how we are telling our story. As a fiduciary asset manager, our job is to listen to our clients and help them achieve their investment goals."

What is our view?

As a multi-manager, we are reliant on the managers we select to engage with the companies and entities whose securities they purchase on behalf of our clients. Our role is to set expectations for our managers and evaluate their performance against those expectations. We continue to believe that active engagement generates better overall results than outright exclusion, and in actively managed portfolios, we expect our managers to do exactly that: have ongoing discussions with the issuers of the relevant shares and bonds to improve reporting on ESG risks and implementation of alleviating measures. When ESG is merely a box-ticking or marketing exercise, it adds little value.

This approach allows for the fact that the world is complex, ambiguous and uncertain and that there are trade-offs involved. Our domestic managers are largely on the same page, and they recognise that South Africa faces a particularly difficult trade-off between the "E" and the "S" of ESG, at least in the short term.

Ultimately, the evolution of ESG is not making life easier for asset owners or asset managers. In the near future, it might not even be called it ESG anymore, particularly if using the term distracts rather than clarifies. Perhaps it could revert to the simpler form of "responsible investing" - responsible both in the sense of not causing harm to the environment, workers, communities and other stakeholders, and in being accountable for long-term stewardship of investors' capital. Either way, a key focus must remain taking into account the risks posed by things like climate change and social instability. There is no benefit to being blind to fundamental changes that can undermine the sustainability of the companies we invest in through our appointed asset managers. These principles remain important, and we remain committed to them, irrespective of the labelling.