J O Hambro
Capital Management Group

News

13 Mar 2024

At a *The New York Times* conference in late 2018[1], BlackRock CEO Larry Fink proclaimed that “demand for ESG [environmental, social, and governance] is going to transform all investing.” Less than five-years later and Mr Fink was referring to the “weaponisation of ESG….by the far left and … the far right” at the Aspen Ideas Festival in June 2023[2].

The increased politicisation of the ESG to which Mr Fink was referring was vividly evident in the (failed) campaigns of Ron DeSantis and Vivek Ramaswamy in the Republican nomination race for this year’s presidential election[3]. With only 22% of people in the US seemingly knowing what the now benighted ESG acronym stands for[4], it was probably not the best campaign strategy, something politicians in the UK may care to reflect upon in the run up to our General Election. As an aside, I have now heard two well-known BBC financial journalists state that the “S” in ESG stands for Sustainable, not Social!

The political backlash against ESG has a positive side, as it is forcing investors to become more rational and reconsider some of the more grandiose claims made at the height of the ESG boom. With increased anti-greenwashing scrutiny by regulators globally, politicians’ belligerent attitude to ESG may prove an unintended blessing to asset managers. Little wonder that many of the ESG tourists are leaving the field now that the sun is setting on the easy inflows into ESG labelled funds. More importantly, it will be a test for where voter preferences on sustainability issues really lies as they cast their vote at the plethora of elections taking place around the world in 2024.

The changing political narrative was recently highlighted by the ironic juxtaposition of the Labour Party’s announcement of a dramatic reversal of its green policy agenda on the same day it was revealed that the planet had for the first time hit 1.5C of warming in a twelve-month period. The inability of strained public finances to sustain the “Inevitable Policy Response” to tackling climate change, first set out by the UNPRI in 2018, was laid bare by Labour’s green retreat.

Inflation, higher financing costs and policy gridlock have damaged the speed of the energy transition by companies, particularly in the UK and Europe. Many projects have been mothballed, shutdown or remain mired in red tape. In China and India, by contrast, more flexible permitting arrangement have enabled a dramatic acceleration in the deployment of capital to grow renewable energy and EV charging capacity, though this is in parallel sadly to increased use of coal.

The exponential growth in generative AI is already accelerating demand for electricity. The lack of investment in electricity grids and myopic strategic planning by many governments is threatening the pace of the transition to a low carbon system. Political short termism is lengthening corporate transition plans. Energy companies are again increasing investment in fossil fuel production because of the financial and political incentives in the system. No amount of engagement is going to counteract government policy incentives, no matter how perverse these may seem.

Successful investing is rarely, if ever, achieved through idealism. Pragmatic reality is now being forced upon sustainable investing as being green is not a sufficient condition to guarantee good returns. Increasingly, through a combination of economic reality and anti-greenwashing regulation, the investment industry is switching its emphasis from ESG labelling to sustainability enabling. How capital flows and is enabled in complex systems is far more important than ESG engineered approaches based on scores and rankings. The recent announcement by the EU[5] of rules to deliver transparent and regulated ESG is welcome in this regard.

A recent paper by Ahn, Patatoukas and Skiadopoulos[6] on “Material ESG Alpha” raises interesting questions on the efficacy of ESG scoring methodologies in generating alpha. Once profitability and growth factors are accounted for in the methodology, ESG alpha evaporates. The often-misattributed conclusion from R F Ridgway's 1956 paper on “Dysfunctional Consequences of Performance Measurements”[7], and eloquently summarised by journalist Simon Caulkin, has a ring of truth:

> “What gets measured gets managed — even when it’s pointless to measure and manage it, and even if it harms the purpose of the o

An increasing number of academics and commentators are challenging the overly simplistic “win-win” mantra of much of sustainability marketing. While some commentators are professionally belligerent towards ESG, backed by spurious inferences that are equally as unsound as starry-eyed advocates promoting of a permanent ESG risk premium, nonetheless a more critical assessment of investors and corporate sustainability claims is a healthy development. The work of Alex Edmans, Alison Taylor, Ken Pucker, Harald Walkate, Kim Schumacher, Denise Hearn and Florian Hebe, and many others, is challenging us to take a more rational approach to sustainability claims.

Rational sustainability is not about undermining the importance of ethical, environmental and social issues in how portfolios and companies are run. Instead, it is about an honest assessment of the limits and boundaries that we encounter in navigating our way through a complex, messy system where trade-offs are inevitable in the face of shifting economic reality.

The trustees' considerations must be rigorously rooted in consideration of risk and return for the portfolio to meet beneficiaries' financial needs over appropriate time horizons.

---

1 Business Reaches a Turning Point - The New York Times (nytimes.com)
2 BlackRock's Fink says he's stopped using 'weaponised' term ESG | Reuters
3 A Divided Republican Party Is United Against ESG Investing (forbes.com)
4 Most Americans Still Unclear About What ESG Means, Survey Finds (forbes.com)
5 Sustainable finance: Council agrees negotiating mandate on ESG ratings - Consilium (europa.eu)
6 https://lnkd.in/egBaa6Wg
7 Dysfunctional Consequences of Performance Measurements on JSTOR
8 The rule is simple: be careful what you measure | Simon Caulkin, management editor | The Guardian

Disclaimer

Related Articles

Challenges to Responsible and Sustainable Investment

Clients expect expected fund managers to have greater responsibility for the social and environmental consequences of their investment decisions

Read More

28 April 2023