ESG: Risk management or a green bubble?

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A political debate

We watch with amazement as the US twists itself in politicized knots over investment and ESG. The ongoing Department of Labor (DOL) rule drama symbolizes this, where polarized politicians are debating whether it is acceptable for fund managers to potentially consider financially material ESG issues in their investment decision making.

Imagine yourself as fund manager, sitting down with a pensioner who worked hard all their life to create a savings pot and then telling them that you lost them money because you were forced, by law, to not consider the following in your investment decision making:

- The potential impacts of an evolving environmental regulatory landscape on company revenues;
- The potential impacts of low customer satisfaction on revenue generation;
- The potential impacts of low employee satisfaction on talent retention, productivity and strikes;
- The potential impacts of non-executive directors who are too busy to hold company management to account.

These kinds of ESG issues are clearly financially material and important to consider in any investment process that is focused on understanding risk. Despite all the media noise around the DoL rule, it has actually always been clear in Trump and President Biden's respective legal wordings that any factor can be considered in an investment so long as it is relevant to risk and return analysis[1].

It was the 2020 Trump rule that called out ESG factors being subject to enhanced fiduciary scrutiny which caused the perception in chilling effect around ESG considerations in an investment process.

Divergent approaches to ESG definitions

The main source of confusion in the press and between politicians in debates seems to stem from not distinguishing between ethical, sustainable, impact investing and ESG integration. Typically, the phrase ESG integration is used to describe a long-established and widely practiced investment approach which uses ESG information as an alternative dataset (compared to just using traditional sources of information such as the financial accounts or industry reports) to better understand the risk and return characteristics of a security.

The United Nations Principles for Responsible Investment report on fiduciary duty re-affirmed the position that the consideration of ESG within investment is part of fiduciary duty although recognized that this is based on the premise that the ESG considerations are financially material[2].

Of course, there can be subjectivity as to the extent to which an ESG issue is financially material. By the same token, there can be subjectivity over the extent to which a currency depreciation, an economic cycle or a liquidity issue can be material to a security price. This is what creates a
market – different competing views and interests.

Where it becomes murkier is when the investment approach is focused on not only using ESG as an information set to improve risk and return understanding, but also to avoid significant harms or gain additional exposure to positive impact companies, for instance in sectors such as education, healthcare or clean energy. This may be linked to financial risks or opportunities but may also already be priced in or simply a stylistic investment wish of the end client.

ESG considerations across the board

These days ESG integration has become so widespread within the asset management industry that when explained properly, the response from fund managers and analysts is usually along the lines of “of course we do that”.

A detailed global study that represented $31trillion of assets found that 82% of investment managers use ESG information in their investment process, the majority doing so because they believed it was a driver of investment performance or an area of client interest[3].

There are also reasonable concerns that ESG as a concept is causing green bubbles in valuations-given the increasing asset owner interest in ESG, the increasing level of government regulation on ESG such as the EU SFDR and the fast-moving clean technology innovation that is attractive from a growth investment style perspective.

The crux of the concern is that a wall of “ESG money” will flow into a small number of securities considered “ESG”. Indeed, even organisations like the central bank for central banks - the Bank for International Settlements - said in September 2021 that “ESG assets valuations might be stretched.”[4]

The bubble hypothesis refuted, but under scrutiny

However, an analysis of price to earnings and book ratios doesn't support the idea of a green bubble. For instance, the average price to earnings (PE) ratio of the MSCI ACWI is 35. For top scoring ESG stocks it is the same, at 35[5]. In fact, for lower rated ESG stocks, the average PE ratio is 42, indicating higher market prices for poor ESG performers. A similar story can be found on price to book measures, with the MSCI ACWI at 6.2, high ESG scorers at 5.7 and low ESG scorers at 4.9[6]. This implies that middling ESG scorers are being priced highest with lower prices for high and low ESG scorers and clean tech companies. One area of higher PE ratio compared to the MSCI ACWI is in a clean technology focused index, providing some evidence of investor willingness to pay higher prices for long duration green growth prospects.

These varied valuation characteristics struggle to convince us that a systemic green bubble exists. While regulation like the EU's SFDR and increasing client interest in ESG means there could theoretically be greater demand in securities which are aligned with these interests, the regulations are so broadly worded and clients interests within ESG so varied, it appears that there isn't enough focus at present to create a bubble. It is a fair concern to have though and so worth ongoing monitoring.

[1] https://corpgov.law.harvard.edu/2023/02/02/esg-investing-after-the-dol-rule-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights/

[2] Fiduciary Duty in the 21st Century, the United Nations (2016).

[3] Why and How Investors use ESG information: Evidence from a Global Survey by Amel-Zadeh and George Serafeim; Financial Analysis Journal (2018).

[4] https://www.reuters.com/business/sustainable-business/global-markets-bis-esg-urgent-2021-09-20/

[5] Source: Carmignac, MSCI, March 2023.

[6] Source: Carmignac, MSCI, March 2023.

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