ESG Investing Surging Globally, but Investors Beware of Greenwashing

Delegates at the Hubbis Investment Solutions Forum in September were treated to a tale of both great growth potential and also of caution from Andrew Daniels, Senior Analyst, Manager Research at global investment research and management group Morningstar. He told the audience of the growth in sustainable investment activity globally, but also addressed the concerns of 'Greenwashing', the practice of making ordinary funds appear greener than they are in order to win a larger slice of the growing wall of money pouring into ESG alignment.

DANIELS BEGAN BY EXPLAINING THAT HE WANTED TO HIGHLIGHT THREE KEY PRINCIPLES in his brief presentation. Number one is the growth of ESG - environmental, social, and governance - investing is actually a genuine global trend that is growing rapidly. Secondly, he wanted the audience to beware of 'Greenwashing' which is the practice of product issuers falsely marketing products as having ESG attributes. And thirdly, he highlighted what the funds and investment industry can do to address this.

A market enjoying rapid growth

Armed with some detailed and easily understandable slides, he then showed the audience the remarkable growth path of what Morningstar terms Sustainable Investment Assets, showing that these have grown from under USD4 trillion in 2006 to almost USD31 trillion today. "ESG has entered the mainstream," he reported.

He noted some other interesting trends. While institutional money has long dominated that total sustainable asset base, retail is actually growing at a much faster pace and now accounts for 25% of total sustainable assets, up from 11% in 2012.

He also explained that in Asia, the numbers are quite modest but rapid growth is expected. Out of Morningstar's universe of

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more than 3000 socially conscious mutual funds and ETFs, the bulk of the assets continue to be held in Europe with USD595 billion in AUM as of June this year, with North America meanwhile at about USD191 billion. But compare that with Asia with over just USD11 billion as of the end of June. "It underscores how much growth potential there is here in Asia going forward," Daniels concluded.

ESG gaining momentum

He then explained what drives the growth around these assets. ESG and impact investing are moving up the political and economic agenda, and the world has started to focus on economic implications of natural disasters, extreme weather events and what climate change's impact is on food and water supplies.

The second driver is regulation. He noted that more governments, as well as regulators, are playing an increasingly active role to ensure that companies are adopting sustainable practices, as well as encouraging asset owners to make sure that they adopt ESG factors in their investment decision making.

Finally, there is a growing body of research that is showing a positive link between ESG considerations and either return enhancement or risk mitigation. "These factors," he reported, "are combining to significantly change investor preferences, and there are analogues in other industries as well.

Alignment of values and principles

Daniels then covered what sustainable investing is. "It is a complex area," he observed, "and can actually mean different things to different people. There are many terminologies that are being used from SRI to ethical and green investing, but from Morningstar's perspective, we see this in three segments."

The first segment, he explained, comprises investors that consider sustainable investing to be exclusionary based on their values, such as avoiding tobacco, gambling, alcohol, weapons and so forth.

The second is ESG integration where industries are not excluded by screens, but instead integrated into the fundamental research process for alpha generation and risk mitigation purposes. "This is the area we're seeing increasingly adopted by asset managers globally," Daniels said.

And the third type is what is called 'impact investing,' where the capital is allocated based on financial returns, but also based on impact measurement on certain causes, for example, clean water, women's empowerment, education, public health and so forth.

Watch out for false prophets

All of this complexity on the nomenclature applied to this type of investing has allowed some product issuers to disguise their products in the market by using loosely defined attributes and overstating their commitments around ESG to potentially garner assets from the marketplace. They do so to gather assets under effectively false pretences, as more and more money migrates towards ESG.

"And that is what we call greenwashing," he explained. "Although there is no standard definition of greenwashing, the European Commission terms this as unsubstantiated or misleading claims about sustainability characteristics and the benefits of an investment product."

He highlighted the many funds in 2018 have launched with purportedly sustainable characteristics. "Actually," he reported, "while many are actually

truly repurposed towards ESG, some of them are merely renamed. It was just a relabelling exercise, nothing really changed. They are simply trying to grab a larger piece of this growing pie."

And, without naming the managers directly, he showed the audience some major funds that had been market as ESG integrated or impact funds, but its holdings conveyed a different story.

Diligence where it is due

That brought Daniels to his final point, his assessment on how the industry should respond. He said fund managers should be more transparent on how they incorporate ESG into their investment processes as well as their engagement through shareholder resolutions. There are regulators such as the Hong Kong SFC that have issued guidelines for investment management companies.

Most importantly, the investor should conduct their homework, look under the hood, drill down funds at the holdings level rather than simply relying on labels. He closed by showing delegates the Morningstar Portfolio Sustainability Report as one of the main tools to look at while doing due diligence on supposed ESG related strategies. "The report, coupled with time series data, help us ask better questions to portfolio managers about specific holdings throughout our due diligence process. This leads to a better understanding of the investment approach, and ultimately helps us verify whether the portfolio managers are employing the approach as stated," Daniels said.

"This is an exciting and dynamic area for the world of investment," he concluded, "and although in its nascent stages of development, the industry is certainly heading in a positive direction." ■