ESG INVESTING:
THE RISE, THE DECLINE, AND THE QUEST FOR AUTHENTICITY

INTRODUCTION

In the past decade, investments centered around sustainability have seen significant growth, now amassing over USD4 trillion globally. The term ESG, introduced in 2004, has become a central theme in the investment world. Fast forward to nearly 20 years later, and it's a term many investors frequently mention when discussing their portfolios.

However, there's a puzzling trend emerging: sales of sustainable funds are on the decline. This suggests a disconnect; while investors talk about sustainability, their investment choices don't always align with it. Concurrently, the demand for sustainability analysts and portfolio managers seems to be waning. But why is this happening? That's a question that Hubbis has sought to ponder.

» Losing interest, losing steam

Buzzwords like 'ESG' and 'sustainability' are often seen as just marketing strategies. As of December 2021, funds that openly target environmental, social, and governance (ESG) objectives managed over USD2.7 trillion worldwide. European funds represented 81% of this amount, while U.S. funds made up 13%. In the final three months of 2021 alone, investors poured USD143 billion into these ESG funds. However, these funds frequently fail to deliver the expected returns. Additionally, there's increasing scepticism about whether many 'green' investments genuinely align with ESG objectives. This has led to a rising reluctance among fund managers to embrace ESG products.

This dissatisfaction is echoed among end clients. Research from AML Group and The Nursery found a 6% decline in investors valuing ESG or sustainable investing in 2023 compared to 2022. A Charles Schwab survey reinforced this, indicating that just 38% of British retail investors consider environmental, social, and governance factors when making investment decisions, a drop of 6 percentage points from December 2021. A significant factor is the underperformance of these investments compared to their non-ESG peers, as highlighted in the Charles Schwab study.

Furthermore, ESG investments often come with a higher price tag, a cost many investors are becoming reluctant to bear. Charles Schwab's research suggests only half of the surveyed investors are willing to assume these extra charges.

Yet, it's worth noting that younger demographics, particularly Gen-Z, continue to prioritise ESG factors in their investment decisions. Some argue that it's the fund managers, not the investors, losing interest in ESG. This trend seems to resonate with intermediaries as well, as identified by the Hubbis team.

A lack of practitioner participation?

During an off-the-record Hubbis round table last year, attended by representatives from several prominent family offices, a glaring problem was brought to light: the prevalent disconnect in the sustainable investing chain. Asset managers are bound by regulations, striving to uphold certain ESG standards. Yet, as this information passes through intermediaries, like private banks, it often gets diluted or misinterpreted. Consequently, by the time the message reaches the end client, it no longer aligns with their initial expectations. Faced with this discord, many clients sidestep traditional routes, opting instead for private investments or taking matters directly into their hands.

This situation highlights a broader industry challenge: inconsistent commitment to the principles and sentiments behind ESG across the investment spectrum. While some diligently pursue these ideals, others may only pay lip service, further muddying the waters for end investors. Moreover, this inconsistency begs an essential question: Is there a universally accepted and understood definition of ESG among asset managers and investment firms? Without a clear, shared understanding, the very foundation of sustainable investing becomes shaky, leading to the challenges we currently observe.

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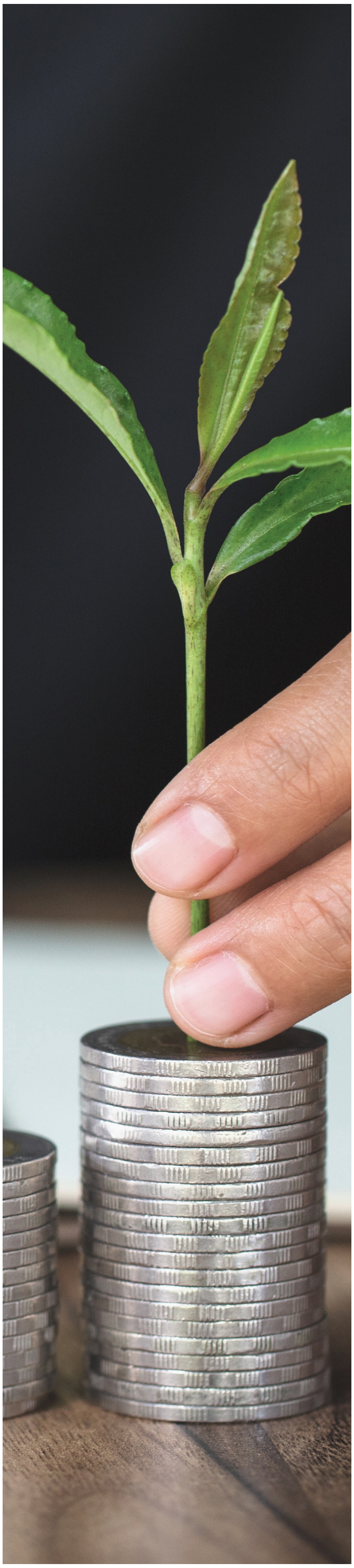
ESG – What does that even mean?

There's considerable confusion around ESG terminology, making it challenging to decipher its meaning and impact. Greenwashing, where companies falsely claim environmental responsibility, surged as stakeholders, including fund managers, private banks, IAMs, and end clients, rapidly shifted focus to ESG-compliant ventures. This rush led many businesses



to adopt greenwashing as a strategy, subsequently tarnishing the reputation of genuine ESG efforts. The repercussions are evident; Lipper data shows that the total assets under ESG fund management plummeted by USD163.2 billion globally in the first quarter of 2023 from the previous year.

This vagueness surrounding ESG definitions has allowed for misuse. A study named 'Do ESG Funds Make Stakeholder-Friendly Investments?' compared U.S. companies in ESG portfolios to those in non-ESG portfolios. The findings were startling: ESG portfolio companies had inferior records for labour and environmental compliance. Moreover, once added to ESG portfolios, these companies showed no improvements in adhering to labour or environmental standards. This discrepancy between ESG investing perceptions and the reality in the investment world is hard to ignore.

Yet, as the concept of ESG investing evolves, there's reduced room for misrepresenting its true essence. This refinement can be viewed as a purification phase in the evolution of responsible investing. With data and disclosures becoming standardised and ratings growing transparent, biases get minimised. Even as the ESG landscape becomes clearer and regulations more stringent, it makes one ponder the weight financial incentives carry in this domain.

Performance over the planet?

Investment in green funds hasn't been consistently promising. Whether this is due to their management approach or intrinsic limitations in their chosen asset classes remains unclear. For example, our standard emerging markets fund outpaced its sustainable counterpart throughout the past year. This trend only shifted in favour of the sustainable fund more recently. When both funds share a management style and manager, it becomes apparent that top-performing assets might not always be categorised as sustainable or green. As a result, these high-performing assets are often absent from sustainable portfolios, an aspect warranting deeper investigation.

Interestingly, ESG funds don't seem to hold their ground financially. A recent study from the Journal of Finance titled 'Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows' analysed Morningstar sustainability ratings for over 20,000 mutual funds, accounting for over USD8 trillion in investments. While highly rated sustainability funds attracted more capital, none surpassed the performance of the lowest-rated ones.

Further performance data reinforces this narrative. In the first half of 2022, while equity markets faced challenges, ESG funds lagged even further behind. Our findings show global ESG firms fell short of their benchmark by 2.5%. A significant 78% of ESG equities trailed behind their benchmark.

Given this, it's evident these funds aren't delivering as expected.

This raises the question: Is this underperformance inherent to ESG investing, or is there a deeper underlying issue?

But why are ESG funds doing so badly?

One possibility is that a pronounced emphasis on ESG is unnecessary. In competitive markets, to optimise long-term shareholder value, corporate leaders should naturally prioritise the interests of employees, customers, communities, and the environment. Consequently, specific ESG goals might skew decisions.

Furthermore, there's data suggesting that companies might use ESG as a smokescreen for lacklustre performance. A study entitled 'Stakeholder Value: A Convenient Excuse for Underperforming Managers?' found that managers who failed to meet earnings expectations often highlighted their ESG efforts. In contrast, those who surpassed such expectations seldom mentioned ESG. This implies that sustainable fund managers might be inadvertently favouring financially weaker companies by investing in those vocally supporting ESG principles.

The implication from this data is evident: funds targeting firms that vocally support ESG might be compromising financial returns without significantly advancing genuine ESG objectives.

A thought on where this leaves us

Having reached this point of our journey down the path of ESG investing's seeming rise and decline, one might have been left with a negative taste in their mouth. However, not all is gloomy. The growing pains of the ESG investment sector might be just that: transient hurdles in an evolving landscape. As the industry matures, there's hope that the core principles of ESG will be better defined, understood, and uniformly implemented, eliminating room for misinterpretation or misuse. However, as the pendulum seems to be swinging against ESG as a stand-alone concept, only time will tell whether it comes back in its favour. ■

Want to find out more?

These topics and more will be discussed at our upcoming investment themed events –

HUBBIS INVESTMENT FORUM - Hong Kong
Wednesday 27th September, 2023
Mandarin Oriental Hotel, Hong Kong

HUBBIS INVESTMENT FORUM - Singapore
Wednesday 1st November 2023, 2023
The Fullerton Hotel, Singapore

The events will be attended by 300+ key decision makers, management, and front office personnel at a significant segment of the wealth management industry in Hong Kong. Including product gatekeepers and advisers at Private Banks, Retail Banks, Securities Firms, IFAs. Independent Asset Management Firms (IAM), External Asset Managers (EAM), Multi-Family Offices (MFO) and Single-Family Offices (SFO). Also in attendance are lawyers and tax advisers who provide advice to UHNW clients.

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