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Recent Events Have Changed ESG Investing: Temporary or Permanent

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INTRODUCTION

In our experience, ESG investing policies have tended to be dominated by two topics, the environment, and weapons spending. The invasion of Ukraine has led to rethinking both.

The environmental focus has specifically centered on reducing carbon emissions and has often included outright bans on fossil fuels. In the past, the effort to limit defense spending tended to focus on either banning investment in defense companies or focusing on banning companies involved in controversial weapons. The recent invasion of Ukraine by Russia has triggered significant discussion on energy policies and defense spending and, thus far has triggered some meaningful changes in government policies. While this is likely to translate to changes in how some investors define and approach ESG investing, we believe these changes on how investors approach ESG will be long-lasting.

The initial reaction to the Ukraine invasion has not been positive for ESG focused investment strategies, relative to broader based investment strategies. In the month of February during the invasion, Reuters reported that equity ESG funds saw a 60% slowdown in monthly inflows to $9.4 billion from $24.4 billion, while other equity funds only saw a 13% drop. This occurred as energy prices rallied dramatically since the invasion. In the month of the invasion, the MSCI Euro 600 was down -3.4% while the Oil & Gas Subsector rose +0.8%[1]. Year-to-date through April the MSCI World ESG Leaders Index was down -16.6 % versus the MSCI World Index being down -15.7%. In addition, an article cited that a global survey of institutional investors after the invasion showed that just under 40% were reevaluating ESG approaches given geopolitical developments[2].

It is not just investors that are considering or undertaking a change in their approach to ESG, but governments policies have shown some meaningful changes. As energy prices soared and concern about dependence on gas supplies from Russia increased in Germany, the decommissioning of nuclear power plants was delayed. Germany and other countries announced an increase in defense spending and Finland and Sweden plan to join Nato. In the US, the Administration has discussed making more fossil fuel resources open to development, particularly on government property. Additionally, the German financial regulatory agency, BaFin, announced a delay in rolling out ESG fund guidelines given the uncertain geopolitical environment.

We do not believe the announcements outlined above will be the end of government actions. In our view, it is highly likely that governments and major institutions will roll out new, and possibly more aggressive, energy policies. These agendas are not likely to include a "pull-back" on investment in renewables; however, it may prove to be a more balanced approach than previously seen. Some of the goals for carbon reduction may shift to longer time frames or allow for more flexibility than before. Additionally, policies may be more supportive of near-term use of fossil fuels and complete elimination of fossil fuel investments may be replaced with a more balanced approach to transitioning to clean and sustainable products.

These government trends and the recent financial performance may influence investors' ESG investment paths. Perhaps investment policies will veer away from the use of outright negative screens and target dates by taking a more balanced approach toward corporations. Topics that are getting more focus include prevention of poverty from rising commodity prices, aiding war refugees, and ensuring the safety and abundance of food supplies. The potential immediacy of these issues can lead to rapid changes in societies' choices. In particular, we believe the humanitarian need to ensure ample food supplies may meaningfully increase during the next twelve months, as the disruption of harvests and plantings get added to the impact of supply chain disruptions. This is likely to influence ESG policies and may change how investors view their strategies.

ESG related geopolitical restrictions are another common topic that is now getting significantly more focus. With the government-led sanctions that have been undertaken against Russia, investment restrictions and corporate pullback from Russia has escalated. Questions about past or present exposure to Russia within investment portfolios have become a common question from allocators to investment managers. This new "factor" has created significant investment risk given sanctions and potential investor backlash. Geographic ESG restrictions are not uncommon, though they have been fairly limited, such as negative screens for exposure to Iran and Sudan. These recent developments raise the question of how ESG factors on Russia were rated prior to this most recent invasion of Ukraine, as the country has the same leadership in place as when they invaded and occupied Crimea in 2014. We believe that post invasion investors are increasingly examining which jurisdictions they have exposure to more carefully, as rule of law as well as how legal and regulatory transparency can meaningfully impact investment returns. In addition to current lockdowns in China and changes in policies relating to public companies, these factors are likely part of the reason we have seen international capital out flows from China and the strength of the US dollar.[3]

Investors pursue ESG and socially responsible investing for different reasons. These reasons include, but are not limited to,~~:~~ as a risk management tool, to exploit what they think will be long term investment trends, or to align investing with personal moral values. This can lead to investors having varied priorities and these priorities can change as events or public opinion changes. The invasion of Ukraine is complicating the already complex arena of ESG investing.

CONCLUSION

Investors like to quantify decisions into numbers. This has led to an effort to measure every aspect of investing, including areas like ESG and SRI that can be highly subjective and can lead to perverse guidelines and rules. These could include items such as setting a hard target on carbon footprints or restrictions on investing in fossil fuels but not a hard target on how much to invest in renewables. Or it could lead to pressuring companies to divest "dirty" assets but allowing them to sell to companies that have no carbon reduction goals. It is also hard to use numbers to predict changes in public opinion. In ESG and SRI investing, public opinion can influence which factors get prioritized. While these factors do not minimize the impact of greenhouse gas emissions or smoking cigarettes, it can change prioritization. The invasion of Ukraine has clearly caused some investors to rethink their ESG priorities and approach. ESG related policies at the government and investment levels are likely to change after these recent geopolitical events, any changes have the potential to make investors more thoughtful and flexible in their ESG approach.

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