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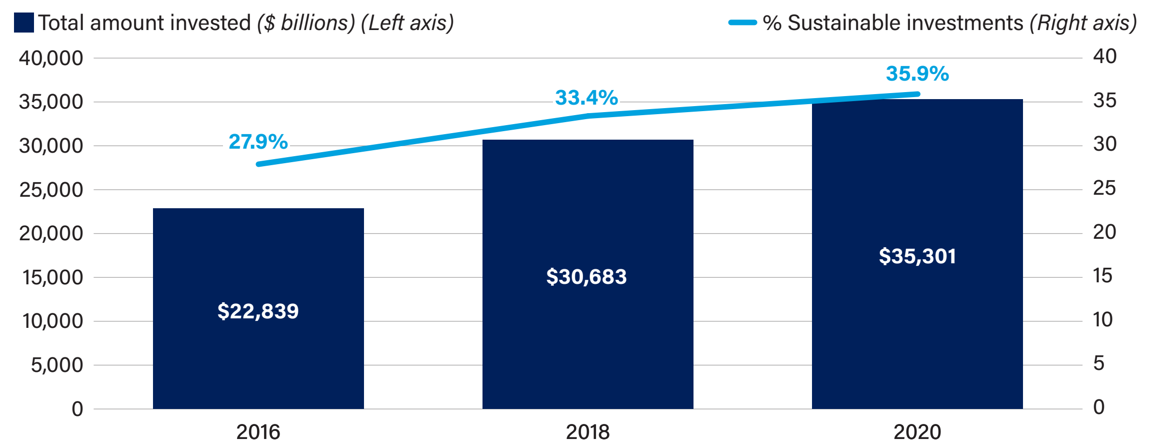
Rethinking Sustainable Investing Approaches: Fitting evaluation to the goals and scale of today

Overview

Sustainable investment strategies continue to grow and have moved from the niche into the mainstream. According to the Global Sustainable Investment Alliance (GSIA), sustainable investment assets under management in five major markets (Europe, United States, Canada, Australasia and Japan) reached $35.3 trillion by 2020, or about 36% of global assets under management (GSIA 2020).[1]

Exhibit 1: Snapshot of global sustainable investing assets



Source: GSIA.

Much of this growth has happened in the last decade, with sustainable investment assets under management (AUM) increasing by 55% from 2016 to 2020 (versus a 20% increase in total AUM).[2] The rapid growth and increasing integration into mainstream strategies create the need to revisit how we approach ESG and whether it fits the current goals and scale.

Historically, sustainable investment (SI) approaches have looked at investments in a static and often exclusionary way. A static exclusion approach clearly defines what is permitted and what is excluded from a portfolio. Other static approaches use ESG ratings based on quantitative criteria evaluating a company's past performance. These approaches are (seemingly) transparent and easy to understand. They also lend themselves well to existing financing structures such as bonds and loans where the use of proceeds can be clearly defined, or funds where it is possible to create an investment universe that includes or excludes particular sectors.

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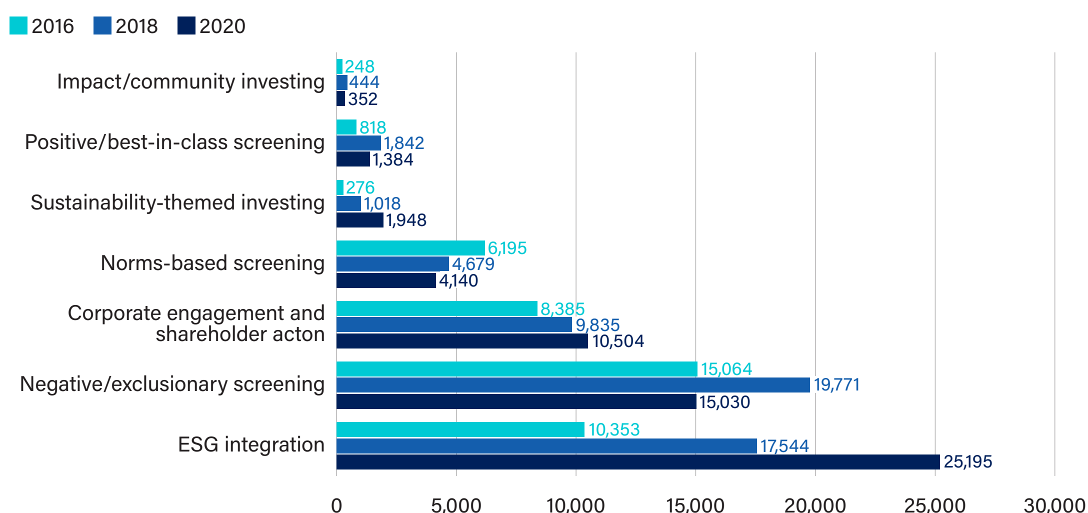
However, we are at an inflection point today. The accelerated use of sustainable investment strategies has unearthed problems with using the static exclusion approach at scale. While a potentially suitable approach for a niche asset class, it has challenges, as many of today's asset allocations strive toward portfolio-level net zero emissions and full consideration of other sustainability-related criteria. In addition, the approach does not lend itself to all types of investments, particularly fixed income sovereign investments which create specific complications for an ex-ante exclusion approach.

We are now seeing a movement toward a more integrated approach. The exclusionary and other static approaches are still significant with $21 billion AUM in 2020 according to data from GSIA, although this was a decrease from $27.3 billion the year before. On the other hand, AUM using an ESG integration approach to sustainable investing increased by 143% between 2016 and 2020 (see exhibit 2). This is in part due to the understanding that ESG factors pose underlying financial risks (and opportunities). It is also because the demand for sustainable investment exceeds the capacity constraints imposed by an exclusionary approach.[3]

Exhibit 2: Global growth of sustainable investing strategies 2016-2020



Source: GSIA.

While the integrated approach allows for a fully investible universe, and the ability to help investees manage material ESG-related risks and opportunities, the lack of transparency in how asset managers make decisions and comparable standards for integrated sustainability approaches have drawn criticism. It seems clear that, moving forward, definitions of sustainability-related terms need to be more precise, and products need to be more transparent, enabling investors to reflect global and market complexities. These products must also work on the scale necessary for the level of assets seeking sustainable investments. An effective sustainable investment approach will require an understanding of the challenges that asset managers are facing today. To help flesh out these challenges, MFS® and Eurasia Group convened a series of discussions with asset managers, asset owners and academics. We discuss below many of the ideas shared during these exchanges.

What is your sustainable investing goal?

Despite the increasing focus on sustainability-related issues, there is still a lack of clarity about what asset owners want to achieve. Goals include meeting public commitments, a desire to have a positive impact and incorporating material financial ESG-related impacts that are often not accounted for in general due diligence.

Not all clients share the same goals, leaving asset managers to balance a diverse set of objectives, including some that are not clearly articulated. Financial returns may still dominate, but it is not clear that end clients, often represented by trustees, have understood the potential tradeoffs involved when constraining investment criteria are applied. While clients may want a more 'sustainable' portfolio, very few are willing to give up returns to achieve this.

In addition, investor reputation, media coverage (and the obfuscation caused by political messaging) can hijack original intentions, causing investors to exclude a country or company, even if others in the portfolio have less favorable overall ESG profiles.

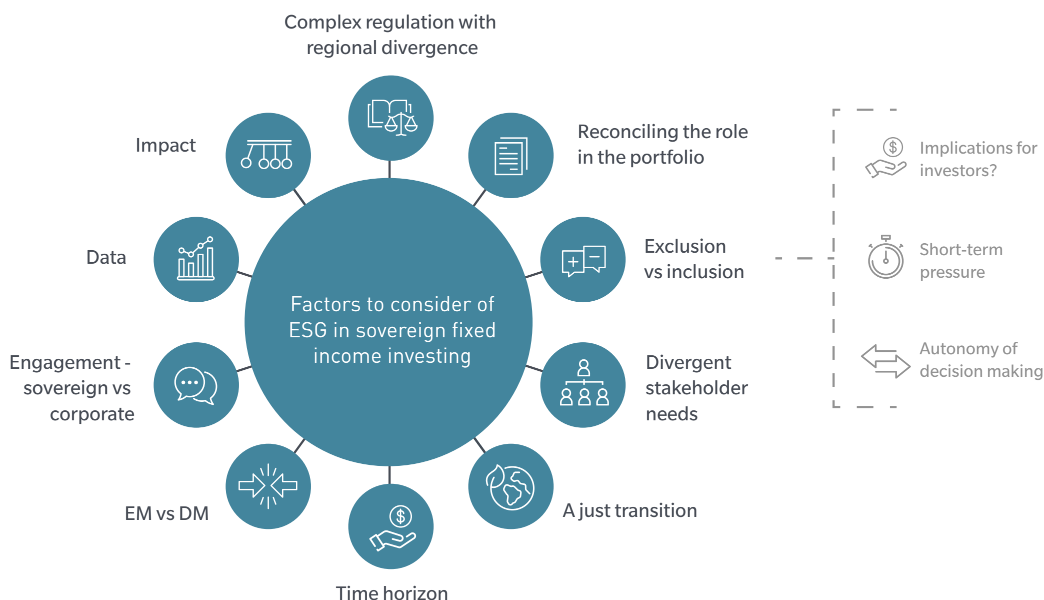
Deconstructing the exclusionary and static approach

Sustainable investment was built on exclusion approaches developed over decades and in some instances codified into laws such as the EU taxonomy. Asset managers, financial institutions and companies have developed many of their sustainable investment strategies based on exclusionary approaches. In addition, the ease of use and transparency of an exclusion approach makes it attractive to asset owners. Regardless, the issues with the exclusionary approach necessitate a change.

Creating a sustainable investment system that can be used across asset classes

The ex-ante exclusion approach is particularly problematic when applied in a sovereign context. This is true especially for those countries that sit in the middle of the pack in ESG terms — it is easy to exclude the worst governance and democracy performers, but harder to evaluate more subtle or conflicting issues. Ex-ante exclusion lists commonly used for other fixed income products will constrain analysts' ability to evaluate more complex situations.

Exhibit 3:



For illustration purpose only.

For example, the Russia-Ukraine conflict and the related energy security concerns pose a dilemma for governments and for sustainable investors alike. European governments have committed to the net zero transition, expressing fully developed plans investors can use to judge for compliance with Paris targets, and eventually for progress on the transition. Most European Union countries are likely to meet an inclusion standard, even if there is clear differentiation across countries. But energy security considerations put a spanner in the works: although high energy prices provide a strong incentive for reducing energy usage, energy security considerations mean the short-term emphasis is on creating a stronger, reliable flow of energy. That in turn may lead to rapid construction of LNG facilities, re-firing of coal plants, extension of the life of nuclear power stations and so on. The impact is hugely differentiated across countries, depending as much on geography and the existing infrastructure as on current policy and future intentions. The shock has uneven impact across countries, sectors and households. It is, in other words, deeply political.

The immediate political imperative of energy security clearly dominates energy transition concerns. But what about in the future? How do we assess governments that prioritize energy security over the energy transition? This example highlights that investors live in a world of tradeoffs, dealing with complexity, competing priorities and second bests. Investors need to understand the factors that affect country policies and the near and long-term implications, which can be complicated and nuanced, creating the need to use a 'scalpel' rather than a 'sledgehammer' when it comes to a sustainable investment approach.

An investment pool that fits the world

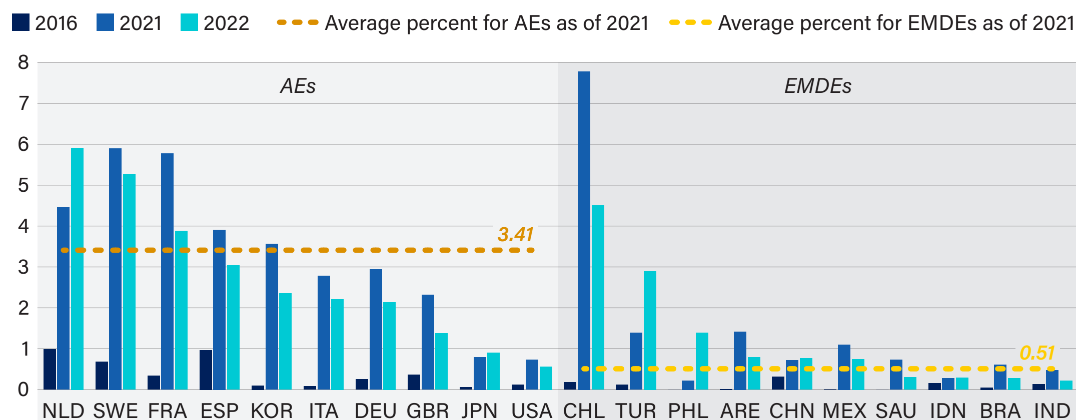
We believe investors' approach to integrating ESG with broader fiduciary duties should be in line with the overall financial objectives of an investment strategy, and realistic given global policies. An exclusionary approach, by design, restricts the investment universe, often beyond what realistic investment pipelines can support. The investor's framework defines how restrictive the approach is. Governance alone is not likely to overly limit investable sovereign fixed income, for example. However, layering environmental and social aspects may do so. The more material the restrictions, the bigger the potential impact on the portfolio's risk and return in the near-term.

> Under the Glasgow Financial Alliance for Net Zero, $130 trillion of assets under management have pledged to align their investments with net zero greenhouse gas emissions by 2050 (which is needed to limit global warming to 1.5°C). However, the October 2022 UN Gap Report notes that current policies are likely to result in warming of 2.8°C, creating a mismatch between portfolio goals and actual economic trajectories.

Inadvertently disadvantaging emerging economies

Another challenge of the current exclusionary and static approach — particularly at the sovereign level — is the high correlation between per capita GDP and ESG ratings. Currently, criteria feeding into ESG ratings tend to discourage investment in poorer countries. In the corporate sphere, ESG scores appear to be systematically lower for EM and developing economy firms than for developed economy firms. The issuance of sustainable debt in EM and developing economies remains a much smaller share of GDP than that of advanced economies.

Exhibit 4: Sustainable debt issuance at much lower levels outside DM *(percent)*



Source: IMF's Global Financial Stability Review, October 2022, chapter 2. AE = advanced economy. EMDE = emerging markets and developing economies.

Asset managers report that ESG considerations in the investment process risk disadvantaging emerging economies in sovereign debt as well. These are the very countries that most need capital to improve the issues for which they are being penalized. A further issue for an investment framework relying heavily on data-focused ESG scores is the lack of consistent and accurate data, making such scores less of a true reflection of a country's risk and reward potential.

The need for forward-looking assessments

ESG ratings are mostly backward looking, with a relative lack of forward-looking indicators and analysis. This is the reason that climate and biodiversity disclosure frameworks are forcing investors, banks and companies to account for new ESG risks based on a tomorrow that looks very different from today. Most of today's approaches — exclusion lists or taxonomies — do not allow investors to exert judgement on likely trajectories, opportunities or the forward-looking impact of any given choice. Supporting countries that are willing and forecasted to improve can increase the chances of better aligning finance with an investor's sustainability-related goals.

Transparent dynamic inclusion: an alternative approach

Evaluating a country or company's ESG performance and potential is complicated. There is an increasing recognition that binary criteria leave out a universe of possibilities that could both create impact and financial return. As ESG criteria becomes more mainstream, they must be integrated into investment analysis. This would enable the analyst to consider all material factors and evaluate them with the aim of maximizing financial and/or sustainability outcomes.

Ensuring transparency

The challenge is to create a dynamic inclusion system that can be effectively communicated and tracked. Transparency provides clients with an opportunity to assess the process and investment decisions. This is easier for governance factors, but more complicated for environmental and social considerations. In an ESG context, a process that relies on verifiable risk factors will help clients understand the tradeoffs and risk assessments that lead to a particular investment decision. For example, an approach to analyze autocratic sovereigns could be underpinned by an assessment of political/policy risks and economic volatility, rather than a simple list that ranks countries according to the degree of autocracy.

Transparency and reporting are increasingly important as sustainable investment rules tighten around definitions and related risk disclosures. Regulations, such as the EU's Sustainable Finance Disclosure Regulation (SFDR), create guidance for transparency that can be interpreted to result in funds being classified as less sustainable than they are. SFDR is currently being used as a label when it is really about disclosure, allowing stakeholders to choose based on how the fund's approach aligns with their goals.

Engagement

Engaging with companies or sovereigns is an integral part of the dynamic approach. Engagement with corporates can have a more direct impact on a company's decision, while engagement with sovereigns is usually less influential. Not only are governments law makers, but they are also accountable only to their populations, not to investors. Engagement can be limited in its scope, and investors are generally policy takers rather than policy makers with limited influence on sovereign decisions. ESG analysis in a sovereign context is therefore more of an information gathering process, helping to identify forward looking trends.

Joining finance and impact

For sustainable investing to continue to grow, it must coincide with financial returns. Improving the ESG profile of a portfolio is not the same as having positive impact on the world — it is easier to achieve an ESG-aligned portfolio, but much harder to directly improve the environment and society. Static and backward-looking ESG analysis can lead to exclusions decision on sovereigns or companies that may have a patchy record and need support to grow in a sustainable way. Engaging with sovereigns or companies that would otherwise have been excluded, therefore, has potential to create a longer-term positive impact if the investor can discern a credible pathway.

Opening a dialogue for next steps

There is no silver bullet for a sustainable investment process, whether in the sovereign fixed income space or more broadly. Assets under management that are beholden to some variation of exclusionary sustainable investment criteria are growing. However, the current exclusionary approach cannot accommodate today's investment level and goals.

Navigating a transparent, forward-looking approach to sustainable investing will require an open dialogue between asset managers and their clients. This dialogue is essential. Taxonomies are likely to continue in some form and can be useful to push into new frontiers. However, it cannot be the underlying method to assess dynamic impact and financial risk. For this, we believe we need an approach that integrates ESG into investment analysis in an observable and transparent manner.

The next step for asset owners is to clearly define their sustainable investing goals and then discuss those goals, along with the topics above, with their investment managers. Owners should ensure they are comfortable with the philosophical approach of their manager, for example on engagement versus exclusion, in addition to more tactical issues such as transparency and reporting.

The next step for asset managers is to ensure their investment process reflects the topics addressed above and that they can provide the promised outcomes — both in terms of sustainability and financial returns. Where there is not yet a rigorous approach to considering such factors, addressing these should be the priority. Managers then need to ensure they can demonstrate to clients how each of these considerations is assessed in their portfolios, and where progress still needs to be made.

By assessing the goals and outcomes openly and with an honest look at the limitations of each approach, asset managers and asset owners can jointly come to approaches that create the impacts and returns that both are seeking while strengthening the process of sustainable investment.

Endnotes:

[1] GSIA definition of sustainable investment is an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management. This definition is broader than that of the Sustainable Finance Disclosure Regulation, which defines "sustainable investment" as an investment in an economic activity that contributes to an environmental or social objective as measured by specific indicators, provided that the investment does no harm to other environmental or social objectives and follows good governance.

[2] http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf.

[3] Roundtable discussions held October 6 and 13, 2022.

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