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The New Normal: ESG Investing in 2021

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In a year dominated by the COVID-19 pandemic, there has been a renewed focus from governments and companies on the need to address climate change and other sustainability challenges. For their part, many investors are integrating ESG and climate considerations across their portfolios in response to changing attitudes and regulations. Where will all this take us?

Read on for our **five ESG themes for 2021** and why we see ESG emerging as the new normal.

1. **ESG outlook: Europe marches forward; US, China and emerging markets onboard** European Union sustainable finance regulations are coming into force, while the US and China are changing tone on climate change. Emerging markets will receive greater attention on ESG issues.

2. **Asset owners join companies and governments to reach net zero** Driven by regulation and changing sentiment, companies and investors are aligning to the low-carbon transition.

3. **ESG data: Ever improving** With increasing quality and availability of ESG data, comes more specialisation — something that could enable investors to tackle wider (and more focused) sustainability challenges.

4. **Re-evaluating ESG-related tracking error** Investors will rethink tracking error budgets against standard benchmarks, in light of ESG integration considerations.

5. **Engage or divest: The debate intensifies** When a company fails to meet ESG expectations, should investors divest or engage? This debate will come into the spotlight in 2021.

Regulation and Policy will Accelerate Global Adoption of ESG Investing

Historically, Europe has seen the most ambitious push towards incorporating sustainability into political and economic frameworks. The European Commission's (EC's) Action Plan for Financing Sustainable Growth has resulted in several pieces of sustainable finance legislation that are coming into force. Notably, the introduction of the Sustainable Finance Disclosure Regulation (SFDR) on 10 March 2021 will increase asset managers' requirements for reporting on their ESG investment processes at both the firm and product level, providing much needed transparency for the entire market.

Outside of Europe, there has been a paradigm shift on climate change in both the US and China. The incoming US President Joe Biden has proposed an ambitious $2 trillion climate plan that targets clean electricity by 2035 and net-zero emissions across the entire economy by 2050. To underline the emphasis on climate change, it is expected that Biden will implement a formal review of key posts in the Securities and Exchange Commission, Department of Labor, Federal Reserve and other US government bodies, with the goal of shifting perceptions and driving adoption of ESG investing. Incidentally, for the first time, the US Federal Reserve recognised that extreme weather caused by climate change "may cause investors to update their perceptions of the value of real or financial assets suddenly".[1]

Biden has also appointed former Secretary of State John Kerry to the newly created, cabinet-level position of Climate Envoy. Kerry views the climate crisis as an "urgent national security threat"[2] and is expected to coordinate a holistic, government-wide approach to addressing climate change, including the US re-entering the Paris Agreement. Kerry has appointed two committed environmentalists to lead his team, indicating the ambition and future direction of the Biden administration's efforts to tackle climate change.[3]

In another encouraging development, China, the world's largest aggregate greenhouse gas emitter, has announced a transition to net zero by 2060. This reverses China's historic position against potential restrictions on economic growth to tackle climate change. To reach net zero, the Chinese government is transitioning from existing regional carbon pricing initiatives to a national emissions trading scheme that is set to be the world's largest carbon market when introduced in 2025.[4]

Elsewhere, countries around the world are cutting their carbon emissions and committing to net zero by 2050 or sooner, in line with the Paris Agreement. Governments will play a key role in financing the green transition. Global issuance of green bonds has risen this year[5] and the question of how the proceeds of such bonds are put to work will come into sharper focus. With it will come greater scrutiny and requirements to qualify as "green".

Beyond climate change, we expect the systemic issue of social inequality to take centre-stage in 2021. This is evidenced by the growth in the market for social bonds and the largest issuance of social bonds to date of EUR 17 billion by the EC.[6]

There are also signs that emerging market governments are becoming more ESG-aware. In some cases, attitudes are shifting as a result of environmental challenges, notably air pollution in China and India. Emerging market government issuance of green bonds continues to rise,[7] which could be instrumental in boosting much-needed green infrastructure development. Companies in emerging markets are also increasingly disclosing ESG and climate risks and engaging with investors on corporate governance and other issues.[8] Hence, 2021 could be a pivotal year for ESG in emerging market debt.

We hope that all this progress will lead to fruition at the COP26 talks in Glasgow in November. The ideal result would be a commitment by all countries to evidence how they will reach net zero by 2050 or sooner and adapt to embedded climate risks.

Overall, we expect policymakers will heed lessons from the fight to tackle the COVID-19 pandemic, something we discussed in our paper, "COVID-19 and ESG: Four Dimensions". The development of vaccines within months, rather than years, would have been impossible without international collaboration and cooperation. As such, governments will increasingly follow this example in creating standardised approaches to incorporate sustainability into policy and regulatory frameworks.

Asset Owners Join Companies and Governments on Road to Net Zero and Addressing Sustainability Challenges

The shift in mindset from governments, central banks and regulatory bodies is leading to a similar shift in company boardrooms. We expect companies to disclose more information on their ESG risks and opportunities, in line with frameworks like the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD). We expect companies will prioritise ESG issues not just within their organisation, but across their entire economic value chain.

Companies are increasingly verbalising their ambition to be carbon neutral, often in response to calls from investors and asset owners. Investors see value in companies that are well poised for the low-carbon transition and that are finding creative, innovative ways to get there. Younger investors, in particular, are demanding greater action on tackling climate change, as highlighted in The Deloitte Global Millennial Survey 2020.[9]

We also expect more and more asset owners to articulate specific and tangible climate-related targets in relation to a timeline, just as companies and governments are doing. As an indication, the Net-Zero Asset Owner Alliance, a group of 30 pension funds, investment firms and insurance companies, managing a combined $5 trillion of assets, have committed to transition their investment portfolios to net-zero greenhouse gas emissions by 2050. They aim to reduce emissions of their equity, corporate bond and real estate investments by 16% to 29% by 2025. We believe such investor and asset owner efforts will snowball and become the norm.

The issues of climate scenario planning and real-world portfolio impact will move to the centre of conversations on climate change. Regulation will be an important catalyst. For example, the UK Department of Work and Pensions has recently proposed to make climate scenario analysis mandatory for pension plans larger than £5 billion by the end of 2022.[10]

While climate change will remain the dominant ESG issue, we can expect to see a more nuanced discussion around wider sustainability challenges. Extreme weather events from Australian wildfires to US hurricanes to droughts across Africa have raised awareness of the systemic impact of climate change. Equally, public figures like David Attenborough have brought issues such as biodiversity loss and ecosystem damage into the public domain. The World Economic Forum (WEF) cites biodiversity loss and ecosystem collapse as a "planetary emergency", with an estimated $44 trillion — over half the world's total GDP — moderately or highly dependent on nature and its services.[11] WEF cites the business impact of nature loss through impacts on operations, supply chains and markets.

To meet these challenges, companies, and ultimately investors, will need to act with the wellbeing of society and the environment at heart. The view that companies exist purely to serve shareholders is fast evolving to the idea that companies have a responsibility for the well-being of a wider set of stakeholders, including employees, customers, suppliers.[12] The trend towards stakeholder capitalism and corporate purpose will ultimately result in companies having to consider the long-term impacts of their operations on society as a whole.

Investors will Benefit from Better and More Specialised ESG Data

Investors are increasingly aware of the scale of sustainability challenges, yet ESG data issues have sometimes made it challenging for investors to adapt their investment strategies in response.[13] For example, data availability and quality are acknowledged to be barriers to adoption of investment strategies to tackle biodiversity.[14]

Fortunately, the state of ESG data is steadily improving. Stricter disclosure standards will result in more and higher-quality data, which will benefit investors looking to embrace ESG frameworks, including the TCFD and the United Nations Sustainable Development Goals (accepting that the latter framework was not created for investment purposes).

Investors will also demand more specialised data specific to their needs, whether they are taking an exclusionary approach or adopting a comprehensive impact investment strategy. The acceptance that "one-size-does-not-fit-all", will drive data providers to supply new and more specialised ESG data offerings.

As ESG data improves, we expect companies to announce more stringent ESG targets and reference ESG-related matters in a more transparent and rigorous way. In general, we believe ESG investing will diverge from its origin as an approach based on investors' subjective values and beliefs, to a more objective, measurable and "scientific" investment approach.

We will also see much-needed progress on aligning ESG reporting standards. Five of the most respected sustainability frameworks and standard-setting institutions[15] recently agreed to work together on comprehensive corporate reporting, including reporting on climate-related risks. In the US, the Board of Governors of the Investment Company Institute is encouraging US public companies to provide enhanced reporting on ESG factors consistent with the recommendations of the TCFD and SASB. Such progress is very encouraging and mirrors that of global governmental collaboration to align sustainability regulations.

Perceptions of ESG-related Tracking Error will Change

Tracking error[16] is a well-known and important measure of risk. Investors tracking an underlying benchmark often have strict limits on tracking error embedded in their investment processes.

Yet, deviations from standard benchmarks become inevitable when ESG considerations are included in index methodologies. For example, investors looking to align their portfolios to the Paris Agreement goals by including portfolio climate targets must accept tracking error deviations as a necessity.

As a result, we believe that perceptions of tracking error deviations arising from ESG investment strategies will change. Deviations from standard benchmarks will not only be viewed as acceptable but, in some cases, will be desired (where permitted). We foresee that many of our clients will positively expect tracking error deviations as proof points that ESG and climate considerations are being actively integrated into the investment process.

Alongside this shift, we will likely see a re-evaluation of the appropriateness of typical benchmarks to investors' individual circumstances. This should lead to an increase in demand for customised benchmarks.

The Engagement vs. Divestment Debate will Gain Prominence

When an investee company's strategy or operations are not in line with ESG expectations, investors face a fundamental question: divest or engage?

Exclusionary screening is an integral part of many investors' ESG investment style. Over time, we have seen growth in the range of business activities and "blacklisted" behaviours, often driven by investors' values-based beliefs and/or regulatory requirements. An example is the European Union's prohibition of investment into companies involved in weapons of mass destruction.

Divestment is also considered a means to increase pressure on companies, particularly when applied across a wide array of investors. When the decision to exclude a company is values-based, the topic of engagement becomes less relevant as the very core of a company's business model fails to conform with the investor's fundamental values.

However, with divestment, investors lose their voice, and hence, a seat at the table to influence positive change. In some cases, investors may have a greater impact by engaging directly with companies to improve standards and using their vote.

As organisations move towards greater disclosure and a stakeholder (rather than solely shareholder) approach, the importance placed on engagement will further increase. And as we transition to a low-carbon world and the investment opportunities associated with Paris-alignment become fewer over time, there will be a greater scope for engagement to drive the necessary changes in strategy and risk management that investors demand from company leadership.

This is particularly important in the context of the "Universal Owner" principle, as a large institutional holder of a diversified portfolio can be seen as having an exposure to the entire economy and financial market. If one portfolio company externalises ESG-related issues, this will impact on other portfolio companies, and hence, the entire economy. Hence, Universal Owners will need to further increase their ESG integration efforts via both active ownership and asset allocation decisions.

The energy sector proves an interesting example. Public and investor pressure to reduce and ultimately end energy generation from fossil fuels is ever increasing. In response, several major energy companies are introducing carbon reduction targets, expanding investment into their renewables businesses and committing to discontinue the exploration of new oil fields.[17] While some energy companies are adapting their business models much quicker than others,[18] all of the incumbents have one feature in common: their exposure to fossil fuels isn't going away anytime soon.

So, we return to the original question — should all (energy) companies be excluded because of their fossil fuel exposure, or should investors develop a more nuanced view, with the aim of driving long-term change through engagement and voting? We expect this will be a hotly debated issue in 2021.

Conclusion

In 2021, ESG considerations will become even more prominent on multiple dimensions.

Increasing cross-border connectivity will inform ESG-related regulatory agendas beyond Europe. Climate change will remain the dominant topic for governments and companies, but will also become a priority for universal owners.

An improving data landscape will lead to more specialised ESG approaches, making ESG a more objective, measurable and "scientific" investment approach.

As investors start to view ESG considerations as a third dimension, in addition to risk and return, perceptions of tracking error against standard benchmarks will change. Related to this topic is the debate around divestment vs. engagement. Investors will increasingly vote for companies to align to ESG expectations in 2021, particularly companies in the energy sector.

Endnotes

1 https://federalreserve.gov/publications/brainard-comment-20201109.htm.

2 https://twitter.com/JohnKerry/status/1330925522579312640.

3 https://ft.com/content/c468eb5b-0b86-43c7-b20d-646948e77c66.

4 https://weforum.org/agenda/2020/11/china-national-emissions-trade-scheme-within-five-years/.

5 Moody's reports that global issuance of sustainable and green bonds totalled a record $99.9bn (£75.5bn) in the second quarter of 2020: https://edie.net/news/7/Moody-s--Global-green-bond-issuance-reached-record-high-amid-Covid-19-crisis/.

6 The issuing consisted of two bonds, with €10 billion due for repayment in October 2030 and €7 billion due for repayment in 2040. https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1981.

7 https://globalcapital.com/article/b1pkxvl3b7vjnp/trendy-em-green-bond-market-reaches-critical-mass.

8 https://portfolio-institutional.co.uk/features/esg-a-growing-trend-in-emerging-markets/.

9 https://www2.deloitte.com/global/en/insights/topics/talent/deloitte-millennial-survey.html.

10 https://gov.uk/government/news/britain-s-pension-schemes-lead-on-climate-risk.

11 https://weforum.org/reports/nature-risk-rising-why-the-crisis-engulfing-nature-matters-for-business-and-the-economy.

12 https://mckinsey.com/business-functions/organization/our-insights/purpose-shifting-from-why-to-how.

13 https://ssga.com/library-content/pdfs/insights/into-the-mainstream.pdf.

14 https://ft.com/content/100f0c5b-83c5-4e9a-8ad0-89af2ea4a758.

15 The CDP, Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB).

16 Tracking error is defined as the standard deviation of the difference between the returns of a fund and the benchmark.

17 For example, Total: https://total.com/sites/g/files/nytnzq111/files/documents/2020-10/total-climate-report-2020.pdf.

18 https://bloomberg.com/news/articles/2020-10-05/exxon-carbon-emissions-and-climate-leaked-plans-reveal-rising-co2-output.

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