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Has the bubble burst? The evolving landscape of ESG equity investing

Earlier this year, the total assets invested in specialist ESG (environmental, social and governance) funds surpassed US$2.8 trillion.[1] But after recent disappointing returns from ESG strategies, a slowdown in fund flows and mounting political opposition, are we witnessing the bursting of an ESG bubble?

At Federated Hermes, we don't think so. The Global Equity team have been researching ESG since 2007, just a few years after the United Nations Global Compact[2] first popularised the term, and integrating ESG into their investments for over a decade. Over the past 15 years, we've both observed and demonstrated the added value that ESG can offer.[3]

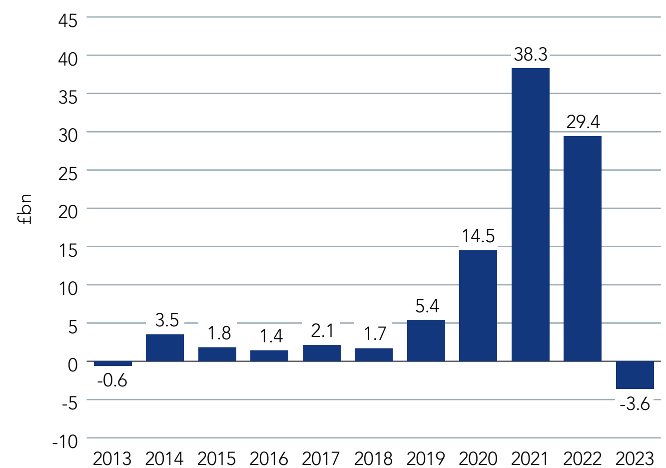
We do, however, acknowledge the challenges, which we set out in this paper. We show how definitions and data have evolved but not always improved, and we look at how this lack of clarity can fuel opposition to ESG. But we also set out the grounds for continued confidence in ESG and our views on how it can best be assessed.

ESG under fire

Much of today's scepticism towards ESG comes down to definitions. To start with, should 'ESG success' be measured in fund flows, fund returns or improvements in sustainability?

It's certainly true that fund flows have slowed in recent months. Assets in ESG funds hit US$2.8 trillion in the first half of 2023.[4] In the second quarter, however, fund flows had almost halved from the first quarter.[5] May 2023 was the worst-ever month for redemptions from ESG funds,[6] and launches of new ESG funds fell sharply in the second quarter.[7]

Figure 1: Fund asset flows into Sustainable Funds since 2013



Source: Morningstar, net flows (£bn) as at 30 June 2023.

This follows a period of sub-par returns as equity investors have pivoted to 'value' stocks and away from 'growth' (which includes many companies that specialise in clean energy and life sciences). High inflation and inflation rates have constrained the outlook for growth companies. Meanwhile, Russia's invasion of Ukraine and the consequent surge in the oil price have led to huge outperformance by energy stocks.

> **Over the past 15 years, we've both observed and demonstrated the added value that ESG can offer.**

[1] Global Sustainable Fund Flows: Q2 2023 in Review | Morningstar.
[2] 04-37665.global.compact_final (unepfi.org).
[3] Despite headwinds, ESG continues to perform | Federated Hermes Limited (hermes-investment.com).
[4] Global Sustainable Fund Flows: Q2 2023 in Review | Morningstar.
[5] Global sustainable fund flows continue deceleration path in Q2 – ESG Clarity.
[6] Is the era of ESG investing over? – CityAM.
[7] Number of ESG fund launches plunges 68% in Q2, says Jefferies – Sustainable Views.

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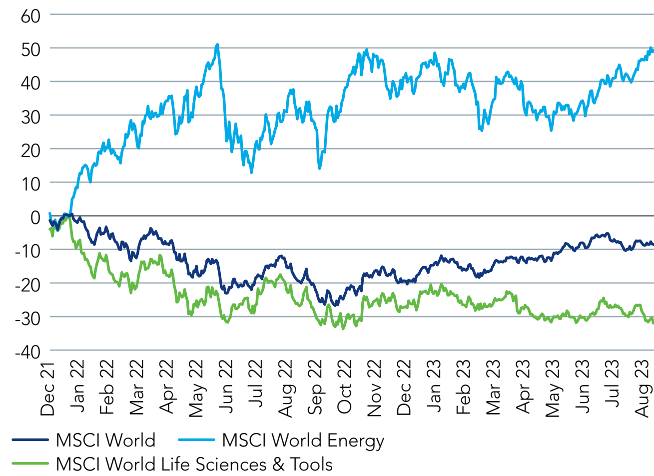
Figure 2: MSCI World vs Energy & Life Sciences since beginning of 2022 (%)



Source Bloomberg as at 20 September 2023. **Past performance is not a reliable indicator of future returns.**

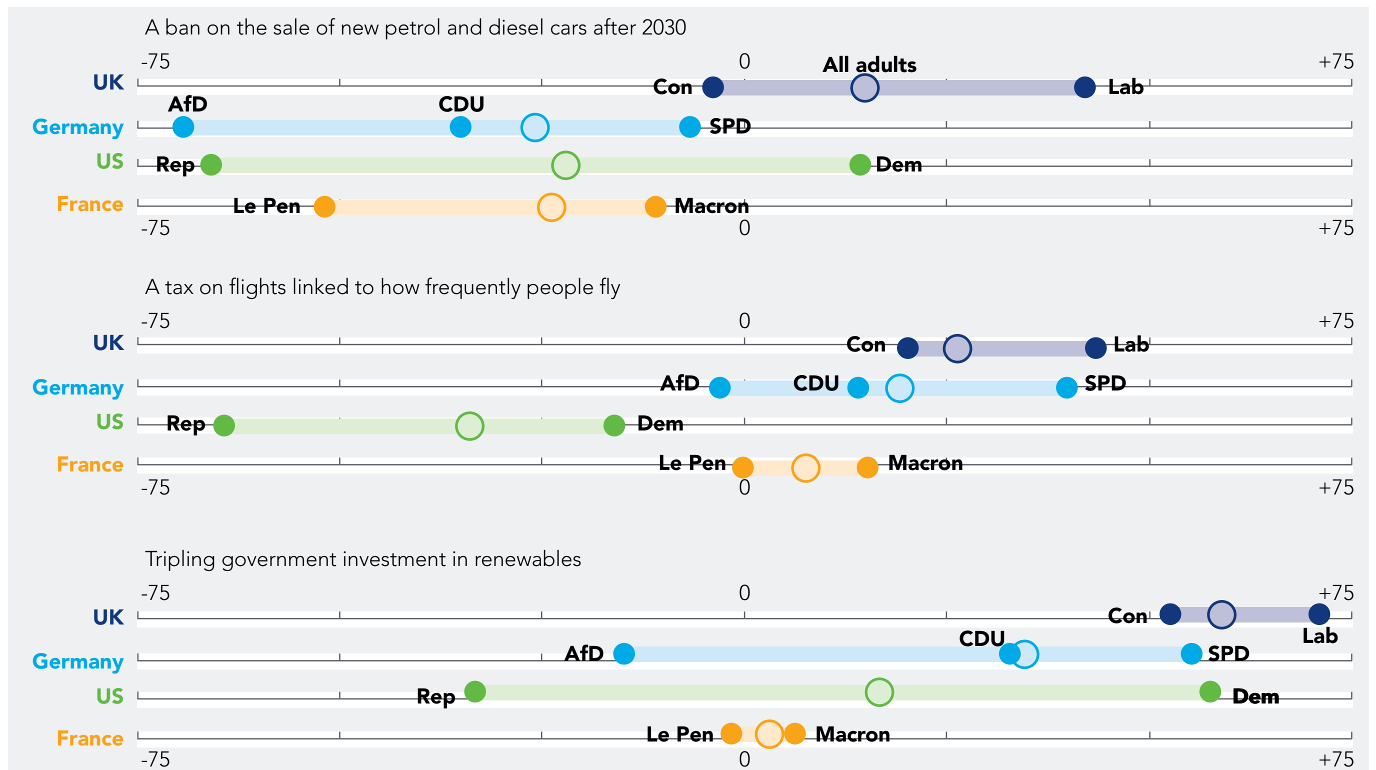
But returns aren't the only factor in this. In recent years, many funds have adopted ESG criteria and have rebranded themselves as 'ESG funds'. The highest ESG inflows were in 2021, when over 300 funds were rebranded as 'ESG'.[8] That process now appears to be largely complete.

Disappointing returns have, however, fuelled growing criticism of ESG strategies. Alongside poor recent returns, ESG's detractors point to anomalies in ratings.[9] Governance scores are particularly in the spotlight, as with the medium ESG risk rating assigned to Silicon Valley Bank, which had not had a chief risk officer for almost eight months at the time of its collapse.[10,11] And there have been many prominent examples of 'greenwashing'.[12]

In the US, the opposition is heavily politicised, with Republican leaders prominent among the critics.[13] We have even seen anti-ESG legislation in some US states.[14] But the US left/right divide on environmental issues is not replicated around the globe. In the UK, for example, 'green' initiatives are widely accepted by Conservative voters, and in Germany, centre-right Christian Democratic Union voters favour taxing frequent flyers and greatly increasing investment in renewable energy.[15] So there is still considerable political will to make progress.

Figure 3: Britons are more supportive of green policies than people in peer countries, with UK Conservatives often as green as the centre-left elsewhere[16]

Net support (% points) for green policies in selected western nations, by party or candidate voted for



[8] Bloomberg Intelligence, ESG Funds' Assets: Understanding Growth Fundamentals.
[9] How Does Tesla Get A Worse ESG Score Than 2 Oil Companies? – CleanTechnica.
[10] SVB Is One More Example Of A Governance Crisis That Seems To Be Only Foretold By Short Sellers, Despite Plenty Of Red Flags Hiding In Plain Sight (forbes.com).
[11] The collapse of SVB and the perils of overlooking the "G" in ESG (verdict.co.uk).
[12] 10 Companies Called Out For Greenwashing | Earth.Org.
[13] How ESG became part of America's culture wars (economist.com).
[14] gri-perspective-esg-risk.pdf (globalreporting.org).
[15] Everyone loses if net zero becomes the new partisan divide | Financial Times (ft.com).
[16] Source: FT analysis of data from YouGov. FT graphic: John Burn-Murdoch / @jburnmurdoch.

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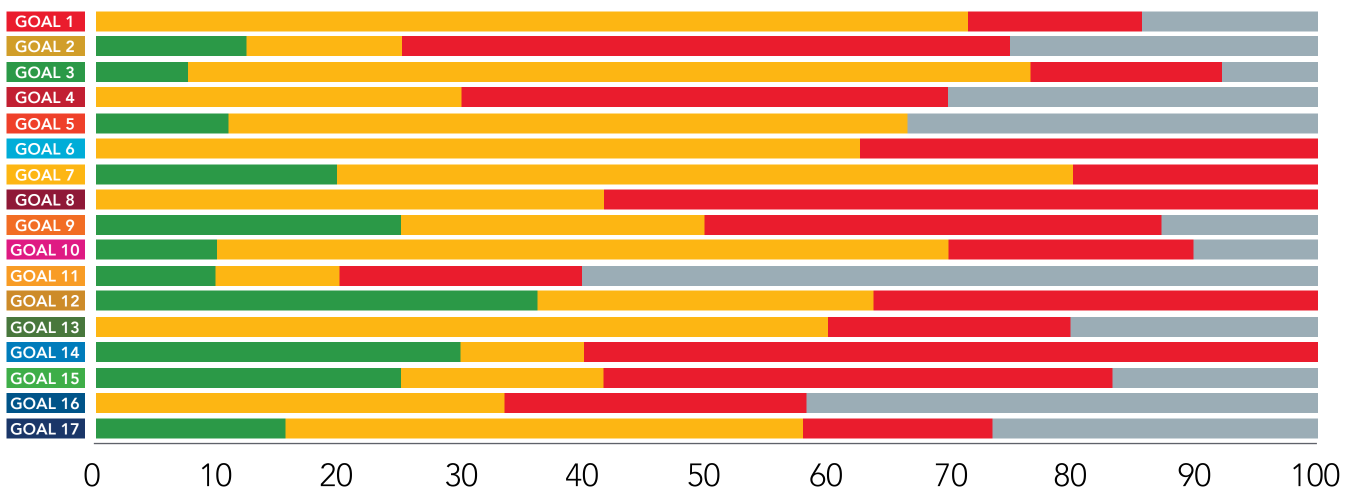
Has the ESG bubble burst?

The recent challenges prompt a question: is ESG investing a bubble? And if so, are we watching it burst? At Federated Hermes, we don't think so. We believe it's important to look past short-term difficulties to the long-term prospects of companies with strong ESG metrics. After all, the whole point of these metrics is to assess *long-term* sustainability.

The issues with ESG ratings and greenwashing are problems of practice, not principle. Indeed, the high-profile failures of US regional banks should underscore the importance of making accurate assessments of governance. At the same time, 'black swan' events such as the pandemic and Russia's aggression will always prove disruptive.

Crucially, though, the colossal challenges that ESG is designed to address have not gone away. The world is not getting better – and it won't get better without huge efforts from us all. This summer, we saw all too clearly the havoc that climate change can wreak, with floods, forest fires and record temperatures. The eight calendar years since 2015 were the hottest on record, and 2023 looks set to top them.[17] Moreover, the latest update on the UN SDGs noted that little progress had been made, meaning a huge acceleration of financing will be required to meet the 2030 goals. So there's no doubt that ESG still has a vital role to play.

Figure 4: Progress assessment for the 17 Goals based on assessed targets, 2023 or latest data (percentage)[18]



A concerning picture of SDG progress at the midpoint:

What's brought us to this point? And what has changed?

How, then, did we get here? When we started out in ESG 15 years ago, its characteristics were very different from what they are today. The evolution of those characteristics has been striking – and not always positive.

An asset class in its own right?

To begin with, ESG was seen as a separate asset class. Allocations came mainly from organisations with particular social purposes, such as charities and foundations, or as 'side bets' by ethically aware investors. It was not a mainstream concern, and there was widespread wariness after the poor returns produced by many SRI (socially responsible investing) strategies.

Today's situation is different. Although there's no consensus on the relationship between ESG and returns, investors are keenly aware that ESG risks can have huge impacts on shareholders. These impacts can be acute, such as the clean-up costs incurred by BP after the Deepwater Horizon disaster and Vale after the Brumadinho dam collapse. Or they can be systemic, as with the global financial crisis of 2007-8. And they can often prove existential for businesses.

[17] State of the climate: 2023 now likely hottest year on record after extreme summer – Carbon Brief.
[18] United Nations: Sustainable Development Goals, Progress update, 2023.

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In a more connected and socially conscious world, there is also much more awareness of the potential for the negative headlines and associated losses that can occur when malpractice is exposed. This is something that no company can afford to ignore. Today, all potential investors seek to understand our approach to ESG prior to investing so, from our own experience, it is something that definitively *has* moved to the mainstream.

Should ESG be based on exclusion?

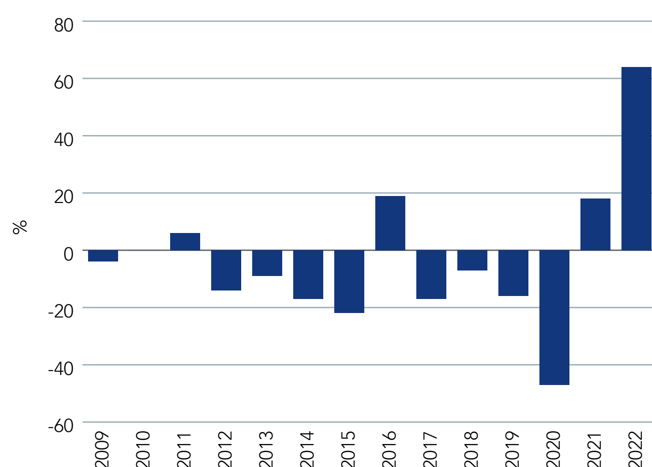
Fifteen years ago, the foundation of most ESG strategies was exclusions, in line with SRI approaches. A focus on exclusion is still commonplace, in part because of the awareness of the potential downside from ESG risks. Today, prospective investors often focus on which stocks are avoided, and funds are frequently labelled according to the categories they exclude (e.g., ex-tobacco, ex-energy or ex-controversial weapons).

Exclusions are easy to communicate to clients and are often designed to avoid acute risks. So, they're a good starting point. But many investors have moved on. Engagement is now increasingly preferred, as it seeks to engineer improvements rather than just avoid those that need to improve.[19,20]

The great advantage of engagement is that it is inherently forward-looking. In a world in which change is urgently required, alignment and targets are more important than what has already occurred. There are also risks to exclusions. The energy sector, for example, makes up a large proportion of most benchmark indices, so a wholesale exclusion poses a considerable risk.

Blunt sector-based exclusions may also deter investors concerned about lower returns. Our recent surveys show that the great majority of investors see engagement as an effective and improving means of advancing the ESG agenda.[21]

Figure 5: Relative returns of MSCI World Energy sector



Source: Bloomberg, accessed 28 September 2023. **Past performance is not a reliable indicator of future returns**

Ethics vs ESG

What is the difference between ethical investing and ESG? There's a considerable overlap between the two, but the distinction has become clearer over the past 15 years. A key part of this has been the risk/value argument: that ESG matters because it can improve long-term financial returns. That argument is, in part, a means of removing the ethical dimension from ESG considerations – if poor ESG affects financial returns, then ESG matters even from an entirely amoral perspective.

But can ESG ever be isolated from ethics? Consider the case of companies that produce armaments as a case study in complexity. In the past, weapons exclusions were seen as a given in ESG. The Russian invasion of Ukraine, however, has changed perspectives starkly. For one thing, it's hard to condemn the producers of weapons that are helping to defend an invaded country and its people – or to decommission landmines. Second, the risk/value argument doesn't hold up: the share prices of many defence companies have performed strongly since February 2022.[22]

There are also greyer areas. Many companies have both civilian and military contracts; others might count tobacco companies as major clients. If a numerical ESG assessment simply cancels out 'positive' and 'negative' activities, that neither tells investors much nor leads to beneficial change. The same applies to companies with both 'green' and 'brown' operations. Consider, for example, a utility company investing into renewables but retaining legacy coal assets: At what point does a company switch from being uninvestable due to its fossil fuel exposure to being sought after as a transition leader?

In many cases, the waters are muddied by ESG's backward-looking tendencies. A company's historical wrongs are held against it, regardless of the progress it has made. The shift from exclusion to engagement should help to resolve this in time.

[19] ESG experts back engagement over exclusion | News | Global Investor Group.
[20] ESG Shareholder Engagement and Downside Risk by Andreas G. F. Hoepner, Ioannis Oikonomou, Zacharias Sautner, Laura T. Starks, Xiaoyan Zhou :: SSRN.
[21] Institutional investors believe ESG factors are more important than financial metrics when evaluating a company's long-term attractiveness | Federated Hermes Limited (hermes-investment.com).
[22] Source: Bloomberg as at 29 September 2023.

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Definitions: what is ESG?

All three of the areas above are complicated by the evolving – and elusive – definition of ESG. This has been a familiar problem over the past 15 years. Is ESG an asset class? An investment approach? A broader philosophy? And as the definition has stayed slippery, investors' expectations have continued to shift.

Initially, the main aim of ESG was to do good, or at least to avoid doing bad. Then it came to be seen as a means of avoiding business risks. From there, returns came into focus as ESG investing was seen as a route to superior long-term performance. More recently, the focus has shifted again, this time to the positive impact that can be made through investments.

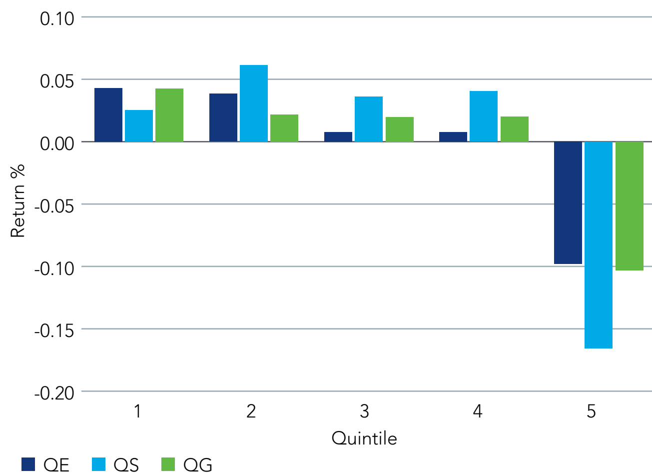
Today, the term is still somewhat nebulous – and we believe there is an opportunity for regulators to provide solid working definitions.

Is ESG value-destructive?

One constant is the lingering suspicion that ESG is value-destructive. This was the mainstream view 15 years ago, and, with the politicised backlash in the US, it's prominent once more. Certainly, there's no compelling evidence that ESG correlates with strong investment performance in the short term.

For us, ESG is more than about identifying the current leaders: we believe that companies with good *or improving* standards of ESG will generate outperformance over the longer term. And, using this definition, the connection to performance is clearer.

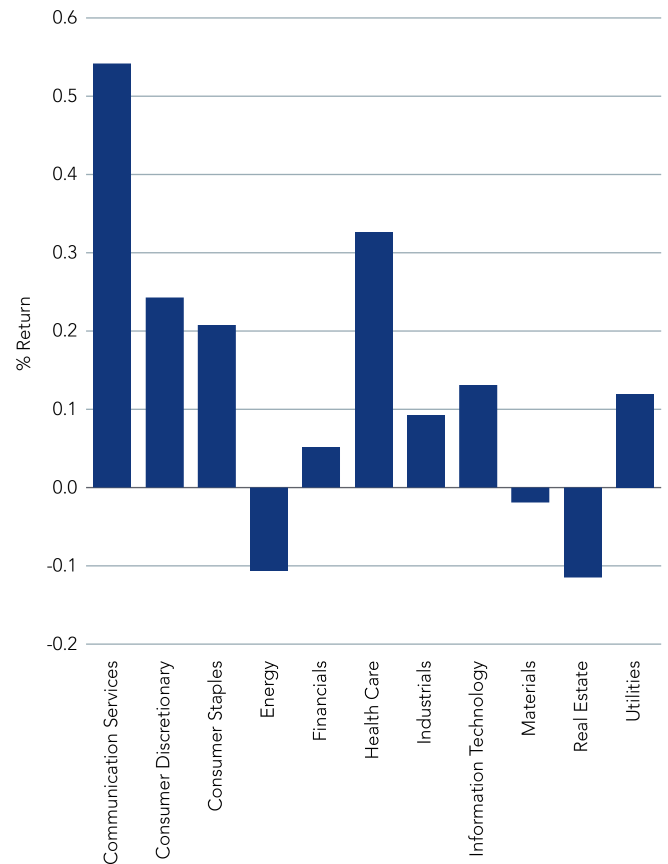
Figure 6: Average monthly total relative returns of companies in each quintile, based on environmental, social and governance scores, from 31 December, 2008, to 30 June, 2023. *Figures are calculated using constituents of the MSCI World Index, assuming monthly rebalancing.*



Source: Federated Hermes, MSCI, as at 30 June 2023. **Past performance is not a reliable indicator of future returns.**

Since 2014, our proprietary research has consistently shown that good governance adds a premium to performance across sectors and regions, with positive social factors also improving returns, particularly in Europe and Asia.[23,24] More recently, we have demonstrated that environmental characteristics also correlate to outperformance in most sectors. As we have long argued, then, ESG is more than a feel-good phenomenon.

Figure 7: Average monthly dispersion in total returns between companies in the top quintile and lowest quintile, based on environmental scores by sector, from 31 December, 2008, to 30 June, 2023



Source: Federated Hermes, MSCI, as at 30 June 2023. **Past performance is not a reliable indicator of future returns.**

[23] ESG investing – how Covid-19 accelerated the social awakening (hermes-investment.com).
[24] Despite headwinds, ESG continues to perform | Federated Hermes Limited (hermes-investment.com).

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That said, we should acknowledge that our definition of ESG is focused within industry peer groups and not explicitly concerned with sustainability. We focus on quantitative criteria to achieve our proprietary QESG score.[25] Crucially, this includes both forward-looking metrics and an assessment of the severity of individual issues, which avoids major problems being 'netted out' by modest progress in several other areas.

We should also acknowledge that, for now, the G and S in ESG appear to be more significant than the E. Although strong environmental factors correlate positively with returns, the connection appears weak and is much less clear than the contribution of governance and, outside the US, social factors.

It's also important to recognise that industry effects can overwhelm stock-specific strengths during periods of extreme market movement. As an example, when the Covid pandemic struck in March 2020, shares in even the best-run airline companies performed poorly. By the same token, the outperformance of energy companies in 2022 was an obvious industry effect.[26] While ESG has continued to work within peer groups during these periods, investment performance has been driven far more by choice of peer group – industry effects – which have largely ignored ESG and sustainability characteristics.

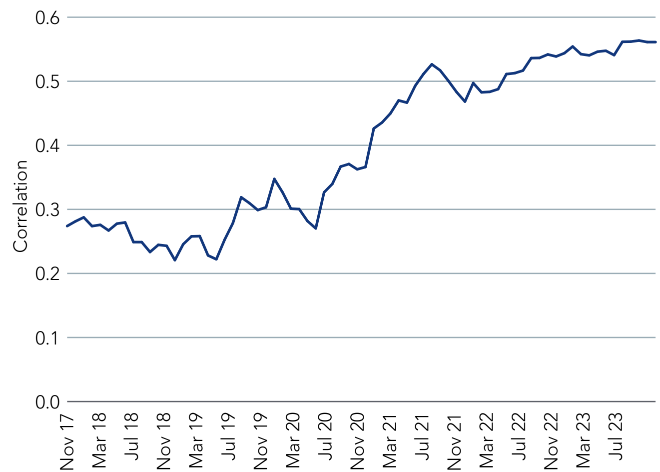
Is ESG hard to measure?

One of the biggest changes over the past 15 years has been the proliferation of ESG data. When we started out in ESG in 2008, measuring governance was seen as a somewhat remote possibility. Later, the focus switched to the environment, where data was more readily available. Since the Covid pandemic, much more emphasis has been put on the social dimension. In the process, we have gone from having very little data to go on to almost having too much. And some of this data isn't particularly good or reliable – making it even harder to separate the 'signal' from the 'noise'.

Nevertheless, there are still areas in which there are significant data gaps – not least on the workforce. And despite the huge amount of data and a growing number of data providers, it remains a huge issue.

One concern is the varied assessments of different data providers, who may accord very different ratings to the same company. At Federated Hermes, we're comfortable with many different perspectives – so long as they are credible, with consistent and transparent methodology. That allows us to take in those perspectives and then make our own investment decisions.

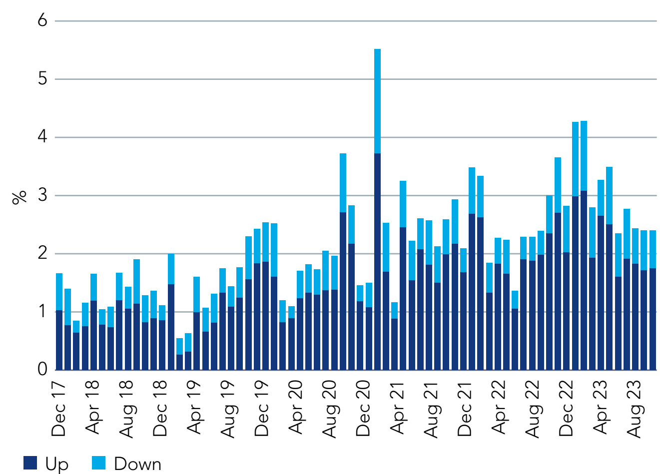
Figure 8: Correlation between MSCI and Sustainalytics Governance scores in the Information Technology sector over time



Source: Federated Hermes as of July 2023.

One trend that we have noticed is an upward bias in ESG ratings from data providers. Does this mean that the data providers are getting softer – or that companies are getting better at manipulating them? Or, conceivably, are companies improving their governance across the board? On rather abstract measures like governance, it can be hard to tell – which is where our engagement comes in.

Figure 9: Percentage of MSCI ESG Scores being upgraded or downgraded



Source: Federated Hermes as of August 2023.

[25] Our proprietary QESG scores combine internal analysis with external sources, such as Sustainalytics, MSCI and Trucost to score a company's behaviours. It allows for a sophisticated comparison against peers and sectors with respect to a wide range of ESG considerations.
[26] Despite headwinds, ESG continues to perform | Federated Hermes Limited (hermes-investment.com).

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And beyond the overall ratings, we continue to question the accuracy of data and worry that the industry's obsession with measuring more dimensions has overtaken the desire to ensure that the measurements are accurate and meaningful. For example, on the face of it, carbon emissions should be the simplest aspect of ESG to assess. You can measure a company's carbon footprint much more easily than you can measure the quality of its board. But even here we continue to see anomalies even as the available data increases. Estimates of carbon footprints even for the largest companies have proven to be unstable, both across time and across data providers.

There are widespread problems with the Scope 1 and 2 numbers used to represent direct and indirect carbon emissions.[27] And we are not alone in seeing the Scope 3 figures, which supposedly encapsulate the emissions that a company gives rise to in its supply chain, as little better than random numbers.[28] As these numbers are used to construct investment benchmarks, they may be leading to a significant misallocation of capital. The UN has noted the concerns that many investors have with ESG data.[29]

So, with much data unreliable and inconsistent, where does that leave us? We would argue that it underscores the importance of engagement, which we see as the heart of ESG investing. We believe that data derived from engagement offers deeper insights than that from data providers, where volume often replaces credibility. What matters, in our view, is expertise and experience: soft skills rather than 'hard' data.

Where do we go from here?

We believe that the best way to make money for our clients is to combine smart use of ESG data with the proprietary insights we achieve through engagement with companies. Although ESG investing can have a positive impact on the world, we see that as primarily an outcome of asset allocation rather than stock-picking. We make no claims to have a positive impact on the wider world through our stock selection. Instead, we understand ESG as maximising our clients' returns by recognising the changes that our world and society are undergoing and picking the stocks that are best placed to withstand them. And in doing this, we see our engagement with companies as both a source of investment intelligence and a means of achieving positive impact at the company level.

We believe that a clear definition such as ours is crucial. Eventually, improved regulation should help the wider investment community to agree on common ESG objectives and definitions.

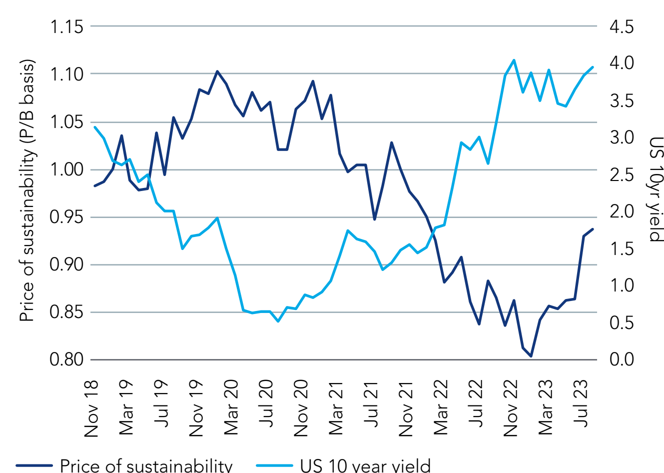
But we also believe that there is strong evidence for the value of both ESG integration and ESG engagement. In an environment of increasing political polarisation, this will be extremely important. Our contention is that strong and improving ESG performance correlates with strong returns over the long term. Better data and disclosures should make this correlation more obvious, and that in turn should draw some of the heat from the current clash over ESG.

We continue to enhance how we measure ESG in a quantitative way, for example integrating more explicit assessments of long-term sustainability through our Sustainable Opportunities score. By more explicitly focusing on the sustainability of a company's future revenue sources, our assessment of ESG will better capture the industry effects which have been so important to investment returns in recent markets.

In our view, sustainability will be an increasingly compelling destination for investors' capital. Although there has been a distinct lack of progress on the environment since 2016, it's not too late to reverse the damage we've done. But if we are to meet the 2030 climate goals of the Paris Agreement and the challenges laid out by the UN Sustainable Development Goals, investment in sustainability will have to accelerate at an unprecedented level.

In the meantime, sustainability offers compelling value. Analysis of the market through the lens of our Sustainable Opportunities metric shows that sustainable companies have sold off so heavily since Russia invaded Ukraine that they now effectively offer their sustainable advantages for free.

Figure 10: Price of sustainability vs. US 10 year yield



Source: Federated Hermes, Bloomberg, as at July 2023.

So far, the market has entirely ignored the long-term structural advantages of these companies. For ESG-focused investors like us, this is an opportunity not to be missed.

[27] Greenhouse gas reporting rules and pitfalls to be aware of (pwc.com).
[28] Why Companies Struggle With Scope 3 Measurement – Unravel Carbon.
[29] Driving meaningful data: financial materiality, sustainability performance and sustainability outcomes | Thought leadership | PRI (unpri.org).

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