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ESG Investing and its Discontents

There is currently a huge debate about the appropriate role of ESG investing. We argue that, far from being an isolated topic, it is intimately linked to the big fault lines of the investment industry, i.e. active versus passive, public versus private assets, and the challenge of preserving purchasing power in a new inflation regime.

Some would argue that ESG investing will inevitably grow, while others deride it as "woke capitalism." Neither description really rings true. Much of the potential controversy comes down to whether ESG investing requires setting extra goals other than maximizing return/risk, represents a different style of investing or is something else. There are core parts of ESG investing that do not require such extra goals. However, at the same time, we argue that many of these approaches to ESG investing are really what it means to actively invest, rather than some distinct and separate category of investing.

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One of the difficulties of writing about ESG investing is that people mean very different things when they talk about the topic. In this note, we distinguish between four different modes of ESG investing: engagement, integration, thematic ESG investing and exclusion. These modes may be overlapping in practice, but they all mean very different things and occupy profoundly different roles in investing. Crucially, the shift in investment regime we are now witnessing has very different implications for these approaches, suggesting possible divergence in performance and flows in coming years. This note covers how different ESG modes will likely interact with a changed macro backdrop, and also how this debate is intimately linked to other big themes in the investment industry—for example active versus passive investing and approaches to hedging inflation.

The investment industry has long been moving toward greater ESG adoption. However, in client meetings over the last year, we have encountered more strongly felt negative views on ESG than at any point in the past decade. There are two very different kinds of negative reactions to ESG investing: First, there is the highly publicized backlash in the US that has political connotations. Second, elsewhere, for example in Northern Europe where ESG investing started over a decade ago, the unease is about returns and risks associated with certain interpretations of what ESG means. This unease relates partly to concerns about the long-term efficacy of the approach that has been adopted and partly to a more immediate worry about the ability to generate returns and hedge risks at certain stages in the business cycle. An example of the latter is that many approaches to ESG investing that are either explicitly exclusionary or that have an explicit thematic tilt underperformed over the past 18 months. In the broader macro context of a different investment regime that features higher equilibrium inflation and losses on public market holdings, it is no surprise that we are seeing a backlash against certain interpretations of ESG now.

This unease reveals distinctions between the different approaches to ESG investing. The most stark ESG approach is when certain investments are excluded outright from an investment universe. It seems uncontroversial, from an asset manager perspective, to exclude investments if the asset-owner client has asked for it. But where an asset owner decides to exclude certain investments, is that always the correct way to reflect the wishes of individual beneficiaries? In the case of a pension fund, for example, beneficiaries may well say they agree with a given set of principles, but to what extent is that endogenous to other broader considerations that link required future purchasing power and the ability to save?

Likewise, can asset managers choose to exclude certain investments even if asset owners have not asked for it? Of course, this distinction becomes academic if excluding non-compliant assets creates a path to higher returns or lower risks, but what if that outcome is unclear? Or what if it takes a long time to see that outperformance, requiring an inter-temporal budgeting of returns and risks? Such considerations cannot be divorced from the overall investment environment including, for example, the ability to hedge inflation risk. The backlash in some areas of the US is really about specific applications of the exclusion approach; we would argue that this is just one of many possible approaches to ESG investing.

What does the future hold?

We have been asked several times this year whether approaches to investing might fundamentally diverge between the US and elsewhere. In general, we do not think this is the case, given the range of approaches to ESG—particularly for active management, which we outline here. If the European Union (EU) adopts double materiality, however, this would imply significant differences. On July 31 of this year, the European Commission adopted the European Sustainability Reporting Standards (ESRS). The key feature of the standards is the double materiality approach, which requires disclosures not only on financially material issues but also on issues that could have material social and environmental impacts on society as a whole.

The ESRS act will be formally transmitted in the second half of August 2023 to the European Parliament and European Council for scrutiny over a two-month period that can be extended for two additional months. Large companies previously subject to the Non-Financial Reporting Directive, as well as large non-EU listed companies (with more than 500 employees) will be subject to the ESRS starting in the 2024 financial year, with the first sustainability statement published in 2025. Listed small and medium-sized enterprises (SMEs) will be subject to new reporting standards in the 2026 financial year, with the first sustainability statements published in 2027. In contrast, the current Securities and Exchange Commission approach is to focus only on financial materiality, and to require sustainability disclosures only on issues that are financially material.

This all throws up a number of more "philosophical" issues that will be a subject of debate in asset-allocation meetings in coming years: What does it mean to be active? Can one influence a company if they know you cannot sell? Does selling the shares of a company in the secondary market impact its cost of capital? What is the role of the investment industry in directing capital in the economy? Is fiduciary duty co-terminus with maximizing return per unit of risk? The fact that these questions are hard to answer is part of the reason why the role of ESG investing is such a source of debate.

This note is very much written from a macro perspective—it is not intended to lay out the details of what constitutes an ESG approach. Instead, it discusses the links between ESG and other broader issues in investment management, linking that to the strategic outlook for investing in the post-pandemic world.

Four Modes of ESG Investing

One problem for any attempt to opine on ESG investing is that the term is used for completely different things. As we think about it from a macro perspective, there are really four modes of investing that could be classified as ESG:

1. Integrating an ESG view with other investment opinions, either at a single security or aggregate level. For example, this could mean taking a view that a particular company is going to face an extra cost or find new growth opportunities because of things that fit under an E, S or G label. Or it could mean taking a macro view based on ESG factors (such as temperature rises or increasing the compensation of the lowest paid). ESG integration also includes taking a view based on a prediction that ESG risks will, at some point in the future, be priced by fiat (for example, that governments mandate a higher carbon price).
2. Engagement: Bringing about a change in the underlying asset to achieve a certain goal in some area that is material to the company.
3. Funds that have a thematic tilt, whereby the methodological process for investing leads it to invest in a range of assets that do not represent the entire market, but that are not a formal exclusion (this would include most Article 9 portfolios, for example).
4. Exclusion: Entirely disinvesting from a security, industry or similar cohort based on an *a priori* view, regardless of a view on returns or risk.

We would argue that mode (1) is not really expressing ESG investing as anything new…it is just investing! It happens to involve ESG-related issues but is not, by its nature, different from taking a view based on accounting or industry trends, or on a view that government policy will change in some way on any topic.

By contrast, exclusion (mode 4) is fundamentally different, because it presumes a second target alongside maximizing return/risk. Some people may disagree with this assertion. For example, one could take the view that excluding assets that are not consistent with the principles of ESG will lead to outperformance in the long run if these assets are set to underperform whenever negative externalities are priced. But if that is the motivation, then we would really classify that as mode 1, integrating a view on ESG with other investment views. Presumably, if it is a view then it is open to being altered if different facts present themselves. However, if "bad" assets (on an exclusionary ESG basis) are just excluded regardless of other considerations, then this is almost by definition taking a secondary objective into account. We would distinguish this from a thematic tilt (mode 3), which could be thought about as an approach that leads to investing in a universe that is, in practice, narrower than the broad market but not through an *a priori* exclusion. For example, this could stem from an investment methodology designed around companies engaged in the energy transition.

The exclusion approach incorporates a spectrum of strategies in practice. It can reflect an *a priori* decision to exclude certain stocks or sectors, for instance. A slightly softer approach would be where a de facto avoidance of certain kinds of stocks is a result of the investment process. For example, this could be an approach that identifies beneficiaries of capital flow into new technologies or an approach to select stocks with certain growth characteristics. These could, in practice, result in always omitting a given sector. We regard such an approach as a fully justifiable example of active investment decisions. When we talk about exclusionary strategies, it is really the former approach that we refer to.

While the motivation for exclusionary approaches may well be laudable, it does not make sense unless the end asset owner has asked for it. The reason: there can (more or less) be agreement on the definition of maximizing return/risk, but there can never be universal agreement on any other parallel target. This issue is now clearly demonstrated by the backlash in the US. Absent an investment policy statement that explicitly directs the investment manager to restrict its universe of investible securities, a manager that chose to make an outright exclusion based on an *a priori* view of the investment universe rather than as an attribute of their investment process and not based on returns would, in the US, be violating its fiduciary duty and would be opening itself to regulatory sanctions and civil liability.

Constraining the investment universe will, by definition, mean that at some point over the business cycle—either on a return or risk basis—there will be underperformance. This happened to be masked because the first decade of ESG as a significant force in investment was one of disinflation and declining yields, thus an underweight in many commodity-related stocks and an overweight in long-duration stocks fitted the macro zeitgeist.

Is ESG-as-exclusion really just another form of factor investing? ESG decisions can often lead to net exposures that are similar to certain factor portfolios. However, this happens in the same way that many active approaches can lead to an implicit or explicit factor bias, and it should not be regarded as remarkable. The one approach to ESG that is essentially the same as factor investing is if a set of ESG scores, either derived by an investor or bought from a vendor, is used to construct a portfolio tilted in a certain way, such as to have a carbon footprint lower than the cap-weighted benchmark. We have written about how these types of portfolios can be built combined with other inputs.[1] Such an approach essentially views ESG as a subset of smart beta.

Engagement, mode (2), is not an ESG-specific point. It has more to do with the choice of how one wishes to invest: actively or passively. A fully active approach is not just about the selection of certain securities; it should also involve engagement with the management of the underlying asset. One of the reasons for the rotation from public to private markets over the past decade could be understood as a desire to access the active alpha that comes from control or bringing about corporate change.

Why Now?

ESG investing is finding itself being questioned with a renewed intensity, and it is intriguing that this questioning is happening for a variety of very different reasons. Some of the recent high-profile media coverage has related to a backlash against ESG in the US. But there has also been a broader questioning of the macro risk exposure of some forms of ESG investing. The long-duration exposure of popular ESG indices[2] has become more obvious in a period of markedly higher interest-rate volatility. In recent conversations with clients, we also encountered a palpable sense of unease over whether some definitions of ESG end up placing too many constraints on the ability to generate a given level of return/risk over the business cycle—and this came from clients based in Europe! ESG has grown as a force in investing over the last dozen years against a backdrop of disinflation and falling yields. We have pointed out before[3] that inflation creates a new kind of challenge that ESG investing hasn't had to deal with before, especially the mode 4 exclusion approach. Our view is that elevated inflation is here to stay. We are not suggesting that ESG investing is incompatible with inflation—far from it—but it does demand recognition that there is an impact from a changed regime that will affect certain ways of implementing ESG themes in portfolios.

It is evident that investors are scrambling to understand the implications of divergent views on ESG around the world, and also how a changed macro regime impacts the investment and risk characteristics of certain ESG-themed portfolios. This is in addition to regulators taking a harder line on "greenwashing" claims but also weighing in on the role of ESG principles applied to investing more broadly.

In the US, ESG has recently been the subject of a sharp political divide. On March 20, 2023, President Biden issued the first veto of his presidency against a Republican proposal to prevent pension fund managers from considering ESG factors in their investment decision making. On March 23, the House of Representatives held a vote to override the veto, but failed to obtain the required two-thirds majority. In Europe, the debate is very different but also very topical from a policy perspective. The EU Action Plan on Sustainable Finance features a series of regulations, of which EU Sustainable Finance Disclosure Regulation (EU SFDR) and EU Taxonomy Regulation are the most prominent. The plan aims to encourage sustainable investing and to redirect capital to more sustainable investments. The SFDR aims to increase transparency, and it mandates increased levels of disclosures from asset managers on how they address Sustainability Risks and Principal Adverse Impacts. It also aims to

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[1] See Inigo Fraser Jenkins et al., Fund Management Strategy: ESG Mandates - how to win them and how to set them, Bernstein Research, September 2016

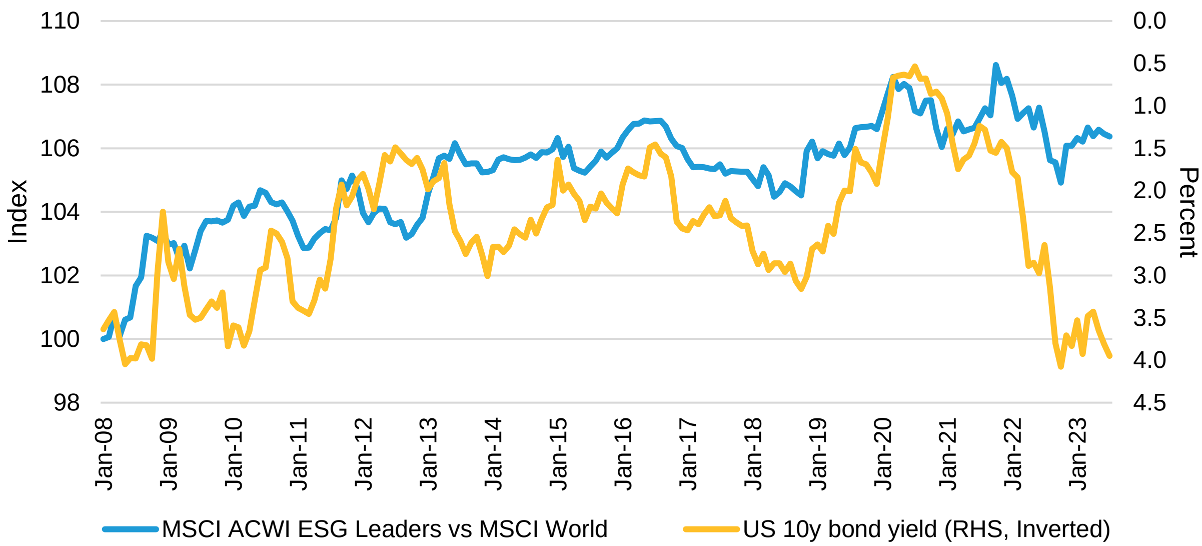
[2] Popular ESG indices at present often have a long duration and higher growth tilt to them. This arises, in part, from exposure to growth industries or stocks involved in, say, the energy transition, and also from a lower weight in high-yielding traditional natural- resources companies.

[3] The Intimate Linkage of ESG and Inflation - ESG and the Hegelian Dialectic

present ESG disclosures in a more standardized way, in order to enable investors to compare different investment options more easily based on different ESG related considerations.

The debate about the role of ESG is reflected in recent performance and flow data. In *Display 1*, we show the relative performance of one popular benchmark for ESG-themed investing. A decade of outperformance versus broader equity markets has been abruptly punctuated by underperformance over the past 18 months. At least some of this deficit likely reflects the long-duration nature of some ESG indices. While most equity ESG strategies are benchmarked to broad equity indices, we think it is instructive in the context of this debate to plot their relative performance against 10-year bond yields (shown inverted in *Display 1*). ESG strategies, on this particular definition at least, underperformed as bond yields rose in recent years. There is nothing unusual about this, we would argue. Any investment approach that uses only a subset of the available universe is likely to underperform at some stage in the business cycle.

DISPLAY 1: PERFORMANCE OF ESG-THEMED BENCHMARK AND DURATION TRADES



Historical analysis and current estimates do not guarantee future results.

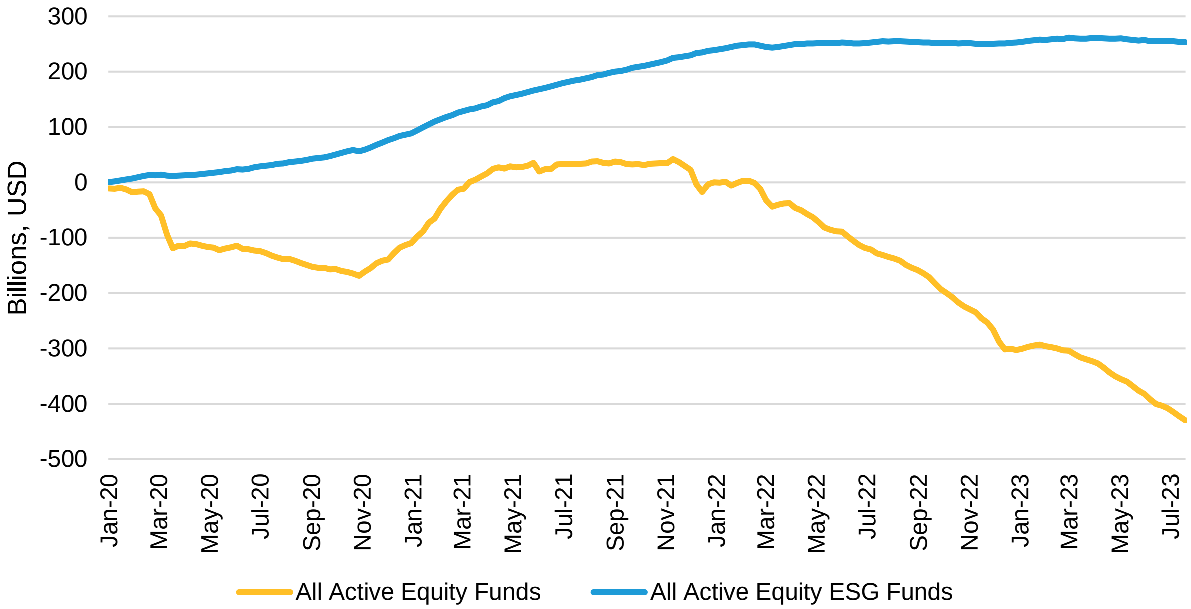
The MSCI ESG Leaders Indexes are designed to represent the performance of companies that have high ESG ratings relative to their sector peers. The indexes target a 50% sector representation versus the parent index, aiming to include companies with the highest MSCI ESG ratings in each sector.

As of July 26, 2023

Source: Datastream and AB

This underperformance has been reflected in flows (*Display 2*). After near-monotonic inflows for many years, flows into ESG funds have paused in 2023. Yet, while this is significant in being the first hiatus in ESG fund flows of any scale, it is still a very small outflow in the context of the much larger outflows from non-ESG active funds.

DISPLAY 2: ACTIVE ESG FUNDS HAVE DEFIED OUTFLOWS FROM ACTIVE MORE BROADLY, THOUGH NET INFLOWS HAVE NOW PAUSED



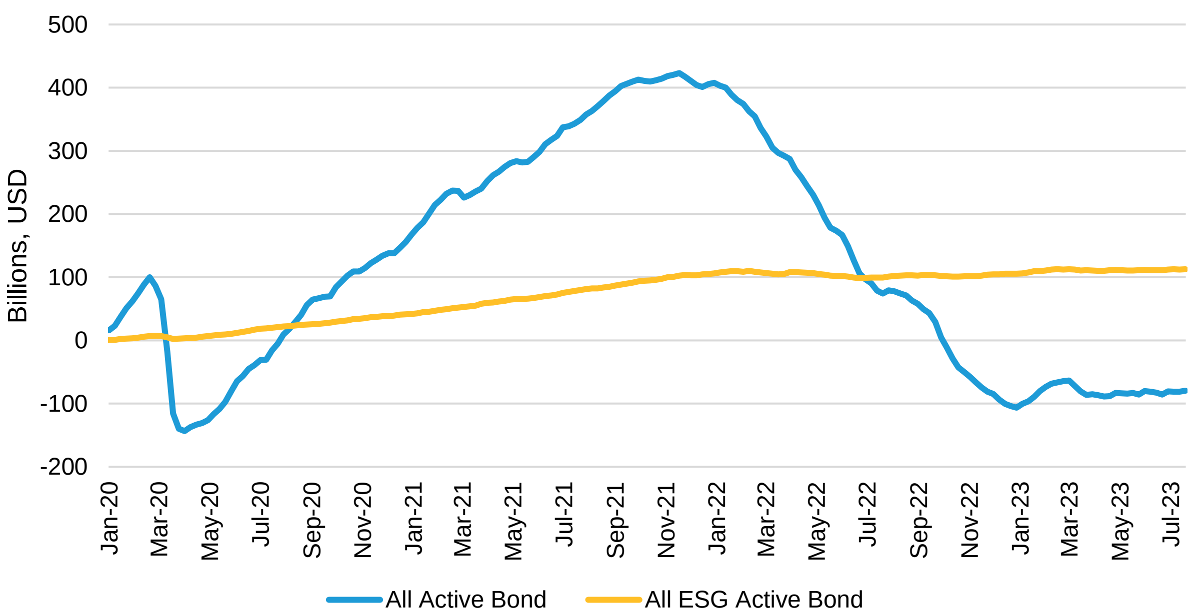
Historical analysis and current estimates do not guarantee future results.

Active funds only, excludes ESG ETFs. Note: If passive ESG funds were included the ESG flows would be approximately 2x larger

As of July 26, 2023

Source: EPFR Global and AB

DISPLAY 3: FLOWS INTO FIXED INCOME ESG FUNDS HAVE BEEN MORE STABLE THAN OVERALL FIXED INCOME FLOWS, WHICH HAVE HAD A CLEAR MACRO INFLUENCE



Historical analysis and current estimates do not guarantee future results.

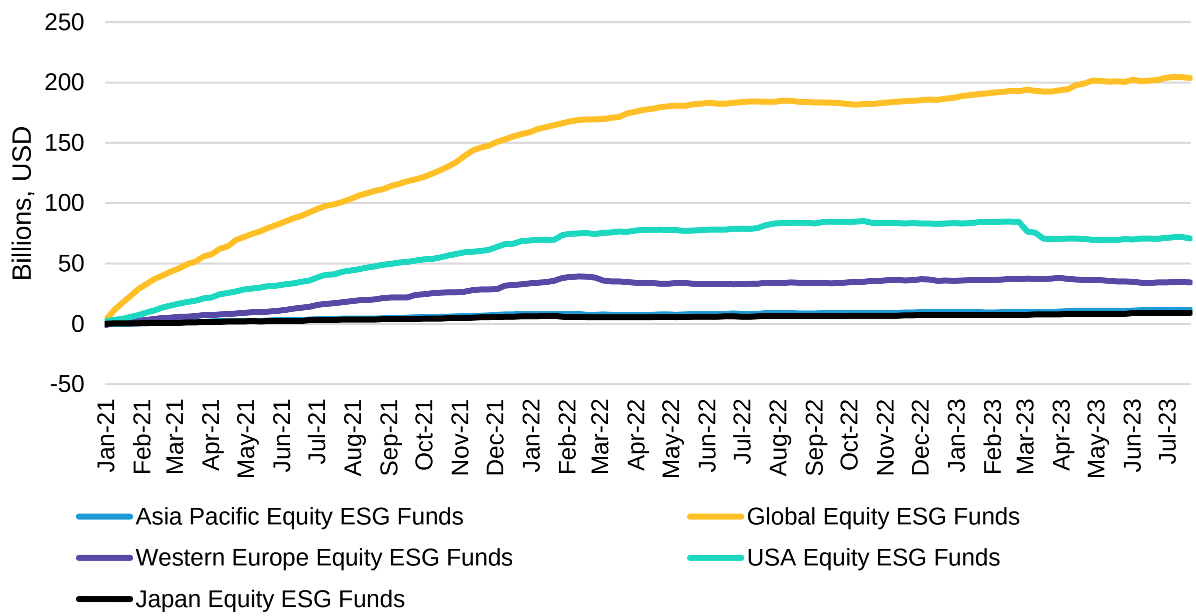
Note: If passive ESG funds were included the ESG flows would be approximately 2x larger

As of July 26, 2023

Source: EPFR Global and AB

In *Display 4*, we break down the flows of ESG funds by region using a broader measure of both active and passive funds. This analysis shows that the US is a clear standout in experiencing a more significant net outflow from ESG funds; the broad measure shows an outflow of the order of $10 billion. This implies a more generalized withdrawal of capital, such as in response to poor performance. We also note that Europe has seen a zero net inflow into ESG funds since January 2022, though it is the one region that has seen a consistent outflow of overall equity capital over the past year, so zero flow represents outperformance for ESG.

DISPLAY 4: US ESG FUNDS HAVE SEEN A SIGNIFICANT OUTFLOW; EVEN IN EUROPE, NET ESG FLOWS HAVE STALLED

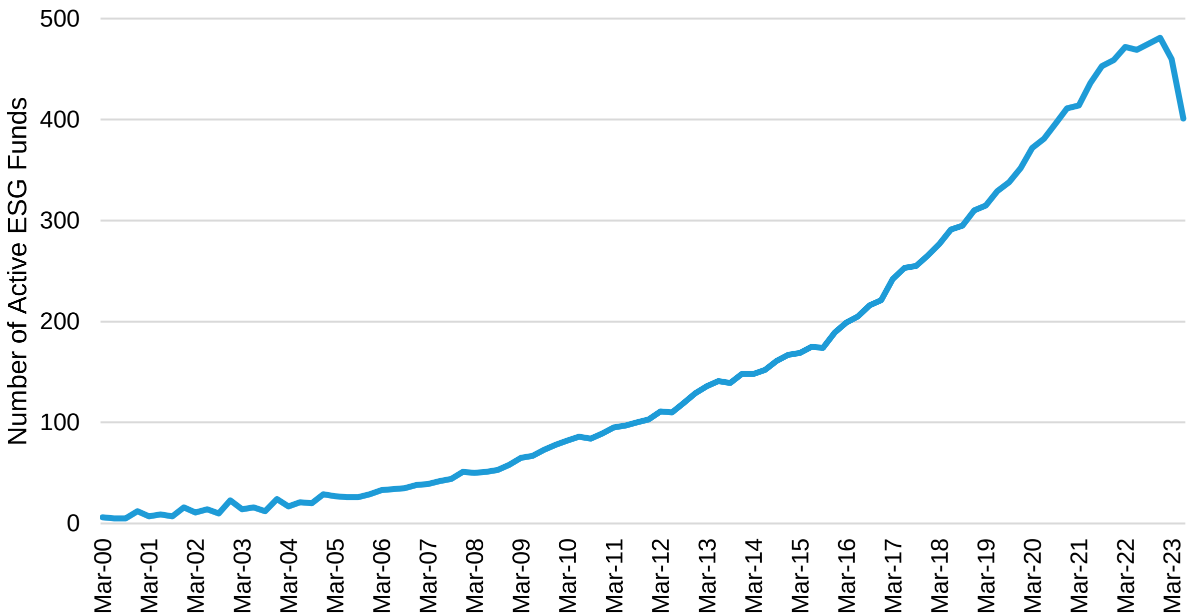


Historical analysis and current estimates do not guarantee future results.

Note this includes both active and passive ESG funds As of July 26, 2023
Source: EPFR Global and AB

The other way to chart the recent change in the ESG industry is the trend in the number of funds. The total number of funds classified as ESG has grown very rapidly over the past 10 years but has just reached a pause for the first time (*Display 5*). It would be hard to claim that there is a clearly defined “right” number of ESG funds, so this pause could represent a maturing of the market or a response to changed macro circumstances. Either way, it is a definitive change from the previous dynamics.

DISPLAY 5: AFTER MONOTONIC GROWTH, THE NUMBER OF ACTIVE ESG FUNDS HAS REACHED A PLATEAU



Active funds. Historical analysis and current estimates do not guarantee future results.

Note: number of ESG funds listed on the eVestment database

As of June 30, 2023

Source: eVestment and AB

It's about Active versus Passive

Part of the point of this note is to highlight how the ESG debate is crucial for other fault lines in the world of investing. An example of this is the active-vs-passive investing debate.

We have long argued that, even if for purely commercial reasons, active managers should not predicate their approach to ESG on exclusion or simply re-weighting portfolios to meet an ESG objective. If that is what ESG is about, it is frankly better done by cheap passive approaches. Seen in this way, exclusion-based ESG is just "smart beta" (we hate the word, but it serves a purpose) or index construction.

Active managers have a very clear path here. They can choose modes 1, 2 or 3: integrating views, engagement, a specific active approach within a theme or a combination of the three. But in those cases, ESG is not some separate category of *investing—it is just active investing*. One is merely considering inputs that happen to fall under the aegis of ESG when forming an investment view. For example, that view might happen to be that carbon will be priced at a much higher point in future. It is not obvious that the term "ESG" will, in the long term, be applied to such approaches. It is simply active investing.

Passive managers are in a bind in this respect. They do not have the option of expressing a view as in mode 1, and we would argue that they cannot ultimately engage in the same way or use mode 3. Thus, they are left with exclusion. (Of course. exclusion is ironically an active decision in the same way that the decision to passively implement an exposure to any index is always an active act of allocation.)

Having spoken to many investors on this point, we know that some of them would take issue with this statement, claiming that passive investors can indeed engage. In the early build-up of ESG investing, "engaging" was taken by some to mean the active use of proxy votes. Indeed, if proxy voting is all that is required to "engage," then very large passive managers can do this very efficiently at scale. However, we believe that the definition of engagement has gone far beyond simply engaging in proxy votes to encompass a more direct involvement in corporate policy.

When we surveyed corporate CFOs and heads of investor relations some years ago,[4] the attribute of passive owners that corporates found most attractive was that they perceived passive investors on their share register as providers of long-term capital. We explained at the time how we think that view displays a fundamental misunderstanding of the nature of passive investing. In tracking an index, being unable to sell is not a statement about provision of capital into the future, but instead a reflection of cumulative historical returns. It is a negative time horizon, not a long-term forward-looking one.

The argument has been made that the inability of an index-tracker to sell means that they care more about governance and other risks than an active manager who has the option of walking away. This case does presume that one knows the right questions to ask. It is relatively easy to do this with generic issues across the corporate sector, such as board independence, but harder when the issues require specific company knowledge. On governance, it seems more likely that there is common agreement on certain characteristics being better for investors than others. For environmental issues, it may be harder to forge agreement, especially if there is a need to trade off a near-term change in return/risk versus longer term goals.

One way of encapsulating the difference between an active and passive approach to ESG is in the question of whether security rankings should be based on the level of ESG scores or the change in those scores. It should be clear by now that we think ESG investing goes way beyond basing investment decisions on ESG scores. Nevertheless, they are very entrenched in the industry, because they add a veneer of quantitative faux-certainty to a qualitative domain. We have witnessed the tension in some parts of the industry in cases where ESG teams have tried to impose a minimum ESG score as a criterion for investment, in contrast with some portfolio managers who may, for example, prefer to buy companies with a low score and ride it higher. Our view is that an investment approach based on the level of an ESG score is passive investing. After all, what is the difference between that approach and other so-called "smart beta" indices? Buying companies where there has been (or—better—has the potential to be) an increase in ESG scores is more compatible with what the point of active investing is meant to be.

Engaging with the management teams of companies to bring about corporate change is a potential path to idiosyncratic alpha, a metric we have long argued is the best one for the success of active managers. From an asset owner point of view, this measure ensures that the manager is delivering something that cannot be easily replicated by cheaper factor exposures. Importantly, we can also show that there is more persistence in idiosyncratic alpha than in alpha as it is traditionally defined—as excess returns relative to a simple benchmark. After all, it is engagement and corporate change taken to the more extreme point of full control that private equity managers have exploited with much success in recent decades.

By contrast, there is an open question of what passive ESG investing means if it does not involve excluding securities.

ESG as Exclusion?

A significant driver of the initial growth of ESG, and one that still gives rise to perhaps the most divisive views, is investment strategies that in one form or another exclude or significantly down-weight companies deemed not compliant with a given ESG categorization. We think the asset management industry will evolve to realize that ESG-as-exclusion only really makes sense if an asset owner asks for it.

It is notable that asset owners in Europe have indeed been asking for exclusion for a long time. For asset managers, this makes the topic relatively clear cut. However, in the US this demand was never really the case to the same degree. ESG investing in the US was historically driven more by asset managers than demand from asset owners. Given the current backlash, the exclusion approach seems destined to shrink in the US, but we think the other modes of ESG we have identified are likely to be more robust and grow.

Exclusion seems set to remain in Europe, and partially in the US. But to the extent it is driven by pension funds, exclusion begs the questions of how to craft such approaches and whether the end beneficiaries are happy with it in a higher-inflation, lower-nominal-return and higher-risk world—a major change from the past few decades. This issue is also fraught with the question of whether ESG-as-exclusion requires a parallel goal alongside that of maximizing return/risk.

One key argument in favor of exclusion is that it could lead to outperformance. If this is the case, then there is no parallel goal needed because everything is about maximizing returns. This also really means that exclusion comes under mode 1, as we have defined the categories of ESG investing. But is there any evidence of exclusion leading to outperformance? We would point to

[4] Inigo Fraser Jenkins et al., Fund Management Strategy: Management incentives, buybacks and the failure of ESG, Bernstein Research, March 2019

two distinct aspects of this argument: 1) evidence from recent performance of ESG-biased funds and 2) as a statement about the long-term pricing of climate, social risk factors, etc.

As we showed in *Display 1*, the period of 2008–2020 witnessed a broad outperformance of ESG benchmarks relative to the broader equity market. However, the period since the invasion of Ukraine, and especially since the increase in rate expectations in late 2021, has seen underperformance. The implication of this pattern is that the tactical performance of ESG, at least as defined by common benchmarks, is very much linked to its characteristic of being long duration. Hopefully, it should be clear to the reader that we do not think all ESG approaches need to have this bias; the building out of a broader range of active approaches with different ways of using an ESG investing lens should help in this regard. The other way of thinking about this issue is in terms of tactical risk hedging. As the volatility in energy prices during 2022 demonstrated, the ability to hedge risk over the business cycle sometimes requires assets that are inimical to ESG exclusion approaches. Likewise, the academic evidence for outperformance of ESG funds in the long run is mixed, implying that this result is very much a function of exact definition and sample period.

The more forceful statements that we have heard from clients over the years on the concept of exclusion leading to outperformance make the claim that, in the long term, the response to climate change will lead to environmental risk and carbon intensity being priced in the market. By this argument, we should not expect to see the outperformance of ESG in historical data, but instead that companies scoring poorly on ESG metrics will end up being forced out of business in future. In that case, exclusion is justified as a path to higher returns. But if that really is the rationale, then it is a view. As with any other investment view, it must be held up to evidence, and investors should be prepared to adapt it if events change or if the time frame is much longer than anticipated. One example is the defense sector, where excluding the sector is now a subject of debate post the invasion of Ukraine.[5] An even more tricky issue arises if there is no agreement on the energy transition, or that the transition takes much longer than previously envisaged.

Asset owners can also express the view that excluding assets that don't comply with ESG goals is simply the morally right thing to do. While it is hard for an asset manager to impose such a view, the owner of the assets can. This is perhaps easier in practice for individual investors and family offices, where there is less of an agency problem in the management of assets. Indeed, this view could possibly become dominant. For pension funds, it is somewhat more complicated. The expression of a view on moral grounds may well be more nuanced, because it presumes that the end beneficiaries are in agreement with such a statement, even in the face of a higher-inflation, lower-return future.

If exclusion or underweighting is the chosen approach of an asset owner, what is the correct way to go about it? Perhaps the most transparent way is to think about combining universal goals, such as maximizing return/risk, with investor-specific goals, such as minimizing a carbon footprint or imposing other ESG constraints. This approach can then be thought of as a constrained optimization problem; we have set out in previous research what form this can take.[6] In setting anything other than a zero weight on non-compliant assets, this approach does, however, presume that the ESG input can be assigned a quantitative score.

The Active Investment Industry and Capital Allocation

The key *social* function of the active investment industry is to allocate capital in a capitalist economy.[7] The social function of capital allocation is an emergent property of the investment industry, in the sense that it is not the responsibility of any individual portfolio manager (nor should it be), but rather a function that emerges when the actions of many thousands of active managers are considered together. The active decisions made by investors make capitalism possible.

The aggregate function of the investment profession in directing capital allocation to maximize growth is well-rehearsed, please see our previous research on this topic.[8] How does ESG fit into this aggregate view of the industry? We think the form that ESG as a mechanism for aggregate capital allocation takes is about channeling whatever broader goals society might agree on into capital-allocation questions. But what if "society" doesn't agree on a consensus view? A more sustainable approach to viewing this social function might be to ensure that negative externalities are taken into account and priced. The key practical

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[5] See, for example, ESG: war in Ukraine leaves ethical investors sitting on defence, FT 31 May 2023.

[6] Inigo Fraser Jenkins et al., Fund Management Strategy: ESG Mandates - how to win them and how to set them, Bernstein Research, September 2016

[7] Inigo Fraser Jenkins et al., The social function of the investment profession, Bernstein Research, September 2017

[8] Inigo Fraser Jenkins et al., The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism, Bernstein Research, August 2016

consequence of the capital allocation aspect of active investing, viewed through an ESG lens, is providing capital toward issues like the energy transition or other similar topics—assuming there is a social consensus on them.

This topic has implications for ESG investing. One reason often cited in the early development of this branch of the industry was that exclusion was a mechanism for raising the cost of capital for "bad" companies, thereby forcing them to act differently. An outstanding question, however, is whether selling equities in the secondary market impacts the cost of capital. After all, every seller has to find a buyer. In other markets, primary credit for example, there is a stronger case to be made that this activity could change the cost of capital. How would one know if divestment had indeed changed the cost of capital? There is evidence[9] that valuation spreads between compliant and non-compliant companies, at least in Europe, have become wider, providing *prima facie* evidence that there might be some change in the cost of capital. Usually, we would use a valuation spread as a case for future mean reversion, but we would be more hesitant in assuming that this value spread will mean-revert.

ESG Investing or Woke Capital?

Well neither label is right, really. If ESG is done well in an active approach, there is, in a sense, no such thing as ESG as a separate type of investing—there is just active investing. Likewise, modes 1, 2 and, in the main, 3 described earlier are routes driven only by the wish to maximize return/risk, not by any other considerations, so the charge of introducing parallel goals does not hold in those cases. Put more bluntly, if ESG uses one of these three approaches, then it is not about one group pushing a non-return-based view down the throats of another group.

In this note, we have laid out the future of ESG as very much linked to the active versus passive split. The active-to-passive rotation of the past decade was partly driven by an environment where the return from asset-class "beta," especially in real terms, was historically strong. In such an environment, there is less incentive to invest actively. While mixing active and passive is efficient from a risk and fee perspective, we think that the balance will shift somewhat. A lower real-return world means that if (we stress the 'if') there are persistent sources of alpha, they become a larger part of end investors' returns. The notion of what constitutes a passive investment changes if more investors recognize the need to use inflation as a benchmark, as opposed to a financial market index.

Why is Inigo talking about this stuff in a note that is purportedly about ESG? A greater strategic role for active management (either in private or public markets) implies greater value being placed on the ability to express views (ESG mode 1) or via engagement, either with or without full control (ESG mode 3). A period when mega-caps are less likely to lead and when inflation is higher should lift the veil on some of the misguided obsession with benchmarking in recent years. Investors need return streams that do not necessarily have representation at scale in public markets. All of this may break the tyranny of the cap-weighted benchmark. But in such a world, if ESG is understood to be reweighting assets in an index (either to a lower weight or to zero), then it seems destined to have less of a role to play.

Asset managers seem less likely to be setting the case for exclusion, which was the basis for the first generation of ESG approaches. However, many asset owners will choose to use exclusion as a significant part of their ESG approach. Where that is the case, asset managers will clearly need to provide appropriate products. We expect to see more of a debate emerge within the asset owner community around the basis for these exclusion approaches. For pension funds, in particular, there probably needs to be an explicit recognition of whether any exclusion approaches express a strategic view on the pricing of ESG characteristics (i.e., focused on returns but taking an active investment view) or whether exclusions are there for broader reasons (not necessarily about returns). Exclusions might well be in line with what beneficiaries want, but we think it needs to be explicit. The boards of pension plans will likely be more focused on these distinctions in coming years.

In survey data, going down age cohorts people care more about achieving ESG outcomes with their investments (i.e., younger people put more weight on ESG outcomes in a sense it is not necessarily related to returns, or mode 2 as we laid out in this report). However, going down age cohorts, another characteristic stands out: people are poorer relative to the historical wealth of a given age cohort.[10] Moreover, going down age cohorts, there is a greater dependence on DC as opposed to DB pension saving, i.e. younger cohorts are shouldering a greater share of the risk of saving for retirement. These are all structural points which have been in place for some time. But one needs to layer on top of this the likelihood that inflation is higher, nominal returns lower and portfolio volatility higher. We note in passing that higher inflation is, in part, a result of ESG concerns

[9] Sarah McCarthy, Inigo Fraser Jenkins et al., Portfolio Strategy? ESG Bubbles continue to grow, Bernstein Research, May 2021
[10] Inigo Fraser Jenkins et al., Age of the aged: Demographics - destiny for the market, doom-mongering or a path to a better benchmark?, Bernstein Research

understood in their broader socio-political context.[11] Younger cohorts need higher real returns than was the case for older savers, but the hurdles to achieving them are greater. It is by no means impossible to reconcile these points, but they do need to be explicit.

Seen in this way, the role of ESG mandates, the form they take among those outlined here, and the capital-allocation function of the investment industry are intimately linked to questions such as the way pensions are funded in a society and the strategic investment environment we face in a world of deglobalization and changed demographics. ESG as engagement or integrated with investment views seems, to us, uncontroversial. When an asset owner or regulator—such as that of a pension system—sets ESG goals that demand exclusion, the implications of that must be linked to the savings needs. There is a risk that enacting the energy transition takes longer than envisaged, a risk that consensus is not reached on the desirability of this as a goal, and a risk that excluding certain assets leads to a worse near-term outcome in terms of return/risk at certain stages in the business cycle. Arguably, pensions are potentially better able to balance these kinds of inter-temporal risks, given the long-time scales of the liabilities they are designed to address.

Younger cohorts seem more inclined to incorporate climate change into both their voting and investing intentions. They also face a higher need for real returns but at the same time face greater hurdles in achieving them. If non-return-based aspects of mandates are indeed set, then that has to ultimately be linked to social safety nets, in the case of investments being insufficient to meet long-term liabilities set in the real economy. This link is perhaps latent at the moment, but we suspect it will become a significant issue that enters public debate. In other words, the nature of ESG investing is ultimately endogenous to strategic questions about the pension system. A discussion must be had here about how the need for long-term real returns for a society in aggregate are linked to ESG-type beliefs and intent.

In case some of this discussion seems too removed from the day-to-day concerns of investors, we end this note with a more explicit call to action:

Active investors should spell out their role in engagement and integrating views on ESG topics with other investment decisions. Such an approach is very distinct from one based on excluding certain assets. Engagement in active management is about achieving idiosyncratic alpha, which we regard as the proper motive for active management. We think that such an approach should not be controversial in the face of the pushback against ESG outlined in this note.

We argue that active investing should be about engaging with underlying assets and taking views on the way certain characteristics may be priced in the future.

An exclusion approach to ESG really has to be asset-owner led, and asset owners then need to be explicit about the rationale for that approach and what its implications may be for return/risk, which can vary for different time horizons. This approach is probably more complex where there is a devolved agency approach to investment, such as with pensions. However, the long-horizon nature of pension investing arguably makes pensions better able to trade off the inevitable inter-temporal risks. Ultimately, we think this aspect of ESG investing will become endogenous to the overall design of national pension systems.

Europe has been the most ESG-friendly region. The hiatus of flows to ESG in the region is notable but is linked to a period of underperformance and is relatively strong compared with continued outflows from European assets overall. We regard that trend as healthy, as it makes explicit the previously latent embedded macro risks. We expect positive ESG flows to resume, but ultimately for the design of ESG investments to merge into a broader debate about pension system design and appropriate strategic allocations.

In the US, the abrupt outflows from ESG have caused much soul-searching in the industry. However, we suspect that in part this soul-searching is because of the conflating of different ESG approaches. Some of the approaches we have outlined here are core to what it means to be an active investor. With time, we suspect that these approaches will increasingly be referred to as just active investing, because the ESG label does not really add anything new. This issue is likely to be subsumed by the bigger issue of active versus passive allocations.

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[11] There are broader macro themes that point to a higher inflationary future, such as deglobalization and climate change. But we would argue that both the “E” and “S” of ESG lead to higher inflation too, the latter through higher wages. This is understanding ESG as a broader socio-political force rather than in the narrow sense of its role in the investment industry. See The Intimate Linkage of EST and Inflation.

INVESTMENT RISKS TO CONSIDER

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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