Woke, war and waiting

There has been a lot going on in ESG this year – and next year may be even more colourful. Julia Dreblow decodes how this relates to sustainable investment and ESG, as we may well see more of the same during 2024

The three areas of focus (war, woke and waiting) are separate but not unconnected. All relate to issues that have the ability to polarise and bewilder. There are also elements of each that risk undermining investors' ability to respond efficiently to clear scientific messaging and public concern, particularly regarding climate change[1].

War

Wars do of course have massive and truly awful social and environmental impacts, however, in an 'ESG and sustainable investment' context they tend to be primarily regarded as an ethical, or 'personal values' led issue. Today, armaments – or defence – related exclusions are common across ethical, sustainable and ESG funds, however, their exclusions vary - as do client preferences. The relevance of this to investors was, however, raised some weeks ago when the Defence Secretary voiced concerns about 'ESG' being a potential risk to the defence industry.

My personal inclination is that ESG's power may be being overestimated. The rise in defence company share values appears to support this, but, of course things can change over time. However, the question makes it worth revisiting what funds in this area do, and whether or not they may be able to evolve. The three principle (often overlapping) reasons for avoidance are:

- ESG 'financial risk'-based avoidance, where some or all armaments companies - and / or their suppliers - are excluded because they fail environmental, social and/or governance risk-related assessments, and are therefore not seen as financially attractive. Such exclusions often reflect concerns about who they sell to and a lack of transparency. In other words, ESG risk is all about pretty conventional risk- based analysis.
- Norms-based exclusions – where exclusions are based on UN conventions, treaties and other international agreements that are intended to end the production of weapons causing 'unacceptable suffering'. Examples include cluster munitions, land mines and white phosphorus. Given that these are international agreements, many asset managers have companywide 'controversial weapons' exclusions.
- Values-led exclusions – where funds have explicit armaments-related policy exclusions designed to meet the needs of certain clients. Fund policies vary and therefore must be very clear about what is excluded. Some exclude manufacturers of weapons systems only, while others go further. Some exclude suppliers of generic products and services that also have military application.

From a sustainable/ESG/ethical investment perspective the area to focus on is what, specifically, has been promised to clients. Funds focusing on nonspecific ESG risks can and may shift their positions depending on their analysis. In the other two scenarios, promises have been made to clients. 'Softening' such strategies should be avoided, as it raises compliance issues, and can lead to complaints, outflows or worse.

Ethical and Sustainable funds are more likely than most to have explicit exclusions, but our (recently revamped) Fund EcoMarket database indicates that most relevant strategy types (which we call 'SRI Styles') can have relevant exclusions. In terms of numbers, 335 individual primary funds 'exclude armaments manufacturers' and 534 funds are run by management groups which 'exclude controversial weapons across all funds'. In addition 31 of the primary funds we list 'exclude all gilts' and 58 'exclude some gilts', typically because of defence spending.

Going briefly onto a tangent, it is also worth reflecting on the idea that war appears to be encouraging some sloppy thinking about fossil fuels and energy security. Playing on fear, the war has allowed those with a certain agenda to promote the need for increased local oil and gas extraction despite Net Zero targets and renewable energy being cheaper, cleaner, potentially far faster to upscale - and not flowing through international markets.

Such 'debates' are unlikely to evaporate during 2024.

(Anti)-Woke

Much of the so-called 'war on woke' is pretty mind-boggling, if occasionally humorous. However, in sustainable investment it also reminds us that the transition to renewables is going rather well in many regards as some people, companies and countries are clearly feeling threatened. Parking the fact climate change is a massively greater threat to all of us, and that this year's UNFCC Global Stocktake tells us we are not currently on track to meet the targets agreed in Paris, this fear is also largely based on a myth. Although they will be disrupted, there are very few organisations, or even petrostates, that can't be significantly reengineered to produce renewable energy and useful, circular economy-friendly products over time - if they are minded to do so. So, perhaps there are other factors at play, like status and control?

This year's events in Florida are an example of how bad things can get. Anti-woke laws have been passed in some US states, banning some investment institutions because of their 'ESG strategies'. The result has been reduced investment options and increasing costs.

Running parallel to this, many insurers have exited Florida because of increasing climate change-related claims (Florida's geology and location make it particularly vulnerable to floods and storms). As a result, insurance options have evaporated, so the state itself is now the 'insurer of last resort' for many residents - according to, eg Bloomberg and the FT. To those who believe climate scientists, this illustrates the need to reduce reliance on fossil fuels and cut emissions, to stop storms and floods from worsening. Yet while not all states (or people!) are 'anti-woke' or 'anti-ESG', the mudslinging and misinformation goes on, with investors too often stuck in the middle.

However, the 'ESG market' has not exactly covered itself in glory either.

Many fund strategies have been naïve and / or over-exaggerated ('greenwashing'). Unambitious ESG risk mitigation-based strategies have been marketed as focusing on holding sound, sustainable companies, when they are not. So, when individual investors find their funds are invested in assets they dislike, trust is undermined and critics are presented with an open goal. (Hence the need for rules).

Yet that does not excuse the dizzying mismatch between anti-climate action rhetoric and reality - particularly in states like Florida. Indeed this is reminiscent of the #WeAreStillIn campaign that erupted after Donald Trump became President in 2016, when many states and businesses made their continued support for the Paris Climate Change Agreement very clear. Evidently, opinions continue to differ. Alongside better fund rules, mapping out a sensible way forward for business and investors is also important, which is where the new (IFRS / ISSB) international sustainability reporting rules the UK's Transition Pathway Taskforce (TPT) work will help.

The US' Inflation Reduction Act is perhaps a more direct approach, investing over \$300bn to 'boost domestic energy production and manufacturing, and reduce carbon emissions by roughly 40% by 2030'. Creating job opportunities is also important. Statista recently reported 13.7m people being employed in the renewable energy sector worldwide in 2022, for example.

Waiting

There have been many other important developments this year which will help put sustainability on a more solid footing. However, at time of writing, the SDR – the UK's much anticipated 'Sustainability Disclosure Requirements and labelling regime' is imminent, but still under wraps. The new rules are, however, likely to be informed by the recent testing, published on 16 November, unambiguously entitled: 'FCA finds further work required to fully embed Guiding Principles for ESG and sustainable investment funds'.

Despite having been on the FCA's Disclosure and Labels Advisory Group I am not privy to the publication date, or their decisions, but broadly what we expect is:

- A mostly principles-based regime, that flows from the Government's Net Zero commitment, and the regulator's need to ensure clients are not misled (greenwash). Key elements are likely to be around ensuring consistency between naming, marketing/coms and what the fund actually does, including both stewardship activity and asset selection.
- Fund and fund management company level information requirements.
- Fund labels that allow for strategy variations (with likely overlaps), helping people to differentiate between funds that focus on forward-looking sustainability issues and funds that focus on ESG risk mitigation.

I remain confident that the FCA's SDR will be helpful, in part thanks to the extensive feedback they received. And, as set out in the Government's Green Finance Strategy, we can also expect more developments in the near future - including a Green Taxonomy (for investee assets) and guidance for advisers. I am also heartened by the EU's apparent interest in our approach, which offers the prospect of potentially better alignment over time, which would help everyone.

But being realistic, the fossil fuel community has deep pockets and powerful friends, including evidently many banks. I doubt many people really want such companies to fail, not least because they are major employers. Most want them to transition. But instead, they are playing a waiting game. Despite occasional fine words many are now openly talking openly about increasing output while sowing doubt - undermining alternative solutions that work right now - and claiming it would be better to wait for as yet unproven 'miracle solutions' that are just around the corner, like CCS and hydrogen.

Regarding further exploration, we have known for at least a decade that there are more readily available fossil fuel reserves than can safely be burned. The UNFCC's pre COP28 communique spelt out the challenge we face as follows:

"The latest science from the UN's Intergovernmental Panel on Climate Change indicates that greenhouse gas emissions need to be cut 43% by 2030, compared to 2019 levels. This is critical to limit temperature rise to 1.5 degrees Celsius by the end of this century and avoid the worst impacts of climate change, including more frequent and severe droughts, heatwaves and rainfall."

And El Niño continues, 2024 promises to keep climate-related destruction on the front pages well after COP 28. More records are likely to be broken, lives disrupted – and worse. The effects of storms are often exacerbated by habitat destruction, but our increasing use of fossil fuels is the prime culprit. We are now at around +1.2C and emissions are still rising. But there is a way through. The Institute of Actuaries and others have made it very clear that maintaining the status quo is a fairytale (see IFoA report 'Emperor's New Climate Scenarios'). We either transition swiftly or face a potentially ruinous climate.

Sources, including the UN, tell us renewables are both cheaper and cleaner than fossil fuels, and thanks to system level changes investors large and small are increasingly well-equipped to find, assess, hold and communicate the benefits of investing in assets that are helping to solve problems. In brief, investors and financiers hold the keys to a better future.

None of this will protect against election fuelled verbiage of course, but at the end of the day what matters is that investors help deliver the future our clients actually want. Doing so will be easier in 2024.

The SDR was published after this article was written. Julia will discuss the new rules in her next article.

Sources

[1] 2022 Office of National Statistics research reported that 'around three in four adults (74%) reported feeling (very or somewhat) worried about climate change' – second only to concerns about the cost of living (79%).

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