BRODEUR PARTNERS

BRODEUR Snapshot

ESG Perspective

NOTE

This Snapshot aims to provide an objective and balanced perspective on ESG. The Snapshot is a compendium of commentary intended to give our Brodeur staff a lens through which to view recent analyses on ESG. Brodeur strongly believes in the values espoused by ESG. Still, we also recognize the need to ensure its implementation is transparent, effective, and evaluated by generally accepted standards and data, where possible.

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INTRODUCTION

There seems to be little disagreement that ESG has become a business imperative. The real debate focuses on how ESG has been implemented and where it has to go in the future to achieve its true mission. Companies are placing increasing focus on ESG implementation and accountability through reporting. Over 90% of S&P companies have some type of formal ESG report. Most are voluntary, although some states have reporting regulations.

While ESG is generally viewed in a positive light, recent media coverage shows greater scrutiny of the underpinnings of ESG as a corporate guidance tool where investment returns clash with measurable benefits. These editorial voices point out that the altruistic benefits of ESG programs are hard to measure because data is not generally available or properly tracked, or there's little consistency in methodology to allow data comparability.

From a public relations perspective, this creates a number of vexing problems with respect to supporting claims around the value of corporate ESG initiatives. Many of these initiatives lack quantified performance results and have only anecdotal examples of effectiveness. When data is reported, it is hard to understand. Those who are cynical use these overly bifurcated data reports as examples of intentional obfuscation. A growing number of skeptics are challenging these reports rather than accepting them.

THE ORIGIN OF ESG

The origin of the term ESG stemmed from legal, risk management concerns, not necessarily good corporate citizenship goals. Saijel Kishan, a Bloomberg economist, points out that the ESG acronym originated from a British law firm that wrote a report for the United Nations Environmental Programme Finance Initiative in 2005. The report treated ESG as more of a risk management investment tactic than a noble environmental mission. Incorporating ESG data “would help protect investments by avoiding material financial risks from things such as climate change, worker disputes, human rights issues in supply chains, and poor governance.”

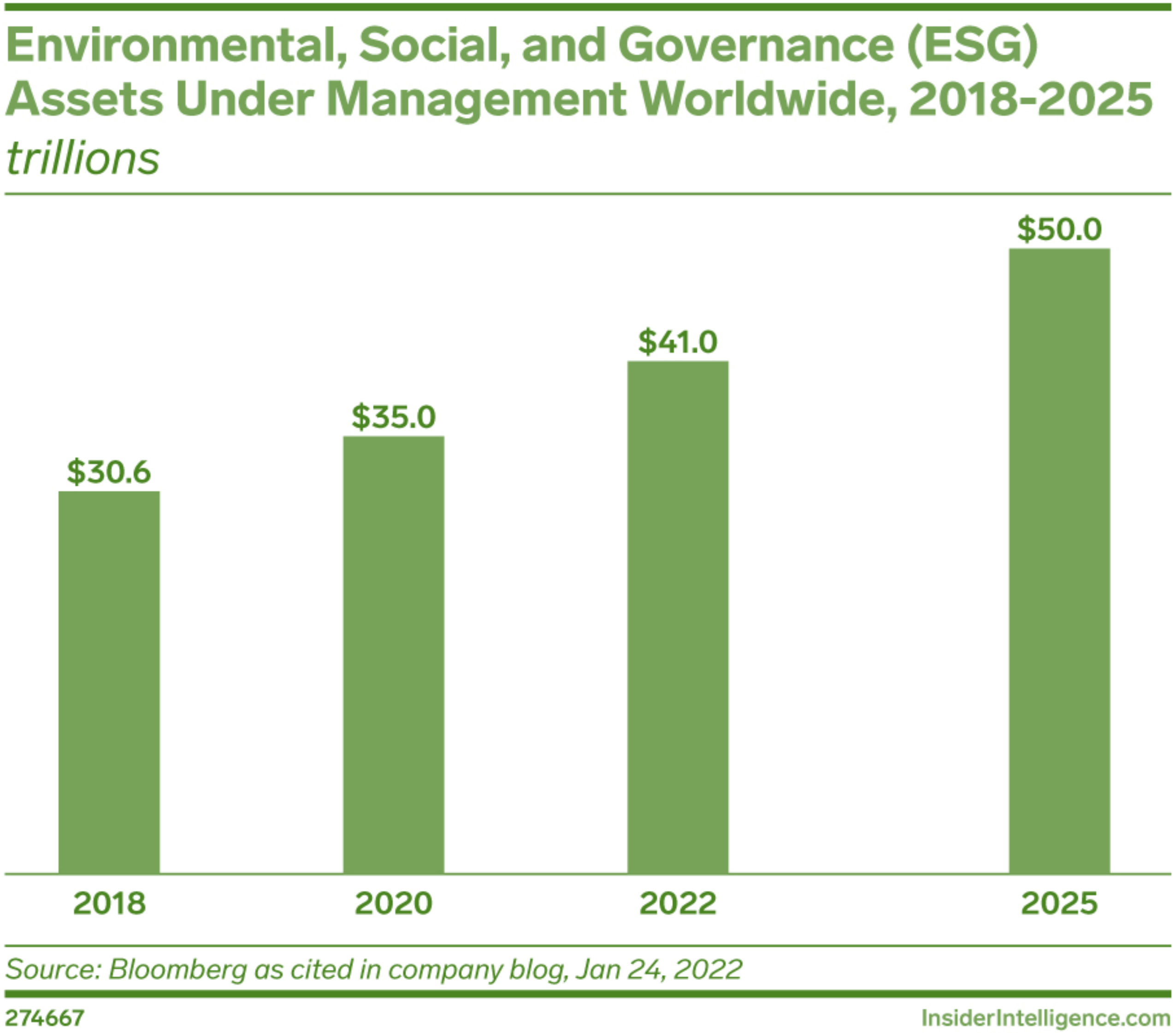
ESG INVESTOR MARKET SIZE

There seems to be general agreement that ESG assets under management will increase from $41 trillion in 2022 to $50 trillion by 2025.

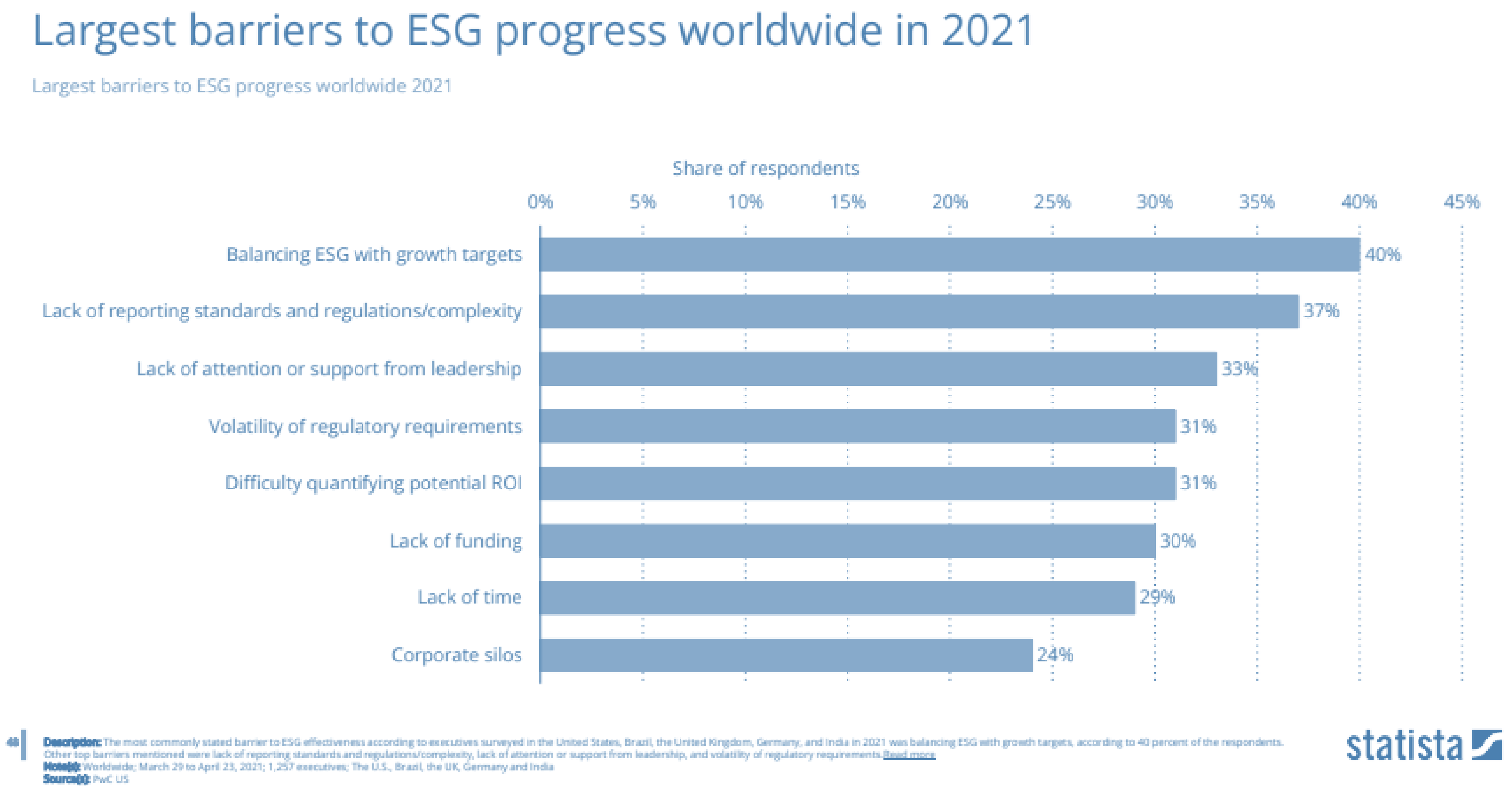
Despite the growth of ESG investing, there are still several obstacles. These include:

- balancing ESG with growth targets
- lack of reporting standards/complexity
- lack of leadership support
- volatility of regulatory requirements quantifying return on investment (ROI)

ESG INVESTOR MARKET SIZE (CONT'D)



ESG INVESTOR MARKET SIZE (CONT'D)



DEFINING ESG

There is no generally accepted definition of the ESG components but the global accounting firm, BDO, defines it as follows:

ENVIRONMENTAL
encompasses issues like energy usage, biodiversity, and emissions tracking and reduction

SOCIAL
covers matters such as diversity, human rights, and community engagement

GOVERNANCE
pertains to issues such as board composition, political contributions, and corporate ethics

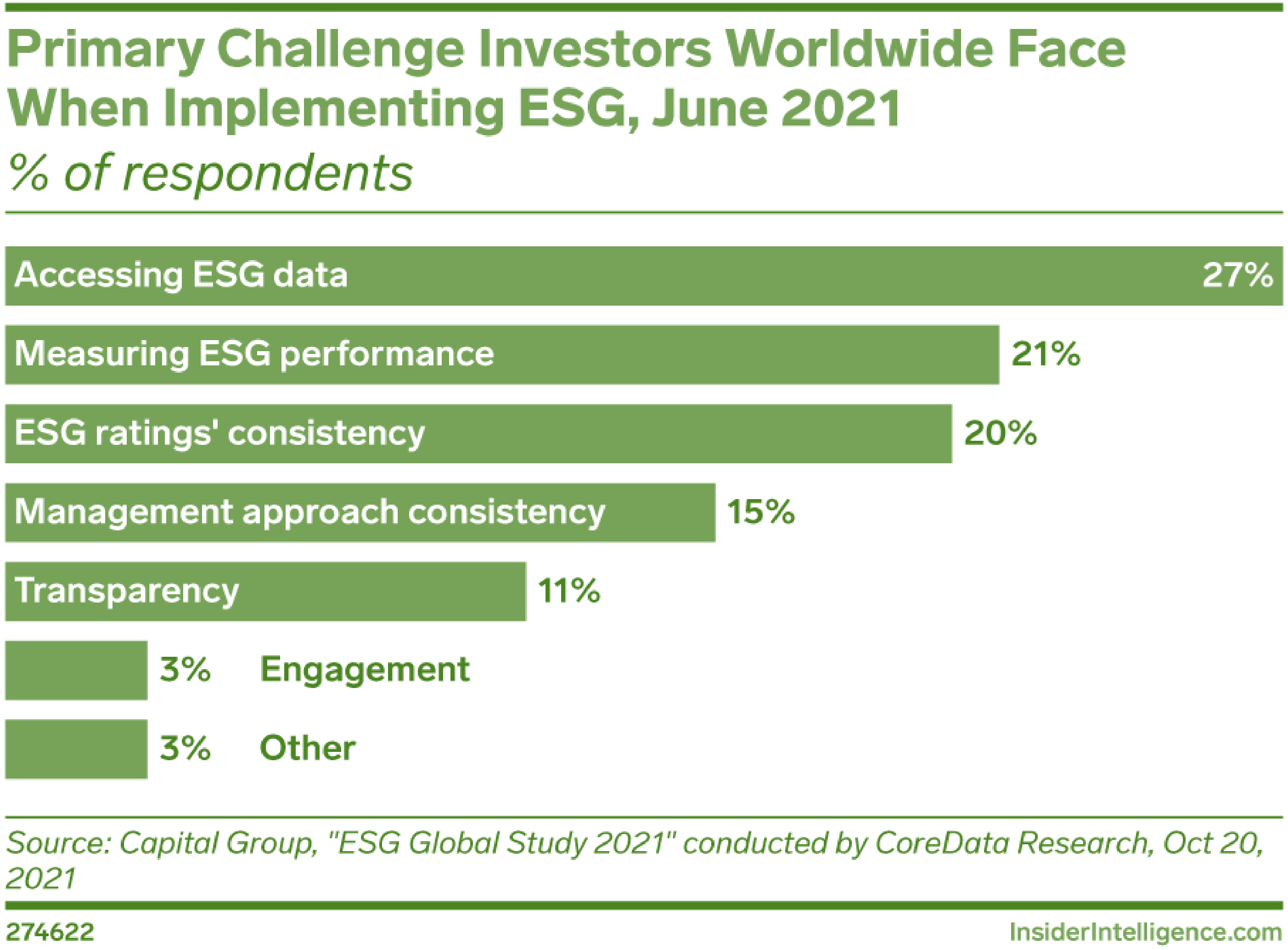
EXPERTS WEIGH IN ON THE ISSUES

Saijel Kishan, a Bloomberg economist, in an article in the Washington Post (6/30/22), provides a good summary of the issues.

You've probably heard of ESG and may know it as a form of investing and finance that involves considering material financial risks from environmental factors, social issues, and corporate governance questions. If you're like most people, you're probably not clear on the difference between ESG and socially responsible investing, impact investing and similar, sometimes overlapping approaches – partly because ESG has come to mean different things to different people. That vagueness has helped fuel rapid growth in recent years. But with that growth has also come increased scrutiny from regulators cracking down on banks and investment firms making exaggerated claims. In the U.S., ESG has also faced backlash from conservatives who deride it as "woke capitalism" and insiders who say it isn't creating the real-world impact it seemed to promise.

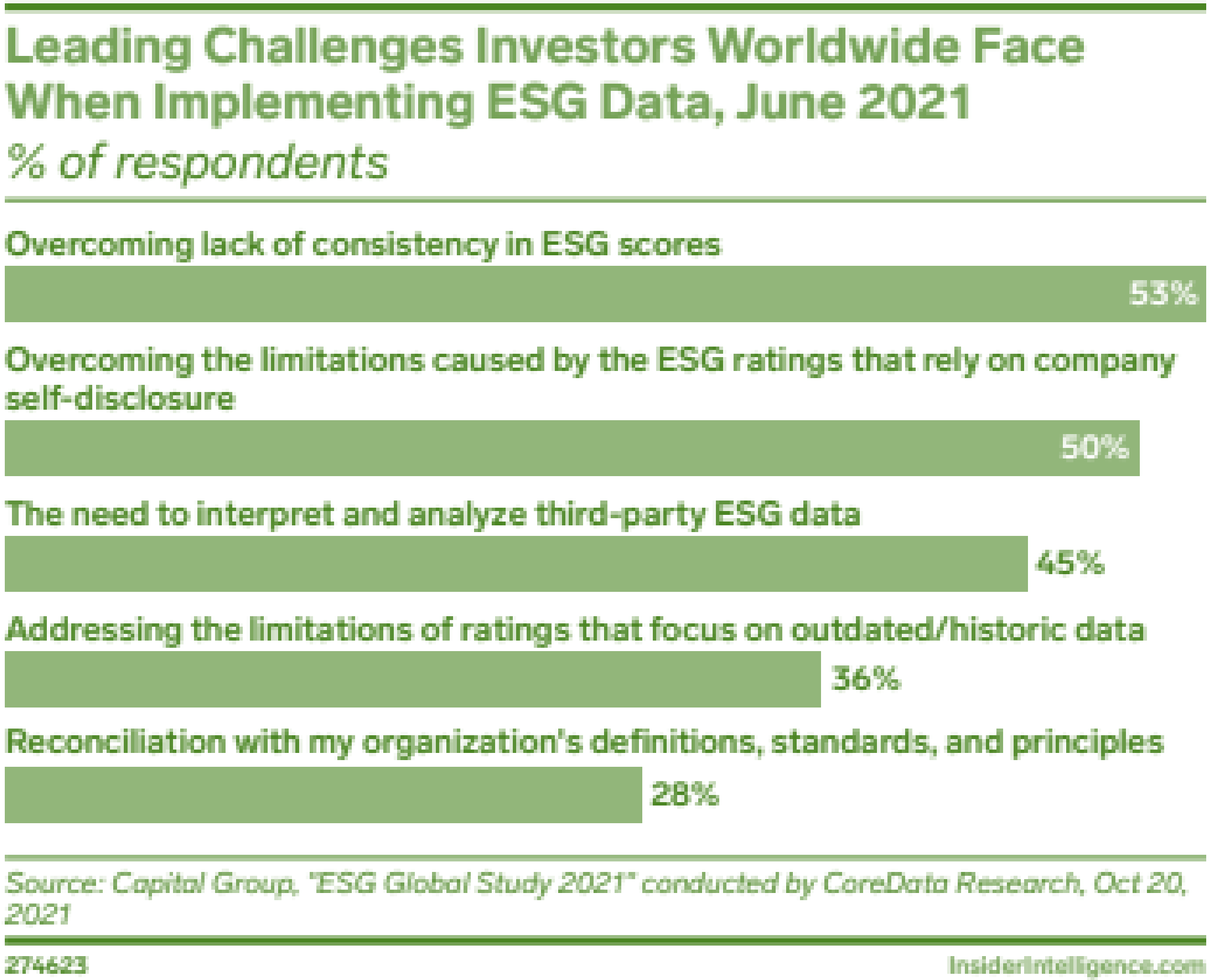
EXPERTS WEIGH IN (CONT'D)

As pointed out by INSIDER INTELLIGENCE, a lack of quality ESG data will threaten the manager's ability to offer products that conform to regulatory standards. Accessing and measuring the data are major concerns, as are consistency and transparency.



EXPERTS WEIGH IN (CONT'D)

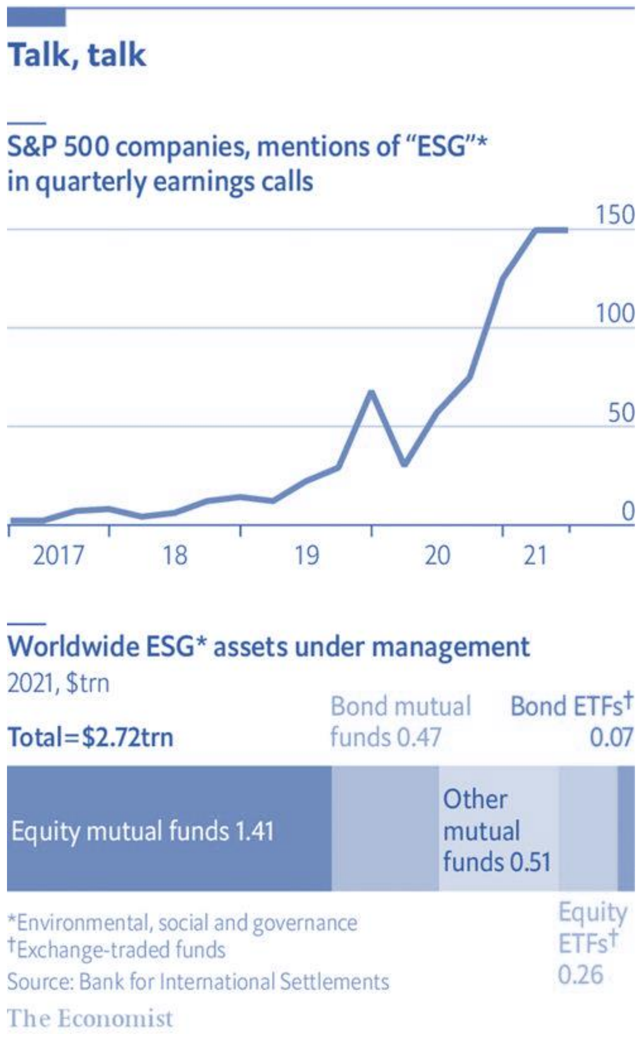
The INSIDER survey reflects the complexity of establishing ESG reporting standards. This includes consistency of scores, reliance on company self-disclosure, analysis of third-party data, benchmarking, and standardization of definitions.



MAJOR OBSTACLES TO BROADER EXPANSION

The Economist (7/21/22) described ESG as “A broken system that needs urgent repairs.”

The article points out the lack of measurable environmental and social performance. “The concept’s popularity has been partly fueled by real-world concerns, especially climate change. Yet it has had a negligible impact on carbon emissions, especially by the biggest polluters. Its attempt to address social issues such as workplace diversity is hard to measure. As for governance, the ESG industry does a lousy job of holding itself to account, let alone the companies it is supposed to be stewarding. It makes outsize claims to investors. It puts unmanageable demands on companies.



MAJOR OBSTACLES (CONT'D)

The Harvard Business Review (08/22) is on the same cynical bandwagon as The Economist.

"People assume that ESG investing is designed to reward companies that are helping the planet. In fact, ESG ratings that underlie ESG fund selection are based on "single materiality" — the impact of the changing world on a company's P&L, not the reverse. Asset management firms have been happy to let the confusion go uncorrected — ESG funds are highly popular and come with higher management fees. The danger with ESG investing is that it might convince policymakers that the market can solve major societal challenges such as climate change — when, in fact, only government intervention can help the planet avoid a climate catastrophe."

THERE IS GOOD NEWS AS WELL

A recent Financial Times article (7/11/22), "ESG Backlash Is on the Wrong Side of History," cites history to support that "good" will prevail and be rewarded.

"There's no getting around the fact that those companies that take their ESG obligations seriously are the ones that demonstrably outperform. Indeed, Bank of America Merrill Lynch research reveals that 15 of the 17 S&P 500 bankruptcies from 2005 to 2015 were organizations with poor environmental and social credentials five years before filing for liquidations."

The Harvard Law School Forum on Corporate Governance analyzed the 2021 proxy season. Their observations were quite encouraging.

> "
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>
> "

GOOD NEWS (CONT'D)

"Beyond voting on shareholder proposals, investors are beginning to vote against directors for poor ESG oversight. For example, during the 2021 proxy season, BlackRock voted against 255 directors for climate-related concerns, according to their Voting Spotlight." Also: "The 2021 proxy season was a tipping point for ESG, and asset managers' message was loud and clear: Any company that is not staying ahead of the ESG curve will face additional shareholder scrutiny. Further, shareholders consider poor ESG programs reflective of poor oversight at the board level and poor risk management techniques."

What are the main reasons why institutional investors implement ESG? In 2021, a Statista survey of investors showed that the main reason was:

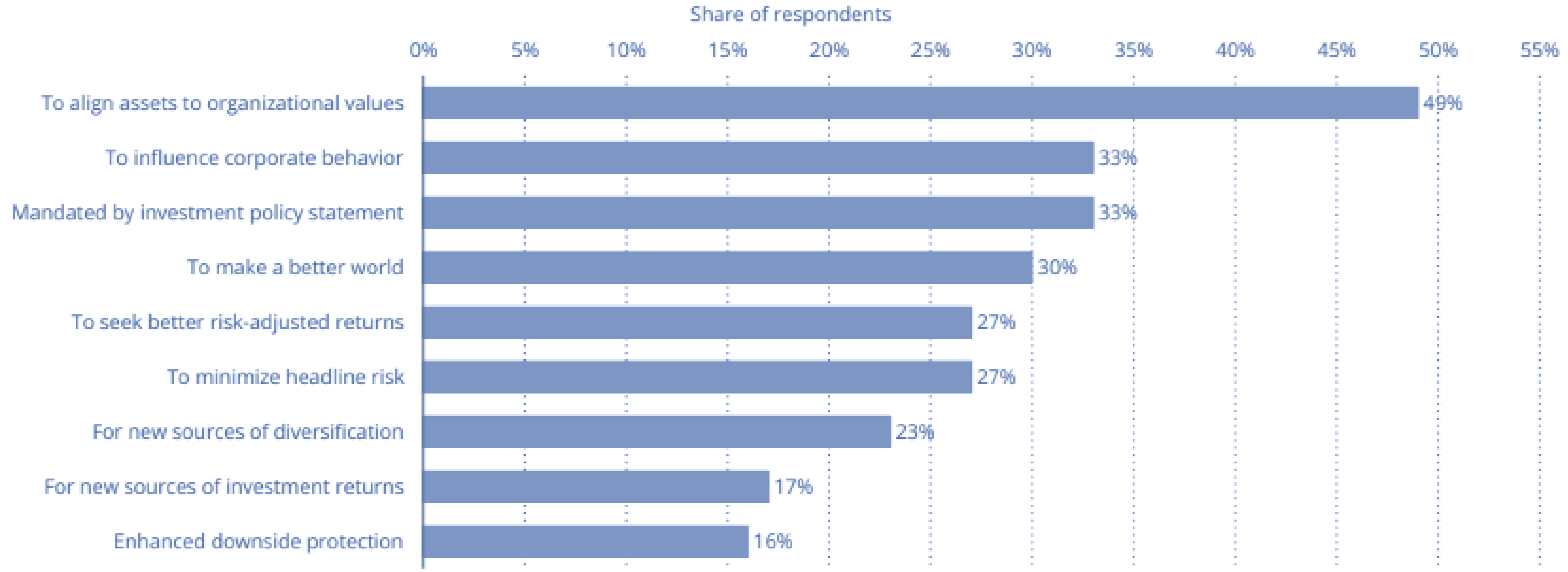
- to align assets to organizational values
- to influence corporate behavior
- mandated by an investment policy statement
- and a catch-all "to make a better world."

Interestingly, risk mitigation was not in the top four but had a significant influence.

GOOD NEWS (CONT'D)

Main reasons why institutional investors worldwide implement ESG as of 2021

Main reasons why institutional investors implement ESG 2021



45 **Description:** Almost half of responding institutional investors worldwide implemented ESG to align their assets to organizational values in 2021. Moreover, one-third of the institutional investors surveyed implemented ESG to influence corporate behavior, or because they were mandated by investment policy statement. Read more
Note(s): Worldwide; October and November, 2021; 500 respondents; Institutional investors
Source(s): Natixis Advisors

statista

WHAT ARE REGULATORS DOING?

The Bloomberg strategist Saijel Kishan (Washington Post, 6/30/22) points to a few examples:

“With the ESG label now widely used by money managers and bankers selling everything from mutual funds to complex derivatives, European and U.S. regulators are clamping down on firms exaggerating their ESG bona fides. In May, German authorities raided the offices of Deutsche Bank AG’s fund unit amid allegations that it overstated its ESG capabilities to investors. The following month, U.S. regulators are looking into whether ESG funds sold by Goldman Sachs Group Inc.’s asset management group are in breach of ESG metrics promised in marketing materials.”

REGULATORS (CONT'D)

"The U.S. Securities and Exchange Commission proposed a slate of new restrictions in May to ensure that ESG funds accurately describe their investments and may require some money managers to disclose the greenhouse gas emissions of companies they're invested in. These proposed rules come off the back of new European laws, the Sustainable Finance Disclosure Regulations, where investments have to be labeled under categories commonly referred to as 'light green' and 'dark green,' according to the priority placed on sustainability."

REGULATORS (CONT'D)

"Sustainable investors have made some strides, such as pressing companies to reduce their plastics use, addressing worker's rights, and performing so-called civil rights audits. They have also succeeded in replacing Exxon Mobil Corp.'s board directors to help the oil giant position itself toward cleaner fuels. Other proponents have said that had investors in U.K.'s Deliveroo Plc taken ESG issues into account, they could have avoided losses after the company faced a backlash over gig-economy exploitation and worker pay last year. Still, detractors say the idea that ESG investment alone is enough to address complex problems is being shown to be wrong and that more government intervention is needed to address societal issues such as living wage minimums and greenhouse gas emissions."

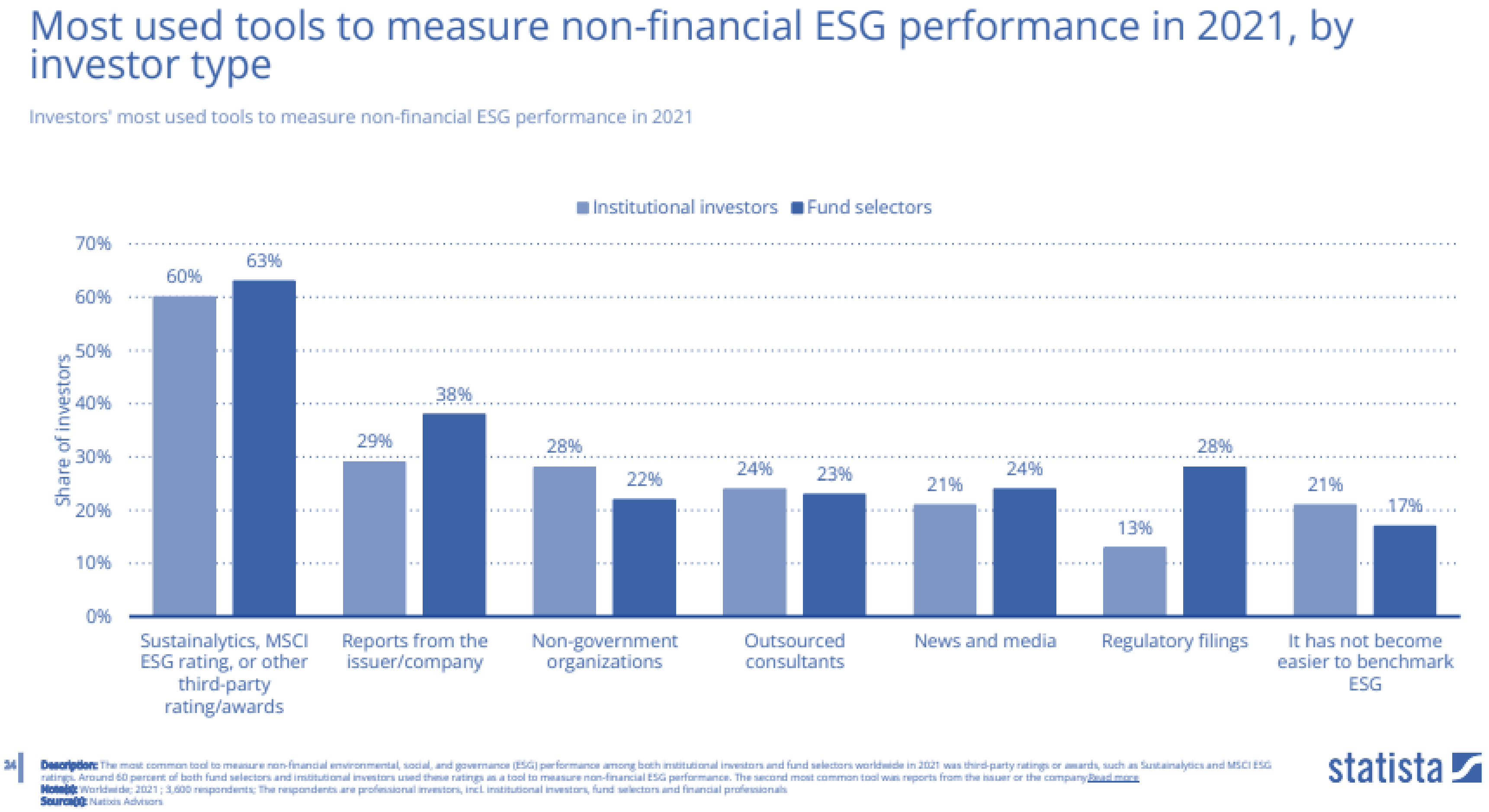
REGULATORS (CONT'D)

"How do these approaches stack up in terms of investment returns? Across three categories — Europe-focused, U.S.-focused, and global — ESG large-cap equity funds have done better this year, on average, than their non-ESG counterparts. While they have lost money — in line with the broad market selloff — those losses are smaller. Globally, ESG funds are down 11.7% this year through June 10, compared with the 14.8% slump of the MSCI World Index. But there have been some early signs that investors are souring on ESG. According to Bloomberg Intelligence, they pulled a record $2 billion net from U.S. equity exchange-traded funds in May, ending three years of inflows."

MEASUREMENT

Measurement is a very big, unresolved issue. As reflected in a large-scale Statista survey done in November 2021, tools used by institutional investors and fund selectors to measure non-financial ESG performance came from a wide number of sources. Approximately 60% used third-party measurement; many were self-reported or more anecdotal.

MEASUREMENT (CONT'D)



CONCLUSION

ESG is experiencing significant growing pains, and there will be a significant burden of proof of claims on both business and ESG investors. Promises such as "net zero emissions," pronouncements of GHG emissions goals, and diversity targets must be fulfilled. If these groups do not self-regulate, there will be loud demands for government regulatory intervention. ESG is a global issue, and the very nature of the multinational investment fund structure requires regionalized and, ideally, global standards. Getting to generally accepted principles will be no easy task. Data accessibility and integrity will be a continuing problem – both in terms of accessibility and standards. Internal taxonomies will have to be developed to manage inconsistent ESG data.

CONCLUSION (CONT'D)

Greenwashing will be an issue that activists will continue to use and will require a data-driven defense to diffuse. Younger investors inheriting wealth – a key target for wealth managers – are driving ESG growth.

From a public relations perspective, the risk of reputational damage from under-supported claims is quite high. In the rush to gain ESG recognition, the impulse is to lay claim to embracing ESG and then trusting that the data will hold up to scrutiny. This will be a very high-risk game.

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