pi ESG CLUB

With protests in parts of Europe and anti-ESG views being shared among lawmakers in the US, the world is facing a growing sustainability backlash. This month's ESG Club looks at the issue to discover if ESG is set to become a niche investment strategy once again.

JUNE 2024

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CLIMATE CHANGE INVESTOR GROUP SETS OUT PRIVATE DEBT FRAMEWORK

New guidance establishes agenda for private debt investors to deliver on net zero, finds *Andrew Holt*.

The Institutional Investors Group on Climate Change (IIGCC) has introduced new guidance aimed at establishing a framework of action for private debt investors to set and deliver net-zero commitments.

The guidance could well be seen as an indication of how private debt has become an important focus within the net-zero transition.

With this, the IIGCC intends to support any private credit investors who are active in direct lending, venture/growth debt, opportunistic credit, structured credit, fund financing and private placements.

The guidance reflects private market-specific nuances and takes the view that, given the unique characteristics of private debt investments, distinct actions are required to set and deliver decarbonisation goals for the asset class.

The development of the guidance was led by IIGCC with support from Ceres, a sustainability investor network, and incorporates input from a group of participants in the private debt industry, including members of IIGCC's private markets working group.

Some of the innovations introduced by the guidance include a 12-month "grace period" post-deal close. This, according to the guidance, is to "give GPs [general partners] more time to collect the relevant information for reporting against the Net Zero Investment Framework (NZIF) and engage with portfolio companies (PCs) to improve transparency, get portfolio company's expression of intent to progressing along PC criteria and potentially finalising deal terms such as ESG margin ratchets."

Three-way model

It also includes a "three-way engagement model" involving private equity sponsors and the inclusion of requests for climate disclosures in loan documentation.

This model, noted the guidance, is recommended between lenders, PCs, and private equity (PE) sponsors, where applicable, to ultimately encourage consistent sharing of climate/ESG data and to foster discussions across data standardisation across private markets.

Through this model, GPs are encouraged to fulfil their full engagement target by engaging with their PCs on net zero and climate-related concerns as well as their PE sponsors where private debt deals are sponsor backed.

This should enable GPs to broaden the remit of obtaining the relevant information to support the achievement of their net-zero targets, noted the IIGCC.

Misa Andriamihaja, private equity lead at IIGCC, explained the rationale behind the new guidance. "By outlining a consistent industry-wide approach, the new guidance can help raise ambition levels for GPs and LPs active in private credit, as well as underlying portfolio companies," she said.

And Andriamihaja added: "Based on input from a wide variety of industry stakeholders, the guidance's most valuable attribute is its recognition of the specific characteristics of private debt investments. Together with last year's private equity guidance, we look forward to seeing investors create and implement their net-zero plans for private market investments in support of their financial goals."

Niamh Whooley, managing director and head of sustainable investing at Pemberton Asset Management, added: "Private credit investors have a voice and this three-way engagement model recommended by the NZIF helps facilitate active engagement in our asset class."

The guidance largely seeks to promote clarity and action in assessing and disclosing climate-related risks within private debt investments, thereby, hopefully advancing climate change practices in private markets overall.

Industry wide

The guidance forms the private credit component of the NZIF, taking the total number of asset classes covered now to seven.

There is no doubt that private debt is a fast growing asset class with unique challenges, especially when it comes to decarbonisation.

"This guidance balances ambition with practicality, providing bespoke net zero-target types and tailored engagement strategies," said Peter Ellsworth, senior director at Ceres. "The emphasis on communication with all parties in this asset class, including private equity sponsors, will help accelerate climate action by private companies.

"We encourage private credit investors, whether or not they have made a commitment to net zero, to use this guide to inform diligence and evaluate how their assets support the emerging clean energy economy," Ellsworth added.

Last year, global investments in the energy transition reached $1.8trn (£1.4trn), according to Bloomberg New Energy Finance (BNEF). This represented a 17% increase on 2022 – despite the macro-economic, geopolitical and supply-chain challenges that characterised last year.

However, this appears to be nowhere near enough. BNEF estimates that annual global investment needs to reach $4.8trn (£3.7trn) by 2030 and $6.6trn (£5.1trn) by 2040 to put the global economy on track to reach net zero by 2050.

ESG INTERVIEW – FRANCES DEAKIN

"We are an investor with impact, not an impact investor."

The head of responsible investment at Local Pensions Partnership Investments (LPPI) likens the asset manager to a stick of rock. *Andrew Holt* reports.

Could you give me an insight into your responsible investments?

It is not about investments that are responsible; it is a whole process that is always being a responsible investor. So our responsible investments are our entire portfolio – it is about the process we go through as an asset manager that makes us a responsible investor.

The portfolio is diversified globally. Asset-class wise, there will be examples that people would expect to see from a responsible investor: wind farms and all the good stuff on the green side of the spectrum. But you need all sorts of investments in a portfolio to get the returns needed for our client funds to pay their pension beneficiaries.

So it is about identifying sustainable investments, which come in all sorts of complexions, colours and types.

So you don't have your portfolio and then a bucket of responsible investments – the responsible investment approach runs throughout your portfolio?

Think of a stick of rock, which is what we are, rather than a packet of sweets.

Therefore how would you describe your philosophy underpinning your responsible investment approach?

It goes back a long way. Probably before LPPI was born, in terms of the conviction of the investors that brought the partnership together. But in terms of the philosophy now, it is very much focused on what we are here to do as an organisation: it is our corporate purpose, that delivery of sustainable return over the long term. That means responsible investment has to be integrated into everything we do.

Could you explain your quite ambitious plan to achieve net zero by 2050?

Net zero is the logical step forward. This is about the long-term sustainability of the market and being a responsible investor. You want to see the whole market rise and we are investing in the whole of the market.

It is around wanting to see that progress towards the Paris Agreement's targets, to be decarbonising all sectors and all companies to be decarbonising. So looking for your sources of sustainable return from as big a landscape as you can. You cannot do that by picking and choosing. You need to work across the whole market.

The net-zero commitment is ambitious in terms of the work that needs to be done. But we are quite clear that is in partnership with everyone in the market: government, policy setters and regulators. It is the whole market's responsibility to get to net zero.

We are an asset manager on behalf of public sector pensions, and our job is to get them a long-term sustainable return. But arguably, you won't be able to do that

if you don't have a net-zero aligned portfolio going forward.

Is it a challenge to keep an eye on the here and now, getting your returns and then having a 2050 net-zero objective?

If you think about the framing of the net-zero commitment, it is not about greening the portfolio; it is about transitioning the portfolio. The most successful transition portfolio will be where you don't need to change anything because the companies you are investing in are changing as you own them.

As long as you keep clarity on what you are here to do, over time more of the market is going to be in that place, but you need to be tracking what you are doing. You need to be setting targets, ambitions and expectations in the market and review that they are meeting them or not. You want the companies you are holding to be the ones which are transitioning.

What are the biggest challenges in addressing responsible investment and net zero from an asset-owner perspective?

There can be practical challenges. For example, how do you evaluate how aligned a company is with net zero? ESG is easier the closer you are to an individual company or asset. The minute you move away from being that detailed, the more complexity you build in. And a net-zero portfolio is complex.

On an individual decision-making level the challenge is data. It is having the information and insight to understand where individual company mandates are and their capacity, and commitment, in moving to net zero.

The whole market has a contribution to make to ensure it is easier for investors to understand where companies are positioned by the reporting information available.

There is a major imbalance on the availability of information in public markets versus for private companies. A great deal of focus is on public equities, but not so much large data sets in private companies. Where there isn't disclosure you have to judge on more generic data that you would prefer not to use.

Do you see that the push back in the US around ESG could come to Europe and the UK?

It is not going to be influential like that in Europe and the UK. In ESG, even though the title itself is problematic, there is an understanding of the sustainability of companies and that the market is evaluated by more than just traditional financial information in the UK.

Investors need to be looking at the drivers of sustainability, which are the E and the S characteristics. Companies being well received by the market need to cover these. That is not going to disappear. So

there is no opportunity to row back on this, even if people wanted to.

Do you see a positive trajectory on ESG-related issues among the companies in which you invest, or are some proving problematic?

There are shades of strength to shades that are less strong across the portfolio. But companies increasingly understand the investor interest in ESG. Evidence suggests that it is something they are taking on board. After all, it makes good business sense.

They may not sometimes have the language to talk about how they are doing this or lack the budgets if they are not multi-national companies, but in terms of the journey, more companies are on it, and that is what we are looking for. It is not just about the best getting better, but the whole market moving forward.

You are also heavily focused on engagement and stewardship. How do you approach them?

Ultimately, it is the point of good asset selection. Choosing the right assets in the first place is important. Once you hold the assets, it is being active in the ownership of them. You cannot be active on every asset you own; you are relying on regulators, asset managers and other players to hold companies to account. But the aim is always to get the best out of companies.

When companies don't react in the way you want does divestment become an option?

Divestment is a loaded term. It suggests a cliff-edge outrage. Where actually, the reality is usually more of a continuous process of portfolio managers re-assessing sustainability for everything they hold and consider whether those companies are on the right path. So you consistently see dis-investment for a variety of reasons, as part of asset management.

Divestment can, sometimes, be the right thing to do, but it has to be a full 360 consideration of what is happening, and not just on one issue, in that you are unhappy with one thing. You look at it in the round. It is not done on a whim.

It is the whole market's responsibility to get to net zero.

Does the S part of ESG also feature in your responsible investment approach?

It does. There appears an apparent over balance given to the E – with climate change under the E putting everything in the shade – but the reality is that climate change is the E, the S and the G all at the same time. If you sit down and assess what the S is, it is everything.

The challenge with the S is that it has no sharp edges. It hasn't any natural measures that help box it up in a nice clean way, which you can with climate change. In our assessment of risk return, the S is most definitely in that mix. Companies who treat their employees appropriately within social norms, fulfilling their responsibilities to society and recognising products that are needed, all of that is the S.

What does the investment industry need to improve upon in addressing responsible investment?

We are not doing a bad job. It comes back to it being incredibly challenging to demonstrate what you are doing. It is easier to articulate an approach and describe a process and harder to get into the outcome with something explicitly, unless you are an impact investor, then that is part of the measurement of the outcome. Our chief investment officer uses a phrase: 'We are an investor with impact, not an impact investor.'"

Are asset managers up to speed on responsible investment – as some asset owners have accused asset managers of being disconnected with the RI journey?

We are running pooled funds, so there can be the need for compromise, but I wouldn't say there is misalignment. It is just recognising the logistics of how we invest.

We are very much supported by our clients and listen to what they want.

Has the government done enough to address ESG, or has it dropped the ball on these issues?

Government and policy setters are an important part of the market. The prime minister has different pre-occupations of what UK plc needs to be delivering. But if the government wants to encourage private capital to invest in climate goals it has to do that by incentivising that capital to where it wants, and needs, it to go.

So the government needs to understand the objectives of investors. The influence comes through the incentivisation or de-incentivisation, which comes through the policy, and particularly the fiscal policy route. And investors need policy certainty.

In the eight years that you have been head of LPPI's responsible investment team what has been your biggest achievement?

The biggest achievement is where we are now. We have put a real importance on responsible investment. RI is not what the RI team does, but what everyone in the business does, wherever they sit. That is a great place to be.

What has been the biggest lesson of your career?

My biggest lesson is that my contribution is a perspective, and that I do not have all the right answers. It is the recognition that there are a lot of other people with ideas and perspectives that can teach me a lot.

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ESG: BALANCING ACT

Anti-ESG voices are getting louder in the US, while in Europe farmers have protested strongly against green policies. So how can those working to build a sustainable and fairer world win over hearts and minds? *Mark Dunne* reports

Santa Barbara in California turned brown over Easter. Mudslides covered roads and neighbourhoods across the county when five inches of rain fell during the three-day holiday. It was worse a month earlier when people were evacuated from the floods that engulfed their homes after seven inches of rain fell in a single day – breaking an almost 100-year-old record.

But what is most interesting about these storms is that Californians typically live with droughts and wildfires thanks to rising temperatures and prolonged periods of low rainfall. The extremes of dryness and wetness in the state have been blamed on climate change.

With such severe weather events claiming countless lives, California's governor, Gavin Newsom, has introduced laws that require companies with revenues topping $1bn to reveal the financial risks they are exposed to from climate change. As part of this they also have to disclose the volume of their greenhouse gas emissions.

But there's more. It is planned that from 2026 larger companies will have to pay a levy, the size of which will depend on the level of harmful gases they release into the atmosphere.

Yet it appears that Newsom's attempts to reduce the impact of climate change is not a policy that has been embraced by most US states. Indeed, only 24 have set carbon reduction targets. And far from ignoring the issue, some states are vocally opposed to decarbonising their economy.

In Texas, some asset managers are being blacklisted in that pension funds in the state are barred from investing in their funds due to their net-zero policies. This is believed to be the reason why some have quit climate investor bodies such as the Net Zero Asset Managers initiative and Climate Action 100+ in a bid to get back onto the approved list.

But it's not just decarbonising the economy that is being politicised. Investing with a social mandate is also under scrutiny as it could mean a boycott of the firearms industry. Indeed, in Wyoming investors have to disclose whether or not they consider social aspects when making an investment decision.

An insecure move

One of the reasons for such a backlash against laws designed to tackle the causes and impacts of climate change or investing with an ESG tilt is that they are seen in some quarters as a threat to the capitalist system, that is to say they could make everyone poorer and increase energy insecurity.

Oil and gas transformed the world and gave some people a lifestyle that previous generations could never have dreamt of when the first commercial oil well opened almost 200 years ago. So some political figures in the US are openly questioning why they should ditch a reliable and economically successful source of energy for a less efficient system, which may not work if the wind is not blowing hard enough, or if it is too hot for solar panels to work (Yes, really).

The problem is that data has emerged which some believe not only justifies their fears but shows that investing ethically means sacrificing returns. Indeed, most sustainable funds underperformed their conventional peers last year. According to Morningstar, 53% of sustainable funds in the US were in the lower end of the performance spectrum.

And investors have since walked away from sustainable investments. In the opening three months of this year, $8.8bn (£7bn) was pulled from such funds, Morningstar claims.

"When people look at ESG funds versus some other funds, they haven't looked great recently," says a senior investment consultant, who did not wish to be named.

However, this may be due to geopolitical events during the past two years, such as wars in Ukraine and the Middle East sending the price of oil higher and therefore boosting the performance of some conventional funds.

But this misses the point. ESG and sustainability are long-term investment themes and long-term investors, like pension schemes, need to be exposed to such themes. These strategies should not be judged on short-term horizons of, for example, 12 months. Unfortunately, this is not the case.

"People tend to be driven by the last quarter, the last year, the last three years, rather than looking long term," the investment consultant adds. "That is another challenge [with ESG]."

Political instability

Unfortunately, the sustainability debate is set to intensify in some regions as citizens in more than 50 countries head to the polling booths this year.

The US is one such country in the middle of a presidential election, which will not help restore confidence in sustainability after last year's performance. Instead of making ESG less political, decarbonising the economy and reducing inequality could be issues that will be used to separate the Republican and Democrat presidential candidates leading up to November's election. But political backing is crucial to making the world fairer and more sustainable.

"In finance we can't solve all the problems we have with climate and ESG. We need a combination of policy and government stability – so it isn't helpful that half of the globe is going to the polls this year," the consultant says.

It's over here

It appears that the backlash against ESG in the US is spreading to Europe. Indeed, some livestock farmers are pushing back quite hard against the country's sustainable policies. This year they have blocked roads with their tractors and occupied public spaces.

Such protests have been happening since 2019 and were triggered by a proposal in the Dutch parliament to halve the level

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of industrial livestock production in the country in a bid to reduce climate pollution.

But the consultant is not seeing much evidence of a backlash against ESG outside of what he is reading in the press. Despite farmers protesting in the Netherlands, any push back is limited. "Across different jurisdictions, ESG is embedded into company reporting. People are looking at it, looking at if there is any element of greenwashing.

"Whether they are doing enough is a different matter, but it is very much on the risk agenda."

An understanding of the importance of these issues is growing, but there is still some way to go until the approaches towards implementing it and measuring impacts are perfected.

"Think about how the awareness of ESG has grown compared to what it was five years ago," the consultant says, but concedes that work is needed here. "There are still problems around greenwashing, around taxonomy and the reporting is quite cumbersome. There are opportunities for improvement going forward."

Inclusive policies

The impact of sustainable policies and investment strategies are not always positive. Transitioning the global economy to renewable sources of energy from extractive forms is a major change. One that could alter the way of life for some and destroy the livelihoods of others.

Indeed, Poland, South Africa and Indonesia are just three of many countries that are economically dependent on coal. The livelihoods of whole communities in these countries depend on local mines. Cutting carbon emissions in these countries is going to be painful.

So making the world a cleaner place that protects the climate and the natural world so that it continues to nourish us with fresh air, clean drinking water, food and medicines needs to consider the impact on communities.

The social aspects of the transition are also an important element of ESG strategies. So providing alternative jobs of quality is a must to make sure that communities are not left behind. But is that message getting through?

"Personally, a just transition doesn't get enough airtime in the UK," the consultant says, although there is a levelling up agenda.

They added that companies are aware of the need for a just transition, especially international pension schemes.

The farming issue in Europe is a prime example of the approach that is needed to bring people on board with accepting more sustainable policies and methods.

Of course, we need nourishment to not only to survive but to flourish, yet with modern animal farming techniques believed to be contributing to climate change we need to find ways of providing the protein we need without it impacting our ecosystem and our nutritional health. Farming provides whole communities with an income and funds local services, the protection of which we need to balance with protecting the ecosystem and the climate.

These issues cannot be left to the corporate world alone to solve. Governments, companies and investors need to work together.

But governments in the developed world are under pressure as their economies are suffering from low productivity. Indeed, this has led them to pulling back on their sustainable targets, so what message does that send to investors? A lack of funding is to blame from governments in Europe that are overseeing low productivity caused by falling birth rates, aging populations and rising diagnosis of chronic illnesses.

They also need to fund the repair and upgrade of their aging infrastructure and repay the huge debt created during the Covid pandemic.

Double whammy

So, can we, as France's president Emmanuel Macron once said, grow the economy and decarbonise at the same time? It's not going to be easy.

"We are on a path to de-carbonisation and de-globalisation," the consultant says. "It is a question of how quickly and painlessly we get there. We have different headwinds with the cost of living and the energy crisis. All of those things are going to feed through at some stage."

It is clear that the message on the long-term benefits of decarbonising the global economy and reducing inequality is not getting through to some, who appear to be living in the moment rather than thinking about the long-term impact of climate change and biodiversity loss.

It could be that the decarbonisation goals for 2050 appear too far away for some, while those targeting 2030 are seen as too ambitious and unachievable. But in a time of growing cashflow negativity among defied benefit pension schemes in Britain, some will be focused on where the money will come from today to pay their pensioners. The risks their portfolios will be exposed to in 10 years' time is not something they are thinking about if they are having to sell units to meet their obligations.

So building a more sustainable world and one that is more equal and safer will mean a seismic change for many. But with the voices of concern at the changes taking place growing louder, there is a big balancing act between making the long-term changes needed and ensuring that communities are protected in the medium term. It is a balance that investors and policymakers have to get right. Otherwise, the backlash could grow to a level that could see ESG become a niche investment strategy once more.

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BIODIVERSITY LOSS – WHY SHOULD INVESTORS CARE?

Edward Lees and Ulrik Fugmann, co-heads of the environmental strategies group, and Alexandra Matthews is an environmental analyst at BNP Paribas Asset Management.

Human-driven pollution, climate change and population growth are all proven causes of the on-going loss of biodiversity. Global gross domestic product is estimated to total around $44trn (£34.6trn). Of this, more than half is reckoned to rely, to some extent, on biodiversity[1].

Biodiversity refers to the variety of living species on Earth, all of which work together in ecosystems, like an intricate web, to maintain balance and support life. Human life is fundamentally linked to biodiversity: it provides necessities such as food, air and shelter and plays a prominent role in economies, society and culture.

However, pollution, climate change and population growth are rapidly depleting biodiversity. Governments and other parties have started to respond. The European Union's Sustainable Finance Disclosure Regulation, the Global Bio diversity Framework and the US Inflation Reduction Act are all example of collaborative efforts to preserve nature.

Why should investors care?

History has shown that when society faces large structural problems, companies that help to solve these problems can do well.

Underscoring the value of investments in nature, the World Bank has found that every dollar invested in the water supply could generate seven dollars in return from related beneficiaries.

For investors, the key will be to identify companies that are related to solving nature-related problems and receiving capital that will be directed at the solutions.

The biodiversity finance gap is valued at about $700bn (£550bn) per year[2], so we believe it is a priority to scale up and effectively allocate biodiversity-positive finance. There are multiple approaches to this, such as excluding investment in practices and industries that harm biodiversity and implementing an investment criteria that favours nature-positive solutions.

What are the challenges of investing in biodiversity?

Concerns over greenwashing are rising within biodiversity listed equity funds. The challenges of investing in biodiversity in the public space are:

The limited universe of listed biodiversity-focused companies

Listed equity biodiversity funds face a unique challenge. Unlike areas such as renewable energy that have clear links to decarbonisation, listed companies rarely have core business activities that directly conserve or restore biodiversity.

Many public companies claiming to be nature-positive achieve this through how they run their operations, not through their business activities.

While some firms integrate biodiversity into their corporate sustainability initiatives or have projects that loosely address biodiversity goals, these are commendable, but often secondary efforts.

However, there are also public companies whose main activities have a meaningful link to biodiversity.

They could include innovative solution-providers specialising in removing salt from seawater, forest management, smart agriculture and recycling technologies, for example.

Keeping this two-way split in mind is helpful when evaluating biodiversity-related investment strategies in the public space carefully and transparently.

Measuring biodiversity impact

Measuring a fund's positive contribution to biodiversity is inherently challenging. The most common tool, Mean Species Abundance (MSA), has limitations. Most companies do not report on biodiversity meaningfully and, as there is little consistency across companies, making comparisons hard. Finally, biodiversity holds intrinsic value, which is difficult to realise and quantify through traditional metrics.

Aiming for ecosystem restoration

A BNP Paribas AM strategy focused on ecosystem restoration seeks to align with the United Nations' goal to return ecological functionality to degraded ecosystems. We believe that pausing and reversing the effects of the biodiversity crisis contributes to achieving this goal. This can be done through three key elements:

Focus on solution providers

Firstly, by investing only in companies whose products and/or services enable environmental solutions which can drive impact as well as achieve longer term sustainable, above-market returns.

Targeting reform in industries with a high biodiversity impact

We also target areas which have the largest negative biodiversity impact: consumer staples, materials, energy, industrials, consumer discretionary and utilities.

Engagement

Finally, through individual engagement and proxy voting, collaborative engagement, and public policy and advocacy, we support and collaborate with the companies we invest in to maximise biodiversity-positive solutions and operations. We work with the BNPP AM Sustainability Centre to drive and guide biodiversity-related engagement.

1) World Economic Forum, January 2023
2) International Finance Corporation, March 2023

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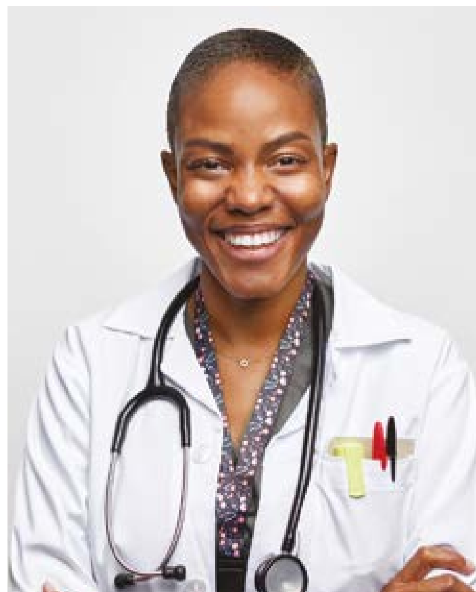

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1 Source: BlackRock as at 31 December 2023.

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