GLOBAL MACRO RESEARCH
THE POLITICS OF ESG

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EXECUTIVE SUMMARY

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Claire O'Neill had a 20-year career in consultancy and finance before entering UK politics in 2010. She served as Minister for Energy and Clean Growth in the UK Cabinet where she led the development of the UK's Clean Growth and Green Finance Strategies and headed the UK CCUS taskforce. Claire also created the global Powering Past Coal Alliance (with Canada), negotiated the world's first public-private Offshore Wind Sector Deal and brought forward the country's Net Zero legislation in 2019. She led the UK's winning bid to host COP26.

She now co-chairs the Global Imperatives Advisory Board for the World Business Council for Sustainable Development and serves as a main Board Director for Occidental Petroleum, the Singapore Stock Exchange and Climate Impact X. She is also a Senior Global Advisor for McKinsey and Company and an advisor to the international investment firm, Hambro Perks. She invests in and advises several companies in a global low-carbon technology portfolio.

Claire is a member of the UK Privy Council, a Fellow of the Royal Geographic Society and the UK Energy Institute and is a Business Fellow at the Smith School of Enterprise and Environment at Oxford University.

- Sustainability is often viewed as extraneous to the central operations of a business, rather than a core part of its mission. However, managing the impact of externalities is a precondition for any business seeking to grow its long-term value.
- The increased focus on sustainability considerations has required companies to measure and report on their ESG performance alongside traditional financial metrics. However, this focus has led to the development of metrics that are often complex and targets which may be unachievable. Better ways of assessing ESG performance are required.
- Up until now, companies and participants have focussed heavily on disclosures, which are often time consuming and offer diminishing returns beyond certain level. Instead, senior managers should focus on simple messaging which conveys their ESG strategy and recognise business areas ripe for disruption to capitalise upon.
- Without a means of valuing externalities, such as a universal carbon price or pollution price, it is difficult to take economic and capital allocation decisions while effectively considering all aspects of financial and sustainable performance.
- Managers should also reject binary thinking when deploying capital to finance sustainable innovations. We should recognise that we require multiple applications, given those that work under one set of circumstances may not work in another. Adopting such an approach will become necessary as the world retreats to friendshoring and competing trading blocs, and rising political interests attempt to inhibit different innovations across markets.

THE CURRENT STATE OF ESG PROGRESS

POLITICALLY DIRECTED GOALS

Since the dawn of the ESG movement at the Rio Earth Summit in 1992, governments have acted as the primary drivers of its development. Global conversations about sustainable growth were almost exclusively intergovernmental in nature. Meanwhile, businesses and financial markets stakeholders were at best tolerated within the UN Conference of the Parties (COP) ecosystem and acted as observers rather than participants.

A key question still is why we entrust politicians with such readiness to solely formulate ESG policy. The reason is partly historical; the COP process was modelled on the Montreal Protocol, which was set up to remove chlorofluorocarbons (CFCs) from the manufacturing sector.

While it is true the Montreal Protocol achieved huge successes removing CFCs, it represented a relatively narrow technical problem. By contrast, contending with a challenge of much wider application that requires major shifts in almost every economic sector needs a broader approach than seeking solutions solely derived from governmental direction.

Paradoxically, despite the depth and complexity of contending with ESG issues, there can be innate anti-business bias in much of the ESG movement, characterised by a belief that economic growth and the profit motive are the problem and should have no part to play in the solution. While public policy, regulation and subsidies retain a hugely important role as we pivot to net zero, expecting politicians to regulate a new economic order into existence is sub-optimal.

CLIMATE FATIGUE, POLITICAL DIVISION AND THE BATTLE FOR VOTER ATTENTION

Indeed, even if politicians had access to perfect information and skills, other issues and priorities arise which necessitate their attention, time and resources. Invariably, democracies must battle with fleeting voter attention for longer-term concerns and prioritisation of shorter-term policy issues.

The recent past has several examples of issues that have served to push environmental matters down voters' priorities, such as COVID, Ukraine and inflation to name only a few. While voters may profess their concern in opinion polls and other surveys for environmental matters, they often vote on entirely different priorities. This dynamic is also exacerbated by a sense of climate fatigue, some of which can be laid at the feet of overly pessimistic campaigners insisting the globe is on the cusp of climate Armageddon, which of course hasn't happened. In addition, distortions in the energy market caused by COVID and Russia's invasion of Ukraine renewed calls to prioritise energy security and affordability, as well as decarbonisation efforts.

Political division in key markets is also evident. For example, in the US, a third of state governments have passed anti-ESG legislation and some have even banned state institutions from working with banks and market participants who embrace ESG. Meanwhile, the rise of AI and the threat of disinformation have dominated global discussions in recent times, placing environmental and other ESG concerns into the shade.

ESG REMAINS RELEVANT

Despite this perceived fall in priority, the fact remains that we are still impacting the planet, even if environmental concerns appear slightly less dominant in public discourse. Indeed, the truth is that despite travelling on a decarbonisation journey for over 30 years, carbon emissions continue to rise, albeit with some evidence of slowing. Temperature records continue to break year on year – the last 12 months were the hottest on record, and we are seeing the financial impact of extreme weather events costing billions of dollars in lost economic output[1].

Despite reports of ESG's retreat, if we consider the environmental realm alone, the COP process means that over 80% of global emissions are now covered by some sort of net-zero legislation. Before COP, the world seemed to be on a 3˚C to 4˚C warming trajectory, it is now on a 2˚C to 2.5˚C trajectory if all pledges are met.

More concretely, the largest emitters are accelerating their investment in energy infrastructure, renewable technology and new forms of transportation. China is expected to reach peak emissions in the next couple of years, based in part on substantial investments on renewable energy, while the shortage of Russian gas has pushed the EU to accelerate its roll-out of renewable alternatives, such as green-hydrogen distribution and carbon removal.

PRIVATE SECTOR LEADERSHIP AND REGULATORY DEVELOPMENTS

However, focusing solely on the actions of politicians and governments misses the flourishing role of the private sector in the transition. More than 5,000 companies have instituted net-zero targets, a significant step forward even as some governments focus on other priorities. Additionally, the extraordinary growth in ESG-aligned investing to almost a third of all money managed globally is a testament to the increasing role of the private sector in the transition and emphasises changing investor preferences.

Of course, significant regulatory activity has accompanied the expansion in ESG investments, with initiatives such as the Task Force on Climate-Related Financial Disclosures (TCFD), the EU's Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive, as well developments in the US. While they may seem like an alphabet soup of reporting requirements, these developments have helped improve transparency for investors and offer a route to the holy grail of equivalence between ESG data and financial data, for both companies and investment decisions. Achieving this equivalence would finally allow investors to price the externalities of investments.

These developments in the regulatory world and increasing private-sector adherence to ESG developments suggest reports of ESG's retreat are exaggerated. However, the question for all ESG investors is how to transform sustainable business into 'business as usual'.

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[1] https://www.ncei.noaa.gov/access/billions/

MAKING SUSTAINABLE BUSINESS 'BUSINESS AS USUAL'

Very often, sustainability is seen as extraneous to the core operations of a business, rather than an important part of its core mission. Exacerbating the problem is that disclosures can often lack concrete, quantitative detail about the potential impacts of sustainability matters.

In addition, some firms and investors perceive sustainability considerations as conflicting with the fiduciary duty owed to shareholders. The question often posed is: how can firms balance the needs of value creation and shareholder desires with the long-term planning and investment that is required for continued prosperity, when economic activity is supposed to be sustainable?

However, rather than operating in conflict, investors and businesses should regard both branches of analysis as complementary. For any business seeking to grow its long-term value, managing the impact of paradigm shifting externalities represents a precondition for doing so successfully.

It is only rational for companies to conduct their operations by delivering quarterly returns in alignment with a longer-term strategy. However, if companies do not include in their base case the impact of externalities, it is unlikely they will form accurate forecasts or achieve their core strategies.

Separately, another problem involved with making sustainable business 'business as usual' is that it is unfolding in a non-linear fashion, which poses challenges for financial modelling. Historically, new business practices characterised initially by non-linear growth trends offer poorer returns than incremental business improvements, at least in the beginning. These problems are not helped by the fact that there is no universal carbon price or pollution price, nor a value placed on natural assets. As a result of these pricing and informational challenges, it is difficult to take economic and capital allocation decisions effectively.

The struggle to do so has led to the development of a plethora of metrics, targets and estimates that are breathtaking in their measurement of minutiae. However, it is questionable whether these metrics or targets are measuring the most appropriate data. For example, the 17 UN Sustainable Development Goals between them are associated with 169 targets and 231 unique indicators.

Likewise, science-based targets, a default metric of how market participants assess a company's commitment to decarbonisation plans, have assumed an authority in the popular imagination of ESG investors that may not be deserved. The Science-Based Targets initiative (SBTi) arose as five well-meaning NGOs in 2015 sought to plot companies emission reduction plans against decarbonisation pathways for the whole global economy, which now appear to be far off track. While the SBTi may offer a useful heuristic gauge of a company's commitment, the underlying measurements are not reflective of reality.

Overall, the jury is out on whether good ESG correlates with good investment performance. However, over a longer-term view, it is questionable whether corporates that disregard externalities, whether they are environmental, social or governance-related, will have the capability to generate value in the medium to long term. Therefore, we must consider better way to assess ESG performance.

IDENTIFYING AND REWARDING GREAT ESG PERFORMANCE

Undercutting all of the above is a lack of clarity about what great ESG performance looks like. From my vantage point, there are five key practices of those companies most effectively managing their ESG commitments.

1 Do not drown in ESG target-setting but look for creativity

In my experience, great organisations do not drown in ESG target-setting and, in some cases, have never attempted to comply with some of the most demanding examples, or have ditched some targets when they prove to be unhelpful. In addition, moving beyond environmental considerations, I believe companies need to evolve how they measure firms engaging in novel social policies.

For example, how should we assess and measure companies that try and bring women returnees back to the workforce, not just because it aids diversity targets, but also because it increases their talent pool? I believe we should look out for creative practices that solve problems, rather than focussing too narrowly on some ESG targets.

2 Adhere to radical transparency but on your own terms

Consideration of ESG ratings is becoming increasingly crucial for most companies due to the proliferation of standards and regulatory drivers. However, companies focusing too heavily on their ESG ratings is unlikely to provide much enlightenment beyond a certain level of disclosure.

Likewise, frequent and time-consuming calibration of a company's disclosures or ESG reporting to eke out incremental improvements in ratings seems an inefficient use of a company's time and resources. Instead, senior management teams should focus on simple messaging which neatly encapsulates and clarifies their sustainability strategy.

3 Think consistently about opportunity

Instead of focusing too narrowly on exactly modelling potential returns or seeking to squeeze a particular ESG capital expenditure project into a narrow bucket, senior managers and investors should recognise the potential for business disruption, any opportunities created and the best way to capitalise upon them.

4 Collaborate with other entities to establish best practice

Fulfilling disclosures can often place onerous requirements on companies. For example, collecting accurate Scope 3 emissions data, which seek to estimate indirect emissions created by a company's activity in its supply chain, is an arduous process. Sharing data and pursuing collaboration with regulators, competitors and governments offers a way to construct a larger pool of data and enhance shared knowledge among all stakeholders, which could manifestly speed up processes and allow for more decision-useful information. In addition, greater clarity may in turn lower the cost of capital for corporates.

5 Aim for courageous leadership

Courageous leadership is vital as we seek to move to more sustainable business environments. As in all sectors, groupthink can detrimentally impede the progress of ESG practices. Risk aversion and concerns about customer and shareholder reaction can create a tendency towards incrementalism. Likewise, pressure from well-meaning activists to take certain actions produce unintended effects that may impede the efficacy of ESG practices. For example, calls to divest completely from fossil fuels without recognising the cost and energy supply risk that an overly rapid transition would bring are not helpful to net zero delivery.

We have seen examples in other areas of courageous leadership unleashing rapid innovation. The COVID vaccines are one such example, where pharmaceutical companies rapidly created vaccines to tackle a novel virus because they were allowed to rapidly experiment and rapidly fail, all pursing different methods and models. Those instincts could serve ESG practices well but require courageous decision-making and less risk aversion.

Courageous leadership should also reject binary thinking about the correct way to finance sustainable solutions. Aligning with one particular solution, in my view, is too narrow, and we should recognise that we require multiple applications, given those that work under one set of circumstances may not work in another. This is going to become ever more vital as the world retreats to 'friendshoring' (when geopolitical allies are the focus of manufacturing and other sourcing) and competing trading blocks, and political interests rise to stop innovation. Courageous leaders and firms should highlight the risk of binary thinking and persuade others to invest alongside them.

Although these five criteria are important when we look for great ESG performance, examining these issues takes time and intuition. If we are too reliant on a small set of numbers, we risk missing opportunities for improvement and potential pitfalls.

In addition, in my experience, some of the most invaluable interactions are probing, deep-dive meetings between investors and companies. These investigations can help uncover the best ESG activities that are embedded in winning corporate strategies.

Great corporate strategy and supportive ESG activities are not mutually exclusive, and the more we emphasise the positive results of actions that support the transition, the more likely it is that politicians will want to be associated with those actions. We have to invest time and energy to persuade governments to invest political capital into the transition.

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ESG

- **Investment type:** The application and overall influence of ESG approaches may differ, potentially materially, across asset classes, geographies, sectors, specific investments or portfolios due to the nature of the specific securities and instruments available, the wide range of ESG factors which may be applied and ESG industry practices applicable in a particular investable universe.
- **Integration:** The integration of ESG factors refers to the inclusion of ESG risk factors alongside financial risk factors in investment analysis and research to judge the fair value of a particular investment and may also include the monitoring and reporting of such risks within a portfolio. Integrating ESG factors in this way will not typically restrict the potential investable universe, but rather aims to ensure that what we believe to be relevant and material ESG risks are taken into account by analysts and/or portfolio managers in their decision-making, alongside other relevant and material financial risks.
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