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The state of ESG – what does the Stuart Kirk debate tell us?

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A presentation at the recent FT Moral Money Summit entitled "*Why investors need not worry about climate risk*" by Stuart Kirk – the now suspended Global Head of Responsible Investment for HSBC Group – has proven to be one of the more hotly debated events in the ESG world for some time.

Set against a backdrop provided by the pandemic, the war in Ukraine and supply chain and inflationary shocks that are still unfolding, ESG as an investing paradigm had been looking increasingly exposed and muddled. Accusations of "greenwashing" are rife. ESG themed indices and funds are increasingly found to be exposed to the societal vices and environmental harms that "ESG investing" is supposedly designed to avoid. The corporate world seems to be drowning in a tsunami of pledges and promises around the net zero energy transition with little proof that such a journey is even underway.

So, it was certainly bold of Mr Kirk to rock up at an ESG conference, attended by an enthusiastically ESG-focused crowd, and question whether climate risk should even be on the investor agenda.

We do not intend to debate the detail of Mr Kirk's speech here. The presentation was recorded by the FT and can be viewed on YouTube via this link (https://youtu.be/bfNamRmje-s). Regardless of one's views on the subject matter, it was at the least highly entertaining.

However, what we do think is useful is a dispassionate look at why Mr Kirk's speech matters, and what the subsequent debate suggests about the future course of responsible investing.

Mr Kirk's speech touched many substantive points; many of which have been completely overshadowed by the (somewhat ironic in the circumstances) hyperbolic response since. If we cut through this noise; what do we think Mr Kirk was trying to say?

1. <u>The invisible hand of the markets is efficient</u>

At heart, the speech was about what the capital markets do, why they work as they do, and why they can continue to do so without regard to pricing the climate related risks we so clearly face.

Mr Kirk's fundamental point is that the narrative arc of human economic history is littered with moments of systemic challenge and threat. However, when one overlays the long-term history of asset prices, this volatility is less apparent. The key implication here is not that the threats do not exist, and here Mr Kirk was keen to stress that he does not dispute climate science, but that the markets have proven good at doing two things; firstly, discounting near term risks, and secondly, allocating capital towards the adaptation and solutions that "solve" the problem and then form the bases for new economic models that replace the old.

Our view here is that this was a plea from Mr Kirk for the "market" to be left alone to do what he believes it does best, which is allocate capital and earn a return for doing so. Problem solved.

However, in our view, Mr Kirk would not be the first to assume, mistakenly, that markets are indeed this efficient. Greenwashing, in its broadest sense, encourages and rewards the inefficient allocation of capital towards companies and assets that are not going to be a solution to the problem. This is the true challenge facing ESG and unless tackled head on, will prove the biggest threat to Mr Kirk's efficient market nirvana.

2. <u>Hyperbole as a failed tool to induce action on Climate Change</u>

An important issue raised by Mr Kirk relates to the amount of hyperbole found in the public narrative on climate risks. Mr Kirk's frustrations highlight what is imperfect about ESG integration and climate risk. He presented a graph showing the volume of investments into risk-on assets steadily increasing despite an increased frequency of "climate catastrophe" used in the media. His point was that despite repeated and increasingly noisy warnings on climate change, financial institutions continue to fund risky and what will inevitably become 'stranded' assets.

This increasing investment volume comes at a time when almost all institutions and companies are making "commitments" to become greener and, according to Kirk, are the most vocal about our impending climate-induced demise. ShareAction's CA100+ report highlights signatories often tout their involvement with Climate Action 100+, but less than 5% report or carry out the necessary activities or outcomes they are committed to.[1]

3. So, why the hypocrisy?

Greenwashing and hyperbole on both the sell-side and buy-side have been long-standing systemic problems within ESG, with much of the work within ESG advisory focused on navigating misleading claims. Fundamentally, these misleading claims arise from a combination of factors.

Although not the focus of this article, we could point to a lack of suitable regulatory supervision; a lack of basic understanding of how the ESG ratings world operates; material conflicts of interest around the creation and marketing of financial products and the willingness of a forward-looking market to reward future commitments over tangible delivery now. In fact (and this is a point that Mr Kirk would certainly agree with) there are some very real echoes today of the issues surrounding the sub-prime mortgage market in the lead up to the Global Financial Crisis of 2008.

In recent months, the spat between MSCI and Bloomberg around the methodologies underpinning ESG ratings[2] was swiftly followed by Elon Musk's very public anger at Tesla's removal from S&P 500 ESG Index while ExxonMobil is rated top 10 in the world. Though Tesla is not completely spotless, it perfectly encapsulates the challenges facing capital seeking an ESG aligned home. However, we cannot solely blame indices when companies with ineffectual goals and inadequate reporting also perpetuate inferior ESG practices.

Alas, we arrive at a vicious cycle: improper ESG reporting by companies, lead the investment community to improperly reward certain companies; and companies, in order to have a piece of the $2.7 trillion poured into ESG investment[3] - continue their improper reporting. It is therefore unsurprising that investors are becoming increasingly, and more vocally, questioning of what ESG investing is supposed to represent. In that sense, Mr Kirk's speech was very much of the moment. Interestingly, we note that after three years of unbroken and stratospheric growth, global ESG fund flows have slumped to a three-year low, dropping 36% in the last quarter alone.[4]

4. Climate risk as a REAL and growing financial risk

Perhaps the most controversial (judging by the volume and tone of response) charge Mr Kirk makes stems from his questioning of how climate risks can be quantified in terms of financial returns. Although controversial, our sense is that Mr Kirk is not alone in his scepticism.

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[1] ShareAction, "Power in Numbers? An Assessment of CA100+ engagement on Climate change", May 2022, < https://shareaction.org/reports/power-in-numbers-an-assessment-of-ca100-engagement-on-climate-change>
[2] Bloomberg, "The ESG Mirage", December 2021, < https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line>
[3] Bloomberg, "ESG by the Numbers: Sustainable Investing Set Record in 2021", February 2022, < https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021>
[4] CitywireAsia, "Global sustainable fund flows slump to three-year low", May 2022, < https://citywireasia.com/news/global-sustainable-fund-flows-slump-to-three-year-low/a2386592>

Our view is that although there is no single model that can accurately quantify the cost of climate change impacts nor cost of the remediations and adaptations needed; these costs will exist, and they will be substantial. McKinsey & Co, for example, estimates the cost of transforming the global economy to meet international climate goals could be c.$9.2 trillion a year annually through 2050[5]. That is at least $3.5 trillion more per year than is currently being invested in both fossil-fuel infrastructure and low-carbon alternatives, as well as changes in how people use land.

These costs are also likely to look very different according to the geographic perspective of the observer. Developing economies are likely to continue to be the engine of global economic growth yet also sit on the front line of climate risk. Unfortunately, these areas are already dealing with material climate induced risks. The IMF has already cut India's economic growth from 9% to 8.2% and Moody has downgraded India's credit rating to one level above junk grade – solely based on the increasingly bleak prospects for India's climate[6]. Bouts of food protectionism in the form of trade embargos have also arisen due to scorched crops reducing harvest yields in India, the Horn of Africa, and parts of the US.

In fact, the effects are not just limited to developing economies. Droughts in California have become so severe that farmers are now being paid to leave their land uncultivated in a bid to retain their dwindling supply of drinking water in the Colorado River. The Zuiderzee and Delta Works in the Netherlands, hailed as one of the Seven Wonders of the Modern World, are a complex system of dams, dikes and water drainage works to protect the low-lying landmass of the Netherlands from floods and create additional agricultural land. In 1958, the Delta Works cost €5 billion, around 20% of Dutch annual GDP[7]. Despite success so far, as sea-level and flood risks rise improvements will have to be made, which are a hotly debated subject within the Dutch government, with anticipated improvements likely to cost the taxpayer €100 billion.

5. Humans adapt well in the face of adversity, but climate will be our biggest challenge yet

Mr Kirk also references the Covid-19 pandemic as a cause for celebration of the market resilience and ability to adapt to unforeseen events. Fundamentally, the marked difference between climate change compared to financial crises, pandemics and world wars is that these events were *one-off, temporary disruptors* to the world economy. By any measure, climate risk is, and will be, a long-term, systemic, and growing problem with unquantifiable costs. The other key point is that climate risk cannot be argued as being an unforeseeable risk.

Mr Kirk's basic point is that humans, and by extension, economies overcome. Capital is a key part of the solution and will earn a return as capital always does, even as economic systems evolve or find themselves superseded by new forms. External events, in Mr Kirk's view, are catalysts for change either through technological innovation and / or policy intervention. Capital is the lubricant that allows these wheels to turn and the fuel for growth. In this, empiric and dry, world view, capital

[5] McKinsey & Co, "The net-zero transition: What is would cost, what it would bring", January 2022, < https://www.mckinsey.com/business-functions/sustainability/our-insights/the-net-zero-transition-what-it-would-cost-what-it-could-bring>
[6] Bloomberg, "Heat Wave in India Poses Risks for Nation's Credit, Moody's Says", May 2022, < https://www.bloomberg.com/news/articles/2022-05-23/heat-wave-in-india-poses-risks-for-nation-s-credit-moody-s-says>
[7] European Commission, "Case Study Report: Delta Plan/Delta Programme (The Netherlands)", February 2018, < https://jiip.eu/mop/wp/wp-content/uploads/2018/09/NL_Delta-Programme_Goetheer.pdf>

is therefore agnostic as to the causes of change and the associated moral and societal rights and wrongs. Capital is solely focused on the rate of return.

Radnor Conclusions

We believe that although it is easy to criticise Mr Kirk for the reductive nature of many of his arguments; this misses the real question he did not provide an answer to:

If capital is to be part of the solution; where should it be deployed and how should that be different from how it has been deployed in the past?

This is where we see the biggest ESG challenge for both companies and investors and is fundamentally why this debate sparked by Mr Kirk matters so much. We do not pretend to have all the answers here. Like Mr Kirk, we are not in possession of a magic crystal ball that can tell us what is coming down the track. However, what we can say with some degree of certainty is:

- Capital needs to be re-allocated and will need to be re-allocated where it can make a difference.
- Capital providers will need to know they are making a difference so therefore must have confidence in the assets their capital is invested in

For companies:

The challenge for companies is around materiality and substance. We believe investors will inevitably become much more discriminating in how they assess a company's ESG alignment. Big, bold targets and commitments will become less relevant than the credibility of those targets and the integration of ESG commitments with the fundamental business proposition.

For Radnor, as advisors, this where we spend most of our "ESG" time with clients. ESG risk and opportunities are different for every company and investors know this. Our focus is to draw out and make clear the specific opportunities that our clients face as well as clearly articulating how inbound risks are being managed. This is as much about the evolution of the core equity story for each company as it is about the specifics of ESG reporting.

This is not about which ESG ratings agency a company should engage with (relevant data should be made available for all external stakeholders) but instead what the fundamental ESG message is and how it is being delivered to those who need to understand it. As it is with financial data and metrics, a company should choose how to set and manage market expectations, not the other way round.

Companies also need to understand the pressures that will be mounting for investors as they fight to distance themselves from accusations of greenwashing. Fund managers will increasingly have to justify their holdings from an ESG perspective and those companies that do not make this justification easier for an investor, will have to accept that fewer investors will pay attention.

For the buy side:

The key issue revolves around the challenge of greenwashing. For those fund managers who are genuinely committed to aligning their portfolios towards an ESG theme; on what basis are portfolio decisions being made? For active fund managers, this boils down to the amount of fundamental research undertaken and the depth of the investment selection process. Ultimately, portfolio choices will have to be justified to underlying investors.

Owning a stock solely on the basis of ESG ratings and indices inclusion will be hard to justify when it becomes apparent that a company's ESG commitment and / or performance is less than what was promised. After all, there are very few investors we know who still rely on broker recommendations to guide their investment decisions. Broker research and estimates are merely one component of a broader informational mix.

This can be partly solved by having a high degree of faith in the robustness of the ESG rating or index methodology. This is one of the reasons why we, alongside our JV partners Longspur Capital, devised the Active Net Zero Clean Energy Index (www.activenetzero.com). Here we have focused solely on combining a robust, externally aligned methodology with a high barrier to entry compared to other mainstream climate themed indices. The end result is an index that identifies those companies that are enabling the energy transition rather than those that are simply seeking to passively comply.

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