Posted on January 1, 2022

Sustainable and ESG investing

Even if it has been around longer than what inves- tors believe, sustainable and ESG investing has increasingly won over the center stage for investors across the world, with a large number of asset classes becoming more and more available for those investors who aside from getting a return on investment, are looking to generate an impact beyond financial gains. Nonetheless, investors are increasingly concerned about the quality of such 'sustain- able' or 'green' investments, with terms like 'green- washing' or 'social-washing' becoming more common.

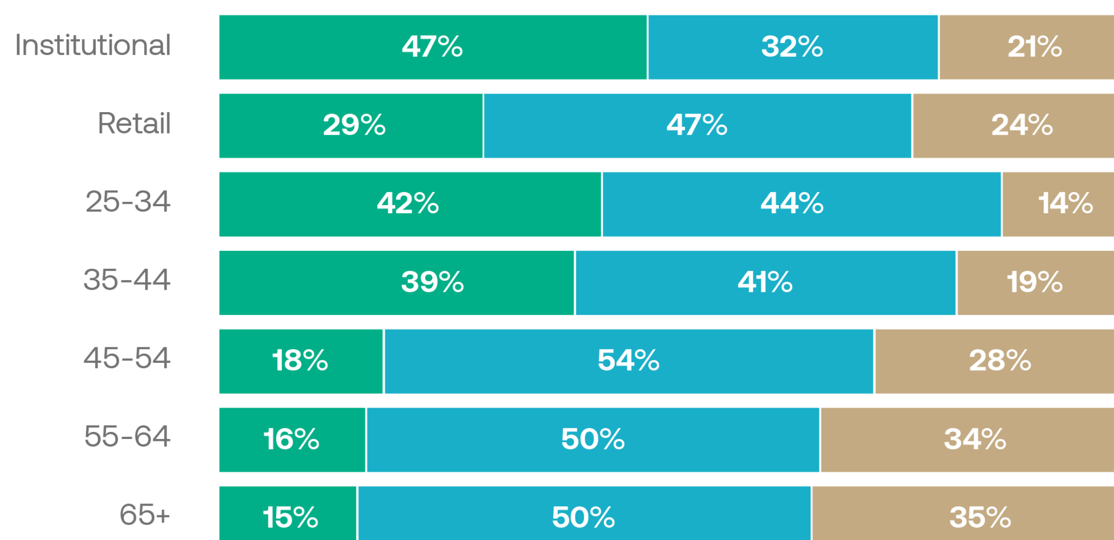
Today, our goal is to get a general understanding of what sustainable and ESG investing means, how that can be achieved in your portfolios, and what pitfalls may lie ahead. Let's start by stating what sustainable investing means. Per a Harvard Business School article, "Sustainable investing, also called socially responsible investing or ESG investing, is a means of investing in which an investor strongly considers environmental, social, and corporate governance (ESG) factors before contributing money and resources to a particular company or venture. The goal is to, whenever possible, use investment dollars to promote positive societal impact, corporate responsibility, and long-term financial return." It is worth highlighting the CFA Institute's addendum to this definition. It further clarifies that "sustainable investing has broader connotations and is more like an investment philosophy, whereas ESG investing works at a practical level to describe investment mechanics.".

Despite its current popularity, it should be pointed out that sustainable investing began in the 1970s, when the first sustainable mutual fund was launched. From then on, additional milestones have paved the way for sustainable investing to become more and more popular, such as the launch of the Dow Jones Sustainability Index in 1999, the development of the UN Principles for Responsible Investing (PRI) in 2006, or the launching of the Global Impact Investing Network (GIIN) in 2009. In more recent history, the appearance

of the COVID-19 pandemic accelerated the adoption of sustainable investing, with a specific focus on social responsibility. This increased interest was also captured by a CFA Institute survey, in which 67% of the participants chose ‘social’ as the ESG area they take into account in their investment analysis or decisions; in 2017, this figure was a much lower 54%. Moreover, the share of respondents that do not consider ESG factors for their investment analysis or decisions decreased from 2017 to 2020 from 27% to 15%, again highlighting the importance of the topic in today’s markets. Furthermore, according to an analysis performed by the International Capital Market Association of the Environmental Finance database, social bond issuance in 2020 was more than USD 11.5bn through mid-May, an 86% increase from the same period the previous year.

Which best describes your interest in ESG investing?

- Higher risk-adjusted returns
- Personal values or invest in companies w/positive impact on society/environ.
- Both



Source: CFA Institute, 2020

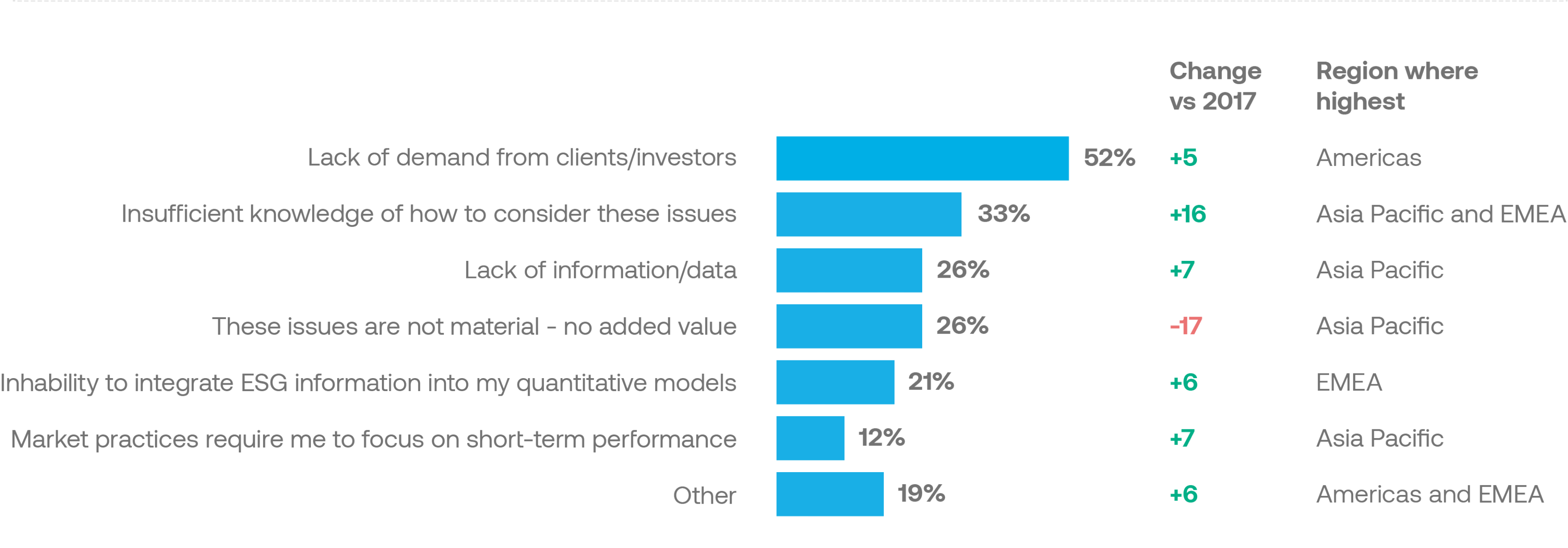
The interest in ESG investing was also tangible in the CFA Institute survey that I mentioned, in which 47% of institutional investors stated that they were interested in ESG investing to generate higher risk-adjusted returns, whereas the desire to advocate personal or social values came in lower at 32%. This same trend was apparent in younger investors (i.e., ages 25 to 34), while other age brackets, as well as retail investors, seemed more interested in prioritizing their values when performing an investment.

Before we move on, it would be relevant to outline a couple of points that investors should consider before they enter the ESG investing sphere. First, investors need to define what ESG comprises specifically for them. This can be determined through a suitability questionnaire, or simply by establishing which of the three letters of the acronym – be that the E, the S, or the G – are most relevant to them. This is important to determine which focus they would prefer to have within their investment universe. Moreover, if the investor decides to enter the ESG sphere through an ETF or a fund, they need to perform thorough due diligence on the fund per se and see whether its interests, its mandate, and the companies it is supporting are aligned with the investor’s principles and beliefs. This part should also help investors avoid ‘greenwashing’, a topic we will discuss later today. Furthermore, a fundamental element to identify the interests and principles of both companies and funds relies on their capacity to do ESG reporting, and whether those reports are aligned with industry ESG standards.

On its face, sustainable and ESG investing sound appealing and, according to a KPMG –CAIA–AIMA–CREATE Survey from 2020, is being propelled mainly by institutional investors who believe that the traditional modus operandi of investing, which only considers risk and return, needs to be rewritten to address ESG factors. In his 2020 annual letter to shareholders, BlackRock's Larry Fink emphasized the effects that climate change could have on the reallocation of capital, and not coincidentally, the term has never been more popular since according to data from Google Trends compiled by the CFA Institute.

Nevertheless, there have been issues around sustainable and ESG investing that make its implementation more challenging – starting with its target users and potential clients. According to the previously mentioned CFA Institute survey, a lack of client demand remains the top reason that firms do not consider ESG issues. Another point that should raise signs of worry across market participants is that, for 33% of investors, there is insufficient knowledge of how to consider ESG issues, as can be seen in the following graph.

Why do you or your organization not take any ESG issues into consideration in your investment analysis decisions? | *Source: CFA Institue, 2020*

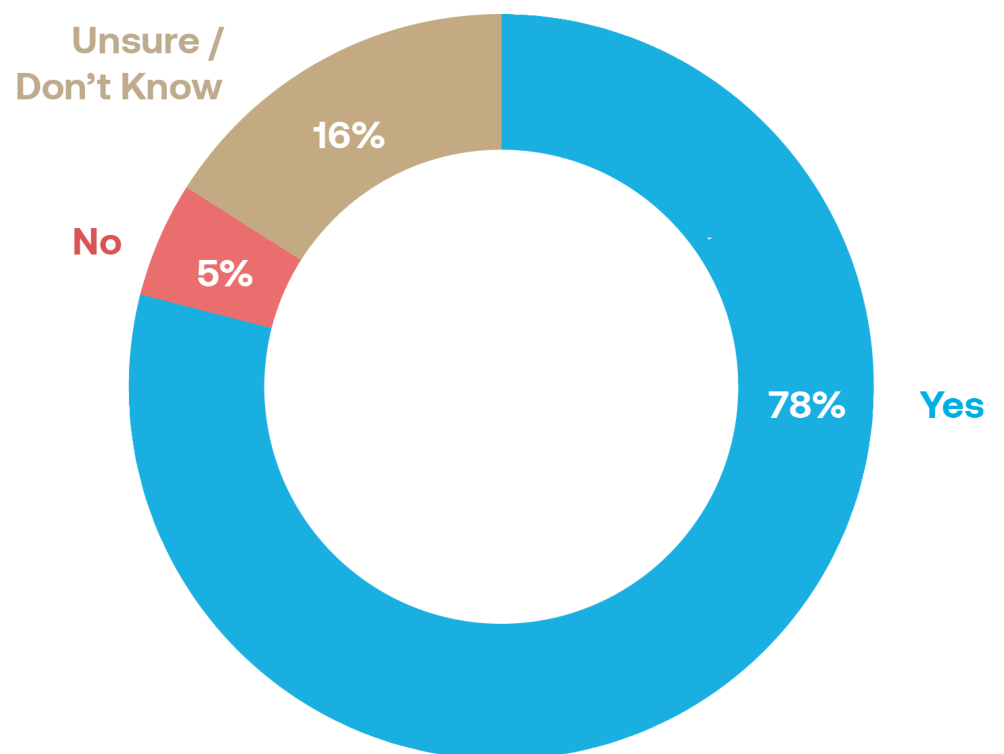


Even if one highlights the increase observed in the materiality of ESG issues when investing – considering the decrease of 17 percentage points portrayed by this survey – there is still a long way to go if we want ESG and sustainable investing to be a primary factor for portfolio managers, asset allocators, and clients. This same trend may be gleaned from the afore-mentioned KPMG survey as well, where 31% of the surveyed sample affirmed to be in the "awareness-raising" phase of impact investing implementation, whereas 10% still had no implementation. One possible explanation for this shortfall is the lack of quality and consistent data on ESG factors. This was noted by S&P in a report where they highlighted those two factors as the key challenge in addressing confusion in the ESG space. Additionally, the rating agency highlighted that "the quality and consistency of post-issuance use of proceeds and impact reporting is still highly unstandardized and fragmented across issuer types and regions making it difficult to compare and aggregate performance.".

Furthermore, another challenge that investors are facing within the reporting realm is the one where they must identify whether the claims from the issuers are trustworthy and reliable, or if those have been 'greenwashed'. Here we need to take a brief pause and define what the industry means when it uses the

term 'greenwashing'. According to Investopedia, "greenwashing is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. It is considered an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly." The green-washing concern is of high importance for investors: a Quilter Investors survey conducted in May 2021 showed that this specific challenge was the biggest concern for almost 44% of investors, who have become "increasingly sensitive" to the effects of companies that could have potentially exaggerated their green credentials. These concerns were also visible in the previously mentioned CFA Institute report, where 78% of the participants of the survey considered that there is a need for improved standards around ESG products to diminish 'greenwashing'.

Do you think there is a need for improved standards around ESG products to diminish "greenwashing"?



Source: CFA Institute, 2020

"Investors have revealed elevated concerns that proceeds stemming from sustainability-linked instruments may be funding projects without a clear beneficial impact."

Meanwhile, additional concerns have started to arise in the ESG industry around "sustainability-washing". Given the importance that new types of sustainable financing tools – such as social, transition, and sustainability-linked instruments – have started to attract, this has become even more relevant considering-ing that investors have revealed elevated concerns that proceeds stemming from sustainability-linked instruments may be funding projects without a clear beneficial impact. Moreover, an additional concern that comes from the sustainability-linked instruments is that those issuers could be tempted to set performance targets that are not ambitious enough, meaning that the issuer would not have to demonstrate a significant improvement over its business-as-usual strategy, or it would not require a significant investment to achieve those targets.

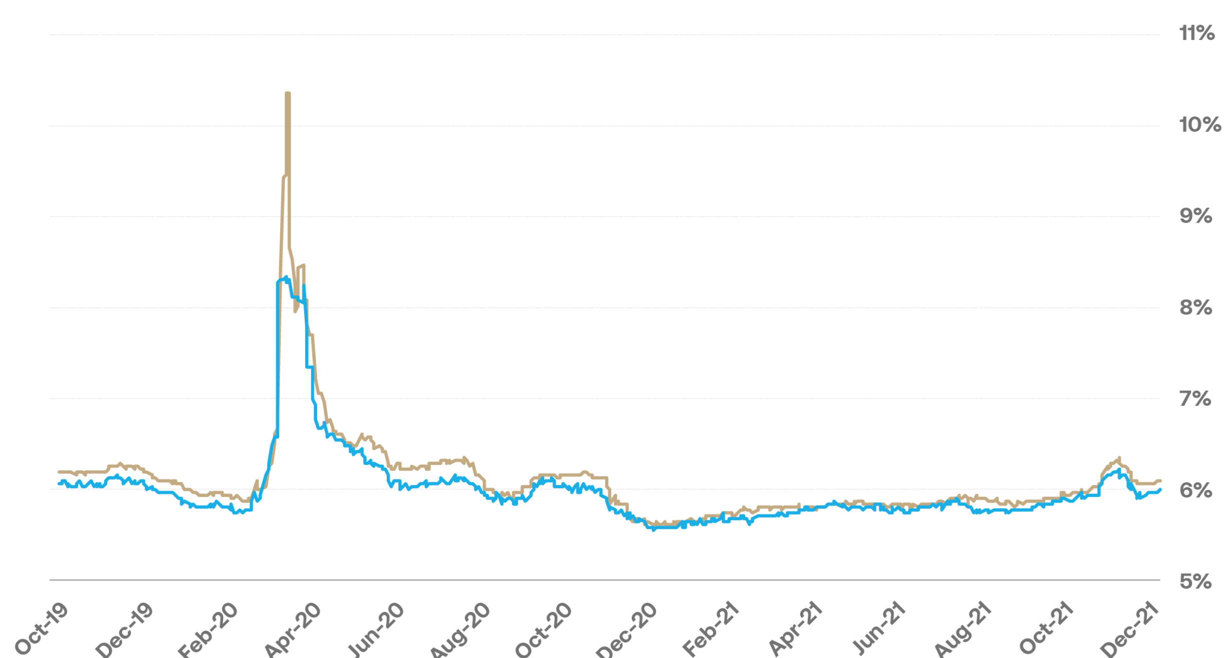
Another obstacle that ESG investors are facing is the heterogeneity of ESG reporting that the industry currently has available. According to data from KPMG, 57% of surveyed hedge fund managers admitted that they do not currently report on ESG performance at all. Of those who do, 11% use customized metrics, and

23% use PRI. Nonetheless, expectations here are more optimistic than in other ESG facets, given that ESG reporting has gone from 'nice to have' to a 'must have'.

On another note, investors have debated around the possible existence of a 'greenium', defined as the difference in yield between a traditional fixed income instrument and one that has ESG objectives, more specifically green bonds. The presence of this 'greenium' has been discussed across investors, and its existence is dependent on different factors. First and foremost, 'greeniums' should be seen as an issuer-by-issuer case and should not be determined in a general analysis, while also taking into account that not all green bonds have a conventional peer against which they can be compared. Secondly, the expected increase in green bond supply may help ease any signs of premium that green assets could have exhibited, due to being scarcer than its traditional peers. Now, let's consider a specific case: AES Andes, the Chilean electricity producer, and distributor company tapped the markets in 2019 by issuing a 60-year green bond, the first for the company. Luckily for us, AES Andes also has a traditional bond that matures in 2079, which allows for an initial analysis in terms of 'greenium' existence. When comparing the historical yield of the two bonds since the green bond was issued, one can highlight that the average spread between the green and the traditional bond is 11bps, as can be seen in the following graph.

The market is letting go of the 'greenium'

AESAND 6.35 10/07/2079
AESAND 7 1/8 03/26/2079



Source: Bloomberg.
Data as of December 31, 2021

Nonetheless, one can observe that the yield of the green bond was largely superior (almost 200bps more) than its traditional peer only in March 2020, when the company reported a capital increase of USD 500mn to finance its renewable energy investment plan. The market reacted sharply to this announcement, considering that the company was not capable of funding part of its green strategy, which in the end made the green bond perform worse than its traditional peer. As stated before, this is an isolated case and each bond should be evaluated within its own context, but it seems that the market is casting aside the 'greenium' that could have been charged to green bonds before.

Yet another challenge that ESG investors have voiced is the need to create an infrastructure with data, professional knowledge and skills, and technology that can support the proper development of the industry. If we go back to the second graph, we can highlight that the three main factors that undermine ESG investing are, unsurprisingly, these same stated missing ones. In terms of upskilling, a couple of alternatives, such as the Certificate in ESG Investing backed by the PRI and launched by the CFA Society United Kingdom,

have emerged in the last years, and most of the investment professionals that participated in the surveys I have quoted stated their interest in building up their ESG knowledge while being aware that ESG should be a fundamental pillar in the security selection process, instead of just one element at the end of it.

In addition to the latter, and as a means to combat both 'greenwashing' and 'sustainability-washing', the industry needs to focus on the quality of information available, thereby allowing investors to compare and have access to different sustainability metrics, while under- standing the most material considerations from a financial and ESG perspective. According to Standard and Poor's, the increased demand for more detailed and consistent ESG disclosure will drive improvements in the field, while simultaneously adding momentum to the development of ESG-focused regulatory disclosure and reporting frameworks.

> — "According to Standard and Poor's, the increased demand for more detailed and consistent ESG disclosure will drive improvements in the field, while simultaneously adding momentum to the development of ESG-focused regulatory disclosure and reporting frameworks."

Finally, the industry shift towards heightened interest in ESG and sustainable investing would also benefit from an improvement in leadership. Leaders need to set the tone and lead by example while being aware that institutional investors are the biggest fish in this pond, thus their influence – and their leadership example – is crucial for the success of this shift.

We cannot deny that progress has been made, and that interest in ESG investing has increased dramatically over the years. Nations and companies have issued green bonds, preferable to traditional investment alternatives in some cases. Nevertheless, the need for a more standardized, homogeneous investing sphere, where everyone can compare and draw conclusions from an equitable starting point, is something that the industry is still lacking. This opens the door for fraud and/or negligent behavior from bad actors. But it is in moments like this that we should remember the words of historian, philosopher, and playwright Howard Zinn, "We don't have to engage in grand, heroic actions to participate in change. Small acts, when multiplied by millions of people, can transform the world."

Melissa Ochoa Cárdenas – Insigneo's Investment Strategist

MBA | Masters in Disruptive Innovation (MDI) | Impact Investing | Sustainable Finance
I am a finance professional with five years of experience in fixed income research and macroeconomic affairs, strategy, product development, and capital markets.