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ESG Trends to Watch in 2023

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Sustainable Investing Reimagined.

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Topic - Thought Leadership

Welcome 2023! Another year like no other just passed, a year in which the markets have experienced their worst year since 2008 and the Great Recession. The war in Ukraine sparked a full-blown crisis, further intensifying inflationary pressures. Supply chain disruptions and the lingering effects of the past few years' fiscal stimulus had been already stoking an increase in prices. As one could expect, the focus of markets and companies were, to some extent, at risk of shifting away from the concerns around environmental, social, and governance (ESG) issues.

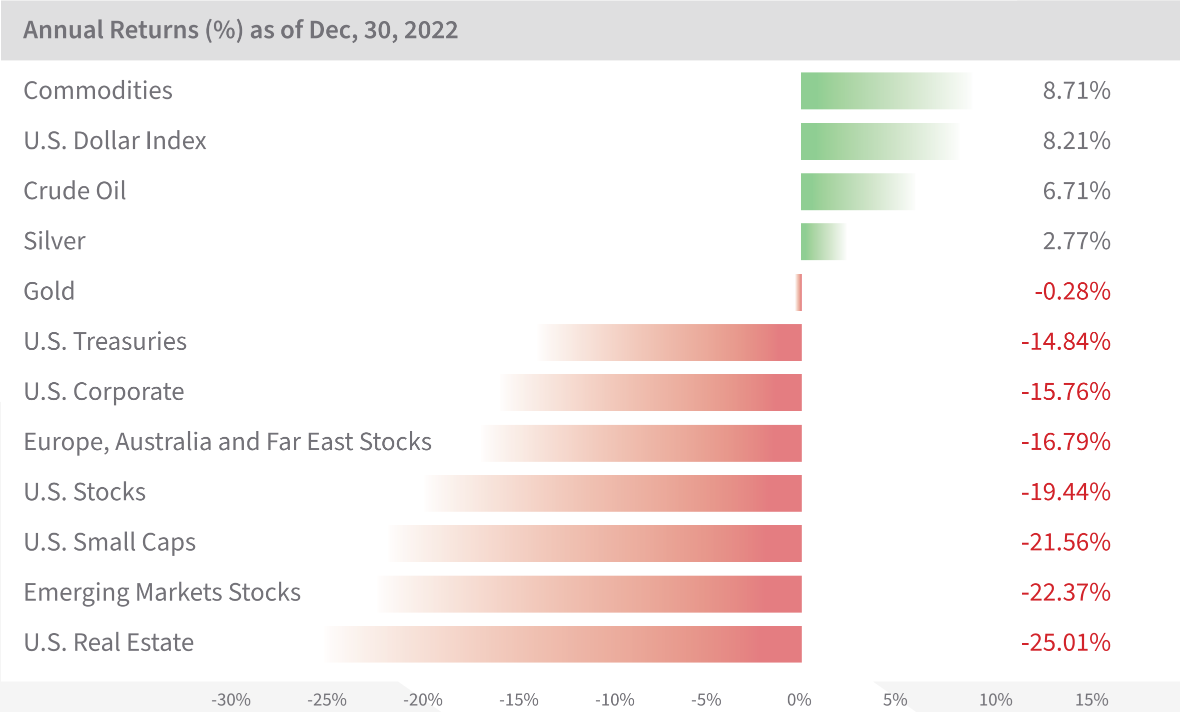
In an effort to tame inflation, the U.S. Federal Reserve (Fed) acted swiftly and took an aggressive stance by proceeding to seven consecutive rate hikes that started in March to reach the 4.25% - 4.50% range.

2022 Fed Rate Hikes to Tame Inflation

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
14-Dec-22	+50	4.25% to 4.50%
02-Nov-22	+75	3.75% to 4.00%
21-Sep-22	+75	3.00% to 3.25%
27-Jul-22	+75	2.25% to 2.50%
16-Jun-22	+75	1.5% to 1.75%
05-May-22	+50	0.75% to 1.0%
17-Mar-22	+25	0.25% to 0.5%

Source. US Federal Reserve

Those rate hikes brought tumult to the markets. All asset classes except for commodities and the US Dollar were significantly down over the year. The high interest rate environment, the decrease of the consumer spending, and the high US Dollar prompted many economists to predict slower growth and, even a recession.



Source: Bloomberg[1].

Although inflation seemed to decelerate toward the end of the year, it remained front and center of the concerns about the economy.

In that context, despite ESG investing experiencing a slowdown of its tremendous momentum of the last few years, it continued to gain ground. ESG investing's politicization in the US, criticism pointing to greenwashing and a lack of standardization, questions of its financial relevance, have contributed to noise and negative press. These are all legitimate questions to be addressed in order to, not only preserve the integrity and the effectiveness of sustainability investing, but to protect investors.

Despite those headwinds, ESG continued to lead as the fastest growing category for investing[2]. The number of ESG indexes globally showed 55% growth in 2022 to surpass the 50,000 across asset classes[3]. Our ESG Trends to Watch in 2022 edition predicted a rapid rise in ESG fixed income which is evidenced today by the number of indices for ESG Fixed Income increasing by a record 95.80%, dwarfing the previous record of 61.09% in 2021.

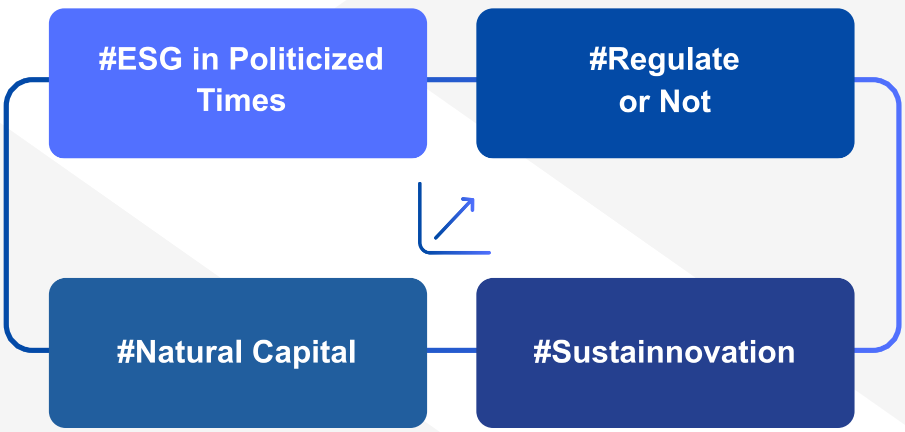
1 Data as of December 31, 2022. Past performance is not indicative of future results. The source for each asset class is set forth in descending order: WTI U.S. Oil, Dow Jones Real Estate Index, S&P GSCI, S&P 500, Russell 2000, MSCI EAFE, DXY, Bloomberg US Corporate Bonds Index, iShares US Treasury Bond ETF, MSCI EM, XAUUSD, XAGUSD. See more information in Appendix.

2 CFA Institute, Index Industry Association (IAA), EY, PwC.

3 Index Industry Association (IAA).

Lastly, Accenture predicts a $30 trillion wealth transfer from baby boomers to 75 million millennials to take place over the next few decades[4] and Bank of America surveyed that 88% of high-net worth millennials are actively reviewing the ESG impact of their investment holdings[5]. As climate and various societal crises are being increasingly felt across the world, we believe that the financial world must keep playing a prominent part in offering solutions.

Here are the V-Square Four Trends to watch in 2023.



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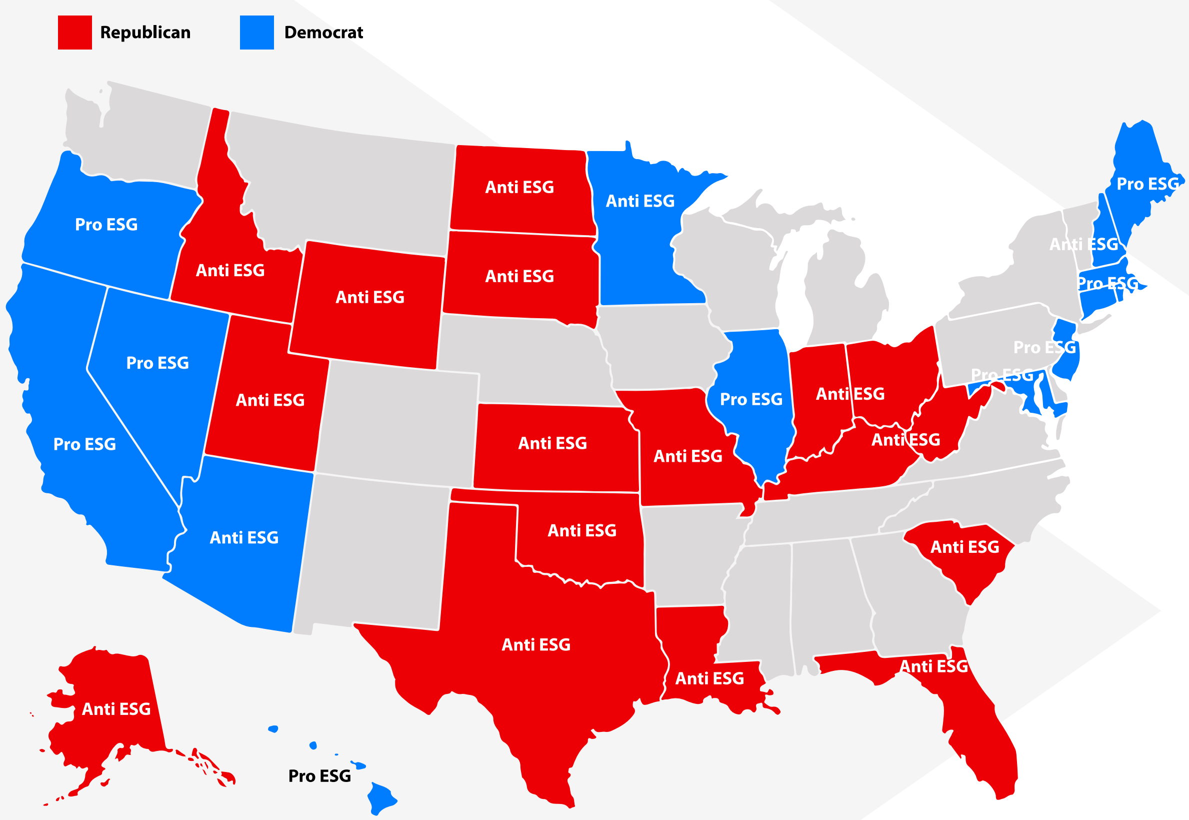
4 Accenture. The "Greater" Wealth Transfer – Capitalizing on the Intergenerational Shift in Wealth.

5 Bank of America. 2018 Insights on Wealth and Worth.

ESG in politicized times – What is the way forward?

ESG investing became a matter of polarization in the US, especially in politics. A few states including Florida, Texas, or Indiana proposed laws seeking to bar investment firms from managing state pension mandates or to be involved in municipal bond issuance. The reasons often cited are that ESG investing may conflict with fiduciary duty, and it potentially discriminates against companies whose businesses are essential for the economy of those said states. Conversely, officials from 13 states and New York City signed a letter condemning the "blacklisting" of financial firms that take ESG concerns into account when making investments. The letter was released by *For the Long Term*, a public charity supported by the Ford Foundation and the Omidyar Network. Moreover, credit rating companies (S&P Global, Moody's, Fitch) drew the ire of ESG opponents as they started to factor ESG concerns in their credit scoring methodologies.

Bills introduced either in support of or against integrating ESG principles into investment decisions



Note: Colors refer to party that received the most votes in the 2020 presidential election as a proxy for political learning.

Source: Capital Monitor, 2022

We believe that these concerns come from a misunderstanding or a misconception of what ESG investing is and is not. The field has greatly evolved since its early years of a rudimentary exclusionary approach. Investment firms today employ various approaches that are essentially iterations of three primary approaches: Socially Responsible Investing (SRI), Impact Investing, and ESG Integration. At V-Square, we like to breakdown the evolution and iteration of ESG into **3 i's**: information, impact, and integration. Typically, SRI investing involves exclusions to an investment universe based on moral or religious criteria; this approach relies on the information from corporate disclosures, either voluntary or mandated. Impact investing often focuses on a dual outcome combining the financial objective (profit) with a desired social, economic, or environmental outcome (purpose). Lastly, ESG integration takes a holistic approach to investment analysis by combining both financial and non-financial objectives to mitigate risks and improve returns.

The political polarization on ESG often stems from inaccurately reducing the whole field to a small part, focusing on excluding energy companies from the investment universe. Two arguments to oppose to that narrative; firstly, experienced sustainable investors know that many energy companies have already started their ESG transition as they recognize the climate transition risks that they may face in the future, for example the risk of having some of their major assets stranded (unburnable carbon, decommissioned equipment, etc.)[6]. Secondly, integrating ESG can indeed be part of managers' fiduciary duty as they seek to identify non-financial factors that create both financial risk and opportunities to the portfolios. This is the concept of materiality that we discussed in last year's issue and again in our Effective ESG investing requires materiality and intentionality article in the Dutch Financial Investigator magazine last fall. Not to consider material ESG factors may be a breach of duty.

The consensus around the need for sustainable investing is higher in Europe where regulation, investor demand, and markets are driving improvements on the field. We anticipate the tensions around ESG in the US to keep escalating this year before eventually starting to ease, as potential new regulation seeks to provide more standards and guidance.

Two themes are likely to endure: more and more investors[7] want to align their investments with critical ESG criteria to achieve sustainable long-term returns, and ESG considerations are about investment results as many of them are financially material.

2. To regulate or not to regulate?

That is the question. The sustainable investing topic faces the triple challenge of being vast, complex, and lacking a unified framework. However, it became mainstream over the last few years as institutions, companies, and organizations deepened their sustainable investment practices. The fight against climate change primarily led the growth of the field. As investors turned to ESG products to express their views, the greenwashing phenomenon, which is essentially misrepresentation or false advertising of ESG attributes or characteristics for a product, also accelerated.

As it is often the case in the search for a remedy, arguments are made for and against more regulation. Proponents are calling for governments and regulatory bodies to cooperate and impose rules to try to level the playing field and provide more clarity for investors. As a response, the US Security Exchange Commission (SEC) released a proposal on climate change disclosure for investment issuers to promote consistent, comparable, and reliable information for investors concerning incorporation of ESG factors. Furthermore, the US Department of Labor (DOL) also released a new rule clarifying the use of ESG criteria and proxy voting in ERISA-governed retirement plans[8].

6 Stranded assets are defined as assets that have suffered from unanticipated or premature write-downs, devaluation, or conversion to liabilities. In recent years, stranded assets caused by environmental factors, such as climate change and society's attitudes towards it, has become increasingly high profile.

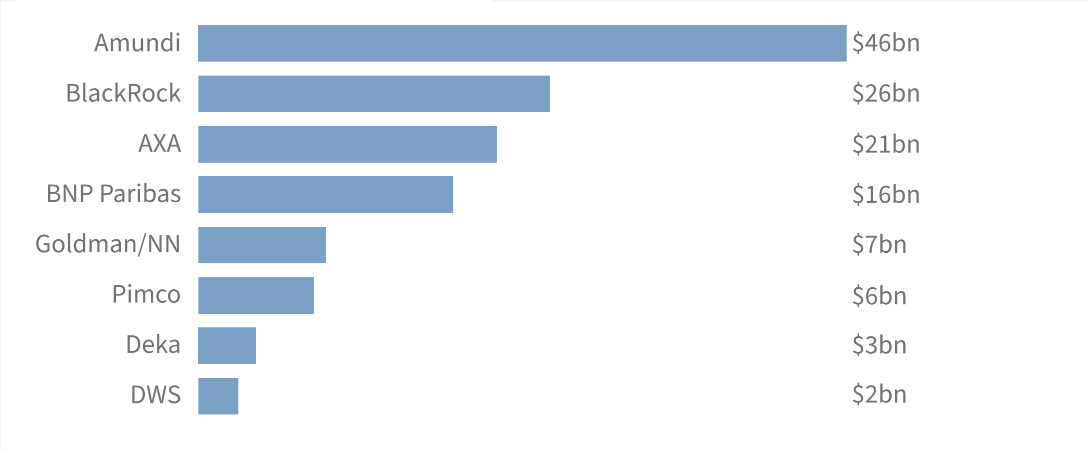
7 Per Morgan Stanley, 85% of all investors are interested in sustainable investing. 95% of millennial are interested (2022)

8 The Employee Retirement Income Security Act of 1974 is a U.S. federal tax and labor law that establishes minimum standards for pension plans in private industry. It contains rules on the federal income tax effects of transactions associated with employee benefit plans.

Early in 2022, Morningstar removed the "sustainable investment" label from more than 1,200 European-domiciled funds warning that more reclassifications were to come. An update to the Sustainable Finance Disclosure Regulation (SFDR), the European green investing rulebook, triggered a massive wave of fund reclassifications, with an estimated $125 billion in assets forced to downgrade from their ESG status. Those changes came with considerable criticism, angst, and confusion on the managers' end. In addition to the general market decline last year, those fund recategorizations also contributed to the overall decrease of assets that are counted as ESG.

Big Reset

Fund Managers have downgraded more than $125 bn in ESG assets



Sources: Company filings, Bloomberg reporting, Morningstar
Note: Table only included asset managers for which estimates are available; figures for NN and Pimco based on Morningstar report. Downgrades refer to SFDR disclosure categories.

Source: Bloomberg. 2022.

Naturally opponents to regulation are touting a *laissez-faire* approach, arguing that managers should be allowed to operate outside of a prescriptive framework, or the industry risks stifling innovation in the financial industry. They trust that markets will ultimately self-regulate. The question is do we really have the luxury of waiting time. One cannot be so sure.

In the absence of clear requirements, litigation risk on ESG claims is also on the rise, and we see this continuing to trend upward. Regulatory authorities plan to propose more rules for publicly traded companies to disclose the risk they face with the climate changing as well as their greenhouse gas emissions across their supply chain. A healthy dose of regulation is needed; it will improve transparency for investors and protect them.

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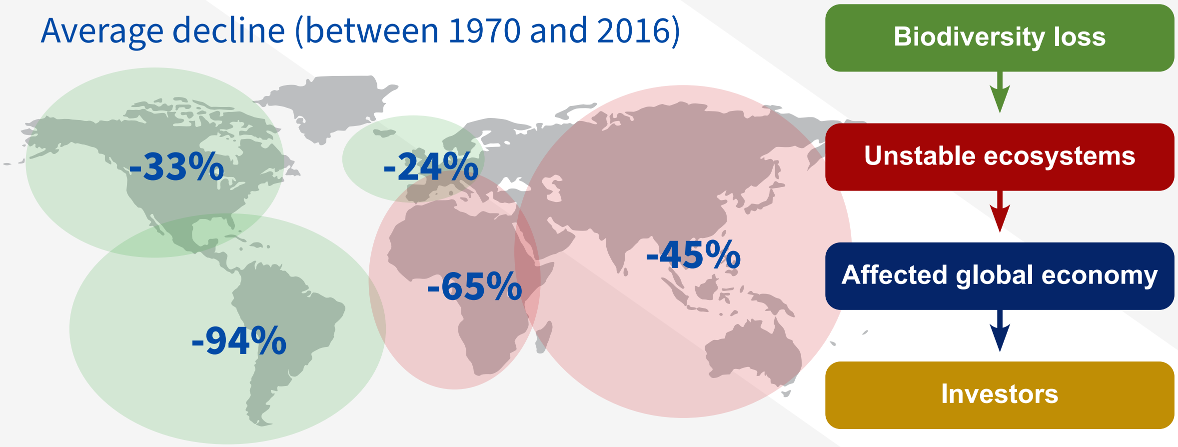
3. Natural Capital – Biodiversity, a material risk for investors.

Although the E of ESG has been centered on climate so far, we must remember that environmental issues also include water management, waste and pollution, and natural capital or biodiversity. Those topics, particularly the risks to the financial system posed by biodiversity loss, are making their way to investors' agenda as awareness grows.

Biodiversity is defined by the United Nations Convention on Biological Diversity as *"the variability among living organisms from all sources, including, inter alia, terrestrial, marine and other aquatic ecosystems and the ecological complexes of which they are part: this includes diversity within species, between species and of ecosystems"*. Alas, it has been declining at an alarming rate due to human activity. The World Wildlife Fund (WWF) reports for example that the population of vertebrate species fell by 68% on average worldwide between 1970 and 2016[9].

Average decline (between 1970 and 2016)



Source: World Wildlife Fund

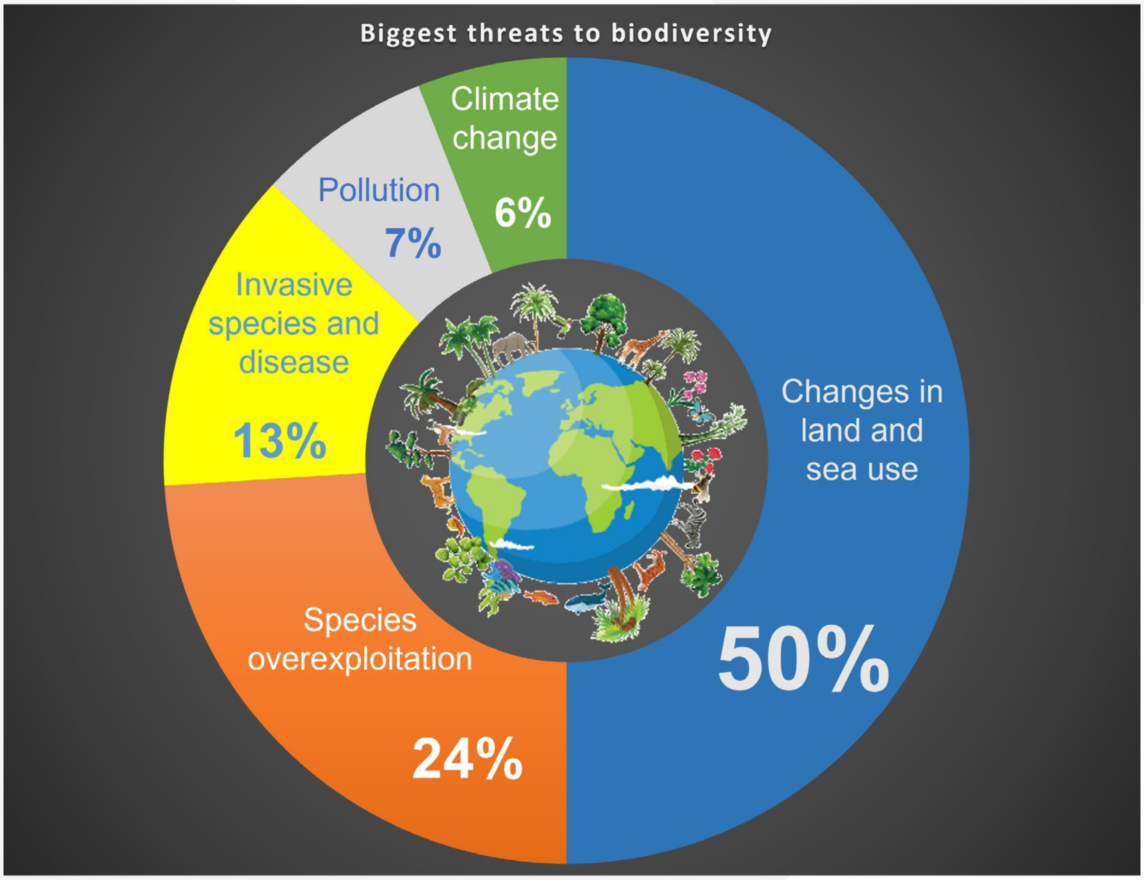
Furthermore, biodiversity loss varies by region, with Latin America and the Caribbean having seen the biggest drop in diversity at 94%[10]. The scientific community cites species habitat destruction, overexploitation of natural resources, invasive species, pollution (marine and land), and the emission of greenhouse gases resulting in climate change as the biggest threats to ecosystems. Changing and unstable ecosystems affect the global economy and, in turn, to investors. Companies are being impacted by biodiversity loss and their business behavior is being increasingly scrutinized.

9 World Wildlife Fund (WWF) Living Planet Report 2020.

10 World Wildlife Fund (WWF) Living Planet Index (LPI).

Governments are issuing new regulation and investors are taking action. Analogously to the TCFD[11] for climate, the Task Force on Nature-related Financial Disclosures (TNFD) is developing a risk management and disclosure framework so organizations can report and act on evolving nature-related risks. Biodiversity risks for investors – faced directly and indirectly – can be broken down into physical risks, transition risks, litigation risks, and systemic risks, in the same vein as how climate risk are approached.

Biodiversity and climate change are two interlinked emergencies: climate change causes biodiversity decline and in turn, biodiversity loss destabilizes the ecosystems and drives climate change. Addressing the biodiversity loss is essential for limiting climate change. In fact, land, forests, oceans are the largest natural carbon sinks, i.e., they help remove half of the greenhouse gas emissions produced by human activity from the atmosphere. They effectively provide nature-based solutions to climate change. For example, protecting, managing, and restoring forests that still represent 30 per cent of the planet's land, offers roughly two-thirds of the total mitigation potential of all nature-based solutions. Improving nature's ability to absorb emissions is another welcome tool to fight climate change.



Source: World Wildlife Fund

11 Task Force on Climate-related Disclosures.

4. Sustainnovation.

Sustainability investing's road to success goes through innovation, and the two terms are sometimes coined into sustainnovation. Innovation is one of V-Square's foundational four pillars, along with intentionality, research, and long-termism. In one of its industry articles from 2019 titled Beyond the Rubicon: Asset Management in an era of unrelenting change, McKinsey & Company called out the critical role of innovation in asset management: "[…] *in a highly competitive environment with more moderate flows, opportunities for growth will more often arise from innovation that creates and captures new pools of assets*". McKinsey expected a surge of innovation from leading active managers with up to $8 trillion at play over the next several years as clients re-examined their core investment beliefs and manager relationships. We agree with this view and would even go as far as predicting that the boutique managers across all management styles are well positioned to effectively deliver on innovation due to their ability to be nimbler and faster.

The field of sustainability is overdue for a reboot. Although we can count over 1,200 ESG ETFs currently available to investors in America, Europe, and Asia Pacific, the overlap of approaches, screens and index compositions makes it hard for investors to differentiate managers and truly diversify their portfolios. Moreover, marketing and branding often trump investors-centric innovation. Six out of the top 10 ESG ETFs are sold by the same provider, BlackRock. The average holdings overlap across these ETFs is 95%[12]. Investors and asset allocators are challenging us to think outside of the box and innovate across asset classes. We see tremendous opportunities in asset classes such listed real assets and fixed income in 2023 and beyond.

Our approach to innovation combines embedded investment research with a fast-tracked cycle placing investors' desired risk-adjusted return and sustainability outcomes at the heart of the process. V-Square has developed a streamlined process enabling us to move from strategy ideation to innovation within a short timeframe. The key to achieve higher efficiency in product innovation was to use the old Japanese manufacturing system, *Kanban (development)*[13], and build a plug-and-play solution platform. This allows us to run a multitude of customized solutions pro-forma and to leverage pre-agreed terms with index and data providers as well as legal and operation setups. Fast-tracking innovation creates good habits within organizations and in turn fuels innovation.

As we look forward through 2023, we are thrilled to see the industry recognizes the opportunities ahead and takes on the many complex challenges that come. Investors are calling for more sharpness, transparency, and innovation. As investors and stewards of our clients' capital, V-Square strongly believes that the trends outlined above will improve the field of sustainable investing as well as our own ability and proficiency in incorporating ESG factors into client portfolios.

12 FactSet, October 2021.

13 Kanban (Japanese: 看板, meaning signboard or billboard) is a lean method to manage and improve work across human systems.

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Appendix – Asset class description

XAGUSD	Silver Spot price quoted as US Dollars per Troy Ounce.
XAUUSD	Gold Spot price is quoted as US Dollars per Troy Ounce.
Russell 2000	The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization.
S&P 500	The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
MSCI EM	The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
Bloomberg Corporate Bonds Index	The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility, and financial issuers.
MSCI EAFE	The MSCI EAFE Index is a free-float weighted equity index. The index was developed with a base value of 100 as of December 31, 1969. The MSCI EAFE region covers DM countries in Europe, Australasia, Israel, and the Far East.
iShares US Treasury Bond ETF	iShares US Treasury Bond is an exchange-traded fund incorporated in the USA. The ETF seeks investment results that correspond generally to the price and yield performance, before fees and expenses, of the ICE U.S. Treasury Core Bond Index.
S&P GSCI	The S&P GSCI® is widely recognized as a leading measure of general price movements and inflation in the world economy. It provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets.
DXY	The U.S. Dollar Index (USDX) indicates the general int'l value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies.
Dow Jones Real Estate Index	Dow Jones EQUITY REIT Total Return Index. This index is comprised of REITs that directly own all or part of the properties in their portfolios. Dividend payouts have been added to the price changes. The index is quoted in USD.
WTI U.S. Oil	Bloomberg's spot crude oil price indications use benchmark WTI crude at Cushing, Oklahoma; and other U.S. crude oil grades trade on a price spread differential to WTI, Cushing.

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Contact Us

We would be pleased to discuss our solutions, products, and capabilities with you. Contact us to learn more about V-Square MAP, and more specifically, about how to set up an investment portfolio aligned with desired investment objectives.

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