ESG investing at critical juncture

Introduction

Disappointing performance from some ESG-labelled ETFs, record numbers of ESG fund closures in the US, increasing cases of "greenwashing"... Responsible investment is at a turning point. Find out more below.

Charles-Henry Monchau *Chief Investment Officer*

Oliver Ramos *Junior Investment Analyst*

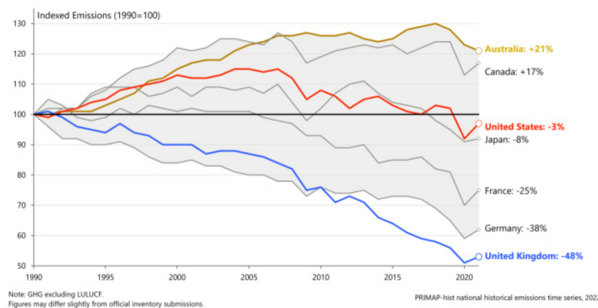
The concept of ESG ("Environmental, Social and corporate Governance") dates back to the 1960s and 1970s, a period marked by growing social awareness and activism. Investors began to recognise that, beyond mere financial profit, the way a company conducts its business has a profound impact on society and the environment.

ESG has transitioned from niche interest to mainstream concern. Institutional investors, pension funds and global financial entities now integrate ESG factors into their investment analysis and decision-making processes. This shift was not only driven by ethical considerations; it was increasingly recognised that ESG factors could have a significant impact on a company's performance and risk profile.

Substantial investment by governments

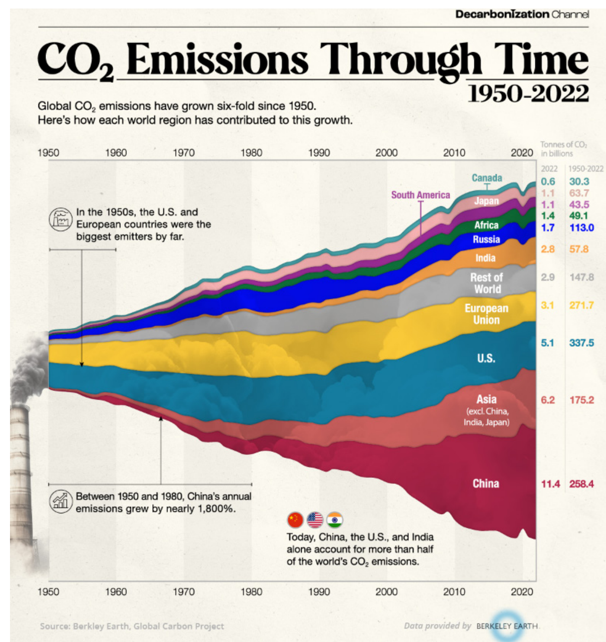
The growth of ESG investment has been aided by the changing regulatory landscape. In Europe, this is best illustrated by the European Green Deal, a comprehensive package of measures launched by the EU in June 2021 to transform the EU into a modern, resource-efficient, and competitive economy. The UK has its own vision linking energy security and the "net zero" goal of replacing the country's reliance on imported fossil fuels with cheaper, less polluting domestic energy sources. The United States has similar plans, with its Inflation Reduction Act (IRA). Elsewhere in the world, Saudi Arabia and the United Arab Emirates are aiming to become world leaders in sustainable development. When it comes to decarbonization, the United Kingdom and Europe are leading the way.

Greenhouse gas emissions among the world's leading economies (1990-2021)



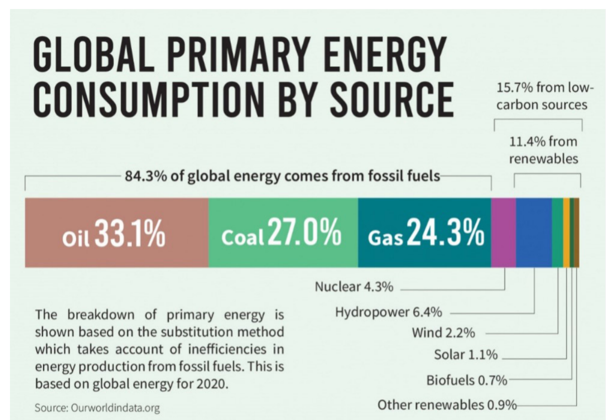
The dark side of ESG

Despite the colossal efforts mentioned above, it must be said that global emissions have risen from 25 billion tonnes in 2000 to 37 billion tonnes in 2022. And three countries - the USA, China and India - account for over 50% of the planet's total CO2 emissions, making their participation essential in the fight against climate change.



Another major ESG investment concern is the potential for negative externalities. For example, an investment in renewable energies may seem intrinsically positive. However, if the production of these technologies involves exploitative labour practices or environmental degradation in the extraction of the necessary metals, the ethical position becomes blurred. In addition, the decarbonization process has forced under-investment in new sources of hydrocarbon exploitation and exploration. The result: underproduction, which has contributed to the rise in crude oil prices in 2022-2023. Decarbonization is therefore inflationary and increases the risk of an energy crisis for countries that mainly import their energy.

After years of effort devoted to the energy transition, the global economy remains highly dependent on fossil fuels, as the graph below shows.



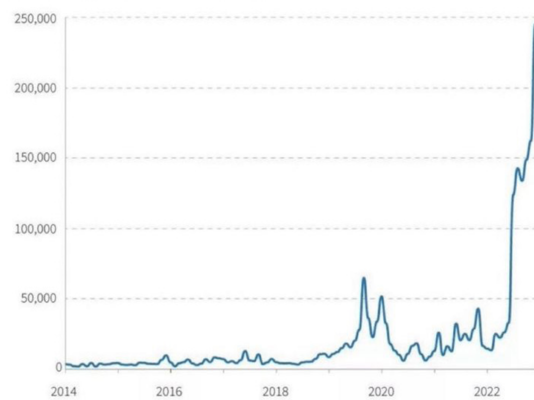
ESG ratings are also a conundrum. Different ESG rating agencies may assess the same company very differently, due to varying methodologies and subjective interpretations. This inconsistency is a major challenge for investors who rely on these ratings to make informed decisions, often leading to confusion and scepticism about the reliability of ESG assessments.

This compounded with the practice of greenwashing, where companies feel encouraged to present their products or strategies as environmentally friendly to attract investment, is a deceptive practice which can lead investors to unwittingly support companies that contribute little to environmental sustainability or social well-being.

There is also growing ESG fatigue, with climate-sceptic tweets reaching a record high in 2023, and companies such as Coca-Cola changing their language on exercise reports to exclude the term ESG for fear of retribution from certain lobbies.

Climate-sceptic tweets

Monthly number of tweets containing terms associated with strong forms of climate scepticism*



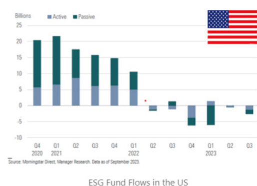
* Data exclude tweets related to India farm protests in 2021

Source : Max Falkenberg and Andrea Baronchelli, City, University of London

14:31 · 25/12/2023 from Earth · **6.8K** Views

Despite the growing popularity of ESG funds and ETFs, there have been instances of underperformance relative to their non-ESG counterparts due to sector bias but also to the higher expense ratios of ESG funds and ETFs. We note that investment flows into funds stagnated in 2023, but with a significant dichotomy between Europe (inflows) and the USA (outflows).

ESG Fund Flows in Europe

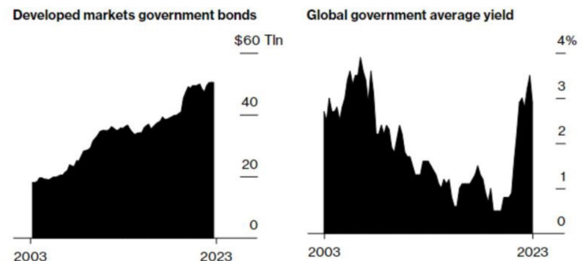


ESG Fund Flows in the US

The economic context could continue to weigh on performance and investment in ESG strategies. Most clean energy and climate change business models are capital-intensive and heavily dependent on public subsidies. Rising interest rates, exploding debt and public deficits in most G7 countries are challenging the business models of so-called green companies. This year's US elections represent a turning point for clean energy financing. While the chances of a reversal of Biden's IRA climate bill are slim, a Trump victory could mean US withdrawal from the Paris Agreement.

Record Debt Piles More of a Burden at Higher Yields

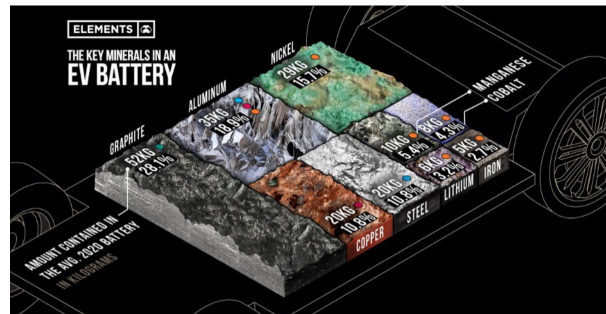
More than $50 trillion of government bonds underscore supply concerns



Sources: BIS, Bloomberg

Potential long-term winners in the energy transition

Several sectors and raw materials seem well positioned to benefit from the energy transition. Contradictory as it may seem, there can be no green revolution without the extraction and use of metals and natural resources. Consequently, the biggest opportunities are likely to come from commodities with the highest supply risk coefficients, such as those needed for electric vehicle batteries: lithium, nickel, cobalt, copper, and graphite.



Copper is a cornerstone of the transition to clean energy. Its high conductivity makes it indispensable in electric vehicles, renewable energy systems (solar and wind) and energy-efficient building materials. As the world moves towards greener technologies, demand for copper is set to double by 2050 (compared to 2022 levels).

Uranium, the key element in nuclear power, presents a very promising ESG investment opportunity. At a time when the world is striving to reduce carbon emissions, nuclear power is an obvious choice, as it is the densest and most efficient source of energy and has a low carbon footprint. Not to mention that it has by far the highest capacity factor, meaning that it produces reliable energy 93% of the time (compared with 23% for solar power). Nuclear also has the smallest land footprint to produce a megawatt of electricity, with just over 1 m2 per 1,000 megawatts (compared with 75 times more for solar and 360 times more for wind). A few months ago, participants at COP28 pledged to triple the use of nuclear power over the next decade, with China and India already having 32 nuclear power plants under construction. This renewed interest in nuclear power sent uranium prices soaring in 2023, reaching levels not seen since 2007.

As for solar power, it is emblematic of the benefits and risks of renewable energies and their relationship with political support. Over the next ten years, free cash flow should become positive and increase significantly for companies such as First Solar. But beware: most of this free cash flow will come from tax credits, making continued political support a sine qua non.

The jewel of ESG investing

While environmental and social components often take centre stage in ESG discussions, governance is arguably the forgotten letter of the ESG acronym. Think back. A few years ago, Volkswagen was embroiled in an emissions scandal, in which the company was caught installing software to manipulate emissions tests.

A corporate culture that prioritised performance over ethics and compliance tarnished VW's reputation, led to billions in fines and had a strong impact on its shares. Just last year, the world experienced several failures due to poor governance, the most striking example being the collapse of Credit Suisse.

The importance of good governance to a stock's long-term performance cannot be underestimated. A recent study published by the CFA Institute shows that companies with good governance not only outperform others but are also less volatile. Studies by McKinsey have shown that companies with a high governance score had a higher return on equity than those with a lower score. In the long term, a quality "G" increases shareholder value and resilience. A quality "G" also leads to high "E" and "S" values. In fact, portfolios focused on companies with strong corporate governance outperformed their benchmarks in all four regions analysed (APAC, Europe, North America, world).

Source: CFA institute

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

Oliver Ramos, Junior Investment Analyst
oliver.ramos@syzgroup.com

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