Huge global demand for sustainable investments growing steadily

Danielle Barron

Demand for environmental, social, and governance investments overtook traditional products in 2020

Socially responsible investing is far more than just a bubble, it's now breaking all records. What investing based on ESG (environmental, social, and governance) factors exactly constitutes can be tricky to define but funds insiders say the appetite for funds with genuine sustainable credo shows no signs of slowing down.

Demand for sustainable investments overtook traditional products in 2020, and global sustainable fund assets more than doubled in 2021. With Bloomberg Intelligence suggesting assets could reach $50 trillion by 2025, observers say that within a matter of years, 100 per cent of investments will consider ESG risks and opportunities.

According to Tara O'Reilly, co-head of Arthur Cox's Asset Management and Investment Funds Group, sustainable investing aims to look beyond traditional financial metrics and invest with other issues, including environmental, social and governance, in mind. ESG funds are no longer considered "niche", she says.

"Many of these issues would already be considered in the general evaluation of an investment and its risks, but sustainable investment is choosing to invest in a way that supports your preference on these issues. Investors are driving much of the demand and businesses are responding. Most funds in our pipeline for launch in the next 12 months are expected to have some element of ESG consideration."

"The growth of responsible investing in the last few years has been extraordinary, with assets in European funds marketed as sustainable hitting €4 trillion, accounting for almost 40 per cent of all assets managed in European Union-domiciled funds. In Ireland, we have seen a noticeable increase in the clients that have either implemented or are considering implementing ESG solutions," says Tom O'Gorman, head of distribution, Ireland at Legal & General Investment Management (LGIM).

Overdue exposure

It's promising that ESG is getting the overdue exposure that it deserves, he says. "We welcome the focus that Irish investors now have around sustainable investing – whether this is within an equity, fixed income or multi-asset solution, Irish investors are now considering the risk, return and ESG criteria of the solution."

"While this area has been gathering momentum for some years there is a sense that it is really picking up pace of late. In 2021, investment in ESG funds approached $700 billion, more than double the 2019 figure, and now makes up 10 per cent of worldwide fund assets," Brian Haugh, head of BDO valuation and financial modelling centre, adds.

Haugh says he is slow to ascribe too much of this acceleration to the pandemic, but he admits that the early data does seem to suggest that ESG investments have been more resilient over the pandemic than ESG-neutral ones, "which will give investors confidence in the area". Rather, he believes that a growing realisation of the realities of climate disaster has pushed the needle more firmly in this direction.

"I believe that Cop26, the publication of the IPCC reports, and the subsequent media coverage of these, was probably a bigger factor. I think that there was an urgency about the coverage that was missing when previously reporting on climate issues, and this seems to have focused the mind of policy makers, investors and the general public on taking big and decisive actions now to avoid climate catastrophe," he says.

Haugh cites the Glasgow Finance Alliance for Net Zero pledge of $100 trillion to finance climate action projects, and says this "will have focused the mind of a lot of fund managers".

"This pledge by 450 banks, insurance funds, money managers, and other investors, combined with the greater clarity around definition of green investment provided by the EU taxonomy, has the potential to channel investment into green finance on an unprecedented scale," he explains.

"There will be a $100 trillion green finance market up for grabs over the next decade, and fund managers who can credibly demonstrate how they can help deliver on this net-zero ambition can expect to be extremely busy.

O'Gorman echoes this, saying Glasgow also saw the launch of the Net Zero Whole Life Carbon Roadmap. This is an industry-led initiative that serves to quantify, for the first time, the specific emission reductions across sub-sectors of the built environment that will need to take place every year so the 2050 target of net zero carbon emissions can be achieved.

> **While this area has been gathering momentum for some years there is a sense that it is really picking up pace of late. In 2021, investment in ESG funds approached $700 billion**
> Brian Haugh, head of BDO's valuation and financial modelling centre

O'Reilly agrees that the EU's ambitious targets in relation to carbon neutrality and its regulations are significantly driving transparency in relation to green investing.

"The cost of this has to be supported by the financial markets, and so the EU is seeking to reorient capital flows into more sustainable investments and as we see this regulation come into effect, we are seeking the greater development of new green products," she explains. "Ultimately, investors will decide on what they believe meets their needs and expectations in terms of green investing."

Objectives

It is clear that green investing shows no sign of slowing its momentum, but the "S" in ESG (social) is often pigeon-holed and misunderstood, O'Gorman notes. "The 'E' and the 'S' are intrinsically linked. We must ensure the global transition to a lower-carbon economy is both fair and inclusive; social and environmental objectives should go hand in hand," he says.

Many still view social investing as a "niche asset class" due to the misplaced perception that social impact comes at the expense of financial returns. However, delivering social impact does not always compromise risk-adjusted returns, O'Gorman argues.

■ **A forest fire in Chiang Mai, Thailand: a growing realisation of the grave dangers of climate change has pushed the needle more firmly in this direction of ESG investments.** PHOTOGRAPH: ISTOCK

"This can be seen particularly in the real assets realm, where there is compelling argument and evidence that real-estate owners should be considering social impact as a crucial aspect of all investment activity, in the same way the environment has become integrated into the process. For example, in most instances, there is a natural alignment between the commercial interests of longer-term real assets owners and contributing to improving economic, societal and environmental outcomes for the local community."

O'Gorman offers the example of LGIM Real Assets' partnership with Clúid Housing – providing €54 million long-term financing to Clúid, one of Ireland's largest approved housing bodies. The funding will enable the delivery of around 200 new social homes across Ireland, marking the first Irish approved housing body to secure a financing agreement of this scale with an international institutional asset manager.

This drives "holistic value", he says. "Through delivering much-needed long-term pension fund capital to the housing sector, we not only meet the needs of our clients, but bring real economic growth and social value."

The end of greenwashing: Eco-friendly investing gets real

Danielle Barron

Sustainable investment has increased dramatically with policing of standards improving in tandem

Green investing may have grown in popularity but with this came the risk of "greenwashing" as funds embellished their environmental kudos. This was enabled by a lack of consensus on what green investing actually was. Recent regulatory developments have served to expose this; late last year, Reuters reported that European financial regulators had been uncovering more cases of greenwashing by asset managers keen to cash in on the "booming" demand for sustainable finance.

John Cotter is professor in finance and chairman in quantitative finance at University College Dublin. He says sustainable investment has increased dramatically, with some areas, such as green bonds, growing exponentially.

"Green bonds dominate the issuance of EU bonds, and ESG funds are now experiencing much better performance compared to non-ESG funds," says Cotter. "In 2021, green firms had better returns on asset performance than brown firms, and the valuation of firms with a green agenda is increasing. This is moving the dial strongly to a tipping point, if it has not passed already."

When it comes to the drivers behind ESG investing, Cotter points to enhanced climate awareness and the public sector push on the green agenda. The pandemic has also led to more concentration on ESG issues, and these have come to the fore in valuation of firms, he says. "The improved performance of green investments has attracted further interest and flow of funds into these investments."

Exaggeration of environmental credentials became an issue. According to Cotter, there has historically been a lack of consistency in much of green finance but he says this is narrowing over time. For example, emission reduction targets of firms, which vary widely, may often not be explicitly stated and can have different target years.

"Large firms are making the most inroads here, but still there are a high proportion of large firms – around 90 per cent – who do not have CO_2 emission targets."

greater transparency

Cotter says the emergence of "green fintech" is critical and will play a significant role in achieving environmental sustainability. "Green fintech is important as it allows for greater transparency in setting and meeting green targets. It is also important as it allows for better analysis of information on the green agenda," he says. "Areas of benefit include the use of green fintech to help investors make informed ESG decisions, the supply of data solutions to support reporting and disclosure, and artificial intelligence tools to analyse company information for the presence of greenwashing."

■ **"Areas of benefit include the use of green fintech to help investors make informed ESG decisions, says John Cotter, professor in finance and chairman in quantitative finance at UCD.** PHOTOGRAPH: ISTOCK

Andy Murphy, managing director and head of strategy at Waystone says despite green investments having become mainstream within the funds industry, regulation is still in its nascence. However, the introduction of SFDR (Sustainable Finance Disclosure Regulation) classifications last year has helped trustees to understand the level of ESG integration within funds.

"The framework that monitors and oversees this sector is still relatively new, although additional legislation under the Regulatory Technical Standards (RTS) is due later this year," says Murphy. This aims to take a closer look at the specifications for the content, methodology and presentation of SFDR disclosure requirements, as well as mandatory templates for pre-contractual and periodic reporting disclosures.

Assigning categories

Murphy explains: "Under SFDR, a fund must effectively disclose and assign a category to the fund and the fund's investment strategy – article 6 funds do not pertain to have any ESG investments or are not advertising themselves as ESG funds. Article 8 funds are, at a very high level, promoters of ESG investing and do strive to find and fund ESG investments, although they are not exclusively mandated to do so, and can therefore invest in to certain non-ESG investments. Article 9 funds are the gold banner in terms of ESG investing, whereby sustainable investing is an objective of the fund."

Tom O'Gorman, head of distribution, Ireland at Legal & General Investment Management (LGIM), says this means asset owners and institutional investors are now clearly defining their position on ESG as both regulatory pressures increase and improvements in ESG data reporting make this more achievable.

"Incorporating these positions will take more time as asset owners assess the ESG fund universe across their portfolio. SFDR classification will assist these decisions as more investors will move to article 8 and article 9 funds. We are seeing some early investors particularly with an impact focus already reshaping their investment portfolios."