INVESTMENT™
WEEK

Fiona Frick: Einstein's adaptability insight for reshaping sustainability

European funds showed resilience

Fiona Frick

15 December 2023 • 4 min read

In the past year, the financial and industrial sectors have seemingly retreated from sustainability amid global risks and political changes, leading some to speculate that the sustainability movement might be a transient phenomenon.

I would argue this trend instead signals an industry maturing and adapting to change, as highlighted by Einstein's view that "intelligence is the ability to adapt to change".

Sustainability is evolving, driven by societal needs and economic transformation. Its ongoing adaptation is set to persist, paving the way for its enduring presence in future investment strategies.

Some headwinds for sustainability in the last two years

In 2023, the sustainability sector faced numerous challenges and growing scepticism. Investors grappled with the underperformance of ESG funds, particularly those with a bias towards tech stocks over energy stocks.

The 2022 market downturn and rising oil prices revealed flaws in these strategies, affecting their short and long-term viability in an environment remaining very dependent on fossil fuel.

Additionally, inflation and interest rate hikes led to a shift away from growth stocks, impacting ESG funds with substantial tech investments.

The sustainability landscape also faced various regulatory and political challenges.

COP28: What was agreed at the UN Climate Summit in Dubai?

In Europe, regulatory scrutiny and greenwashing concerns led to many funds being downgraded from 'dark green' Article 9 to 'lighter green' Article 8, reflecting difficulties in defining sustainability.

In the US, Republican leaders sharply criticised ESG practices, impacting the financing of the oil and gas industry.

Additionally, Blackrock's CEO distanced himself from 'ESG' due to its politicisation and the complexity of stakeholder expectations.

By Q3 2023, global sustainable fund inflows moderated significantly, dropping to $13.7bn from $23.7bn, and assets under management decreased by 4.2% to $2.7trn, as reported by Morningstar.

Despite this downturn, European funds showed resilience, gaining $15.3bn and maintaining over 80% of the global ESG market, while the US experienced $2.7bn in net outflows and a rise in companies removing ESG terms, reflecting divergent European and American approaches to sustainable investing.

ESG is dead, long live sustainability.

The recent slowdown in sustainable strategies, often perceived as a passing trend, signifies the maturing of the industry.

We are witnessing a significant shift as sustainability transitions from

an ideology to a pragmatic, economically driven investment strategy.

This evolution reflects the urgent need to address environmental issues like climate change and societal challenges such as inequality, signalling the onset of a new economic revolution.

A key distinction is emerging between ESG (Environmental, Social and Governance) and true impact investing.

FE fund info's head of ESG product: From SRI to ESG and navigating the paradigm shift.

While ESG offers a management and risk evaluation framework, it lacks a universal standard for defining a 'good' company, as shown by studies like the August 2023 Edhec report.

In contrast, impact investment proactively focuses on a company's positive environmental and social outputs.

The focus of sustainability is increasingly shifting towards measuring real impact, with ESG serving more as a check on governance, behaviour, and risk.

Sustainable investment is now seen as an essential strategy, not just an ethical choice. It is about sustaining economic and environmental health over time, requiring innovative solutions across various sectors.

The integration of sustainability has advanced the approach of financial analysis in assessing companies for investment. Analysts now adopt a holistic view of investment risks, encompassing both financial and extra-financial metrics. Additionally, investors are increasingly engaging with companies to actively drive meaningful changes.

This shift broadens the scope of "active management" to include "active ownership" of assets, focusing on achieving set objectives.

Additionally, democratisation is underway in investment, with ETF providers allowing retail investors to participate in proxy voting alongside institutional investors.

UAE Consensus delivers 'landmark' deal to transition away from fossil fuels.

However, measuring sustainability progress remains challenging, mainly due to self-reported data by companies. But here again there is a progress.

In the EU, more than 50,000 companies will soon be required to assess their environmental impact, a part of a regulatory push for greater transparency in extra-financial data.

These efforts highlight the increasing need for standardised, transparent, and comparable data to guide both companies and investors.

Similarly, the International Sustainability Standards Board issued its first two sustainability reporting standards in June 2023.

Survey participants anticipate that these standards will simplify and enhance the effectiveness of reporting on sustainability metrics.

In conclusion, sustainability in investment is rooted in the understanding that a profound global economic transformation is taking place, presenting both opportunities and risks.

Active managers are challenged with critically assessing how companies adjust their operations in response to wider shifts in production and consumption.

This understanding of economic transition is vital. Reflecting on Albert Einstein's perspective of intelligence as the ability to adapt to change, it becomes clear that in sustainable investing, sustainability is not just an environmental or social issue, but a fundamental part of a robust investment strategy.

This paradigm shift emphasises real impact and positions sustainability as a crucial element for long-term success in a dynamic global economy.

Fiona Frick is managing partner of Circe Invest