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ESG Investing: Steady Growth Amidst Adversity

Consistent global flows, solid performance, and rising demand from asset owners challenge the narrative of stagnation and decline

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Key Findings

Environmental, social, and governance (ESG) investing has grown rapidly in investor and public consciousness between 2017 and 2022. Despite recent debate, inflows into sustainable funds remain strong, especially in Europe. In 2023, the performance of ESG funds and exchange-traded funds (ETFs) matched or surpassed that of traditional funds and ETFs.

In 2023, as per independent fund investment research house Morningstar, sustainable funds had a median return of 12.6% versus 8.6% for traditional funds. This outperformance extended across equity and fixed-income funds asset classes.

Europe, the most advanced regionally in embracing sustainable funds, saw an inflow of almost US$11 billion (bn) into this asset class in the quarter ended March 2024. In contrast, ESG investing appears politicized in the U.S. and is seeing outflows.

Regulators are increasing their focus on climate risk, and there is a drive for transparency and robust reporting on climate and ESG matters. There are clear signs of greater regulatory support in Europe and many Asian countries, which indicate climate, sustainability, and ESG policies are being further adopted by the mainstream. Asset owners also want increased ESG considerations in investments.

Executive Summary

Environmental, social, and governance (ESG) investing grew rapidly in both investor and public consciousness between 2017 and 2022, but has recently faced backlash from certain quarters. Despite the assets under management (AUM) of funds defined as “sustainable” by Morningstar, the mutual fund research company, reaching nearly US$3 trillion (tn) by the end of 2023, a series of interest rate hikes to contain inflation led to poor performance for ESG funds.[1] Politicians in the U.S. and elsewhere, particularly those that support fossil fuel interests, have mounted sustained attacks on ESG, labeling it as idealistic and against national interests. In response, some companies and fund managers have either reduced their emphasis on ESG or disassociated from groups aiming to address issues like climate change and governance.[2]

This report analyzes the actual performance and returns of ESG-related funds and investments, the fund flows into and out of these funds, and the regional differences and their implications. It also explores regulatory trends and oversight of capital markets, as well as the perspectives and intentions of large investors and asset owners. The findings indicate that ESG continues to grow and remain relevant. The performance of ESG funds and exchange-traded funds (ETFs) has matched or surpassed traditional funds/ETFs over most time periods. Regulators continue to focus on climate change risks, and on improving standards and disclosures to assess and mitigate these risks.

In terms of performance, sustainable funds outperformed and generated better returns than traditional funds in 2023, with a median return of 12.6% versus 8.6% for traditional funds.[3] This outperformance was seen across both equity and fixed-income asset classes. This is not an anomaly as sustainable funds have outperformed traditional funds’ returns every year from 2019, except in 2022. Similarly, in terms of ETFs, the median ESG ETF outperformed the median traditional ETF in three of the last four years.

A significant difference between the investment exposures of sustainable and traditional funds is the former’s underweighting of the energy sector. In 2023, the clean energy sector underperformed in the broader market or the S&P500 due to sharp interest rate increases. Meanwhile, the war between Russia and Ukraine gave an exogenous boost to oil and gas prices, allowing energy stocks to recover from a decade of serial underperformance. The negativity surrounding clean energy and arguments favoring fossil fuel stocks appear to be a case of recency bias. Despite windfall gains for the oil and gas sector due to Russia’s war on Ukraine, these stocks have not outperformed clean energy over the past decade.

Organic fund flows for the sustainable funds sector remained positive in 2023, with net inflows of 2% of the starting fund base.[4] This growth outpaced the overall funds industry which saw an organic

[1] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.
[2] Pensions & Investments. Invesco adds to Climate Action 100+ departures. 04 March 2024.
[3] Morgan Stanley. Sustainable Funds Outperformed Peers in 2023. 29 February 2024.
[4] Morningstar. 2024 Global Fund Flows.

growth rate of just 0.17%. Despite a significant slowdown, the ESG/sustainable fund industry still grew faster than the overall fund industry, accounting for 6.6% of overall funds at the end of 2023.

The first quarter of 2024 (1Q2024) saw a small outflow of US$900 million (mn).[5] However, this was largely driven by a large outflow of US$8.8 billion (bn) from the U.S. out of these funds. By contrast, Europe, the most advanced regionally in terms of embracing sustainable funds, experienced an inflow of almost US$11bn into this asset class. This inflow, far from declining, was more than double the previous quarter's subscriptions. Although news from the U.S. tends to be amplified, it is important to remember that Europe is the origin for 84% of funds under management in this category.

The difference extends beyond the quantum of investment flows. The commitment that many U.S. fund houses have towards ESG appears to be weaker compared to European ones, as evidenced by surveys of asset managers. Similar surveys of asset owners and investors show a growing drive to integrate sustainability and ESG in their investment processes.[6, 7]

Regulators are increasing their focus on climate risk, pushing for more transparency, clearer rules, and robust reporting on climate and ESG matters. There are clear signs of greater regulatory support in Europe and many Asian countries, which should see climate, sustainability, and ESG policies being further adopted by the mainstream. Even in the U.S., the Securities and Exchange Commission's (SEC) climate disclosures requirement, although not stringent, can be viewed as a first step.

[5] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.
[6] FTSE Russell. Asset owners commit to maturing sustainable investment strategies.
[7] Principles for Responsible Investment. Global responsible investment trends: Inside PRI reporting data. 20 March 2024.

Background

ESG Growth and Anti-ESG Backlash

According to press headlines and discourse in the financial and general media, ESG is seemingly under pressure from many sides. ESG investing, which rapidly gained investor and public interest between 2017 and 2022, has recently faced backlash from certain quarters. While the assets under management (AUM) of funds defined as "sustainable" by Morningstar, the mutual fund research company, grew to just under US$3tn by the end of 2023, this category also comprises some opportunistic funds with limited ESG characteristics.[8] The increase in such funds has led to headlines about unfair fees and greenwashing.[9]

Meanwhile, the surge in the cost of living, driven by higher energy prices due to the Russia-Ukraine war, weakened overall financial markets. Additionally, a series of interest rate hikes to contain inflation resulted in particularly poor performance for ESG funds.[10]

In a year marked by numerous partisan and contentious elections, politicians in the U.S. and elsewhere, particularly those that have traditionally supported fossil fuel interests, have mounted a sustained attack on ESG, labeling it as idealistic and against national interests. Some companies have responded by quietly removing mentions of ESG from their materials.[11] Financial firms, under threat of boycotts and legal challenges in some U.S. states, have also stepped back, either by speaking less about ESG and sustainability, or in some cases by disassociating them from groups which aim to collectively tackle pressing issues such as climate change and governance.[12, 13]

The concept of ESG is also under fire by those advocating for higher levels of environmental and social governance, and better balancing of broader stakeholder interests in the corporate sphere. Several climate scientists, environmentalists, and activists hold many companies accountable for being insincere in their ESG pledges. Accusations of greenwashing abound.[14, 15]

Consequently, some prominent academics and commentators have declared the end of ESG or called for its renaming or retirement.[16, 17] In a widely noticed instance, a prominent fund house chief, who was previously vocal about ESG, now barely mentions it in annual shareholder letters.[18]

[8] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.
[9] Nasdaq. ESG Funds Cost Three Times More Than You Think. 21 February 2023.
[10] GRC World Forums. ESG under pressure thanks to surging energy bills. 18 February 2022.
[11] Campaign Asia. ESG removal a big McStake for McDonald's sustainability credibility. 23 August 2023.
[12] Pensions & Investments. Invesco adds to Climate Action 100+ departures. 04 March 2024.
[13] ESG Today. Texas Pulls $8.5 Billion From BlackRock Over ESG Investing. 20 March 2024.
[14] Greenpeace. VW's Carbon Footprint Sham.
[15] Union of Concerned Scientists. Greenwashing in Graphs: an ExxonMobil Story. 09 April 2024.
[16] IESE. ESG is dead, long live ESG. 01 January 2023.
[17] VettaFi Advisor Perspectives. Aswath Damodaran: It's Time to Retire the ESG Concept. 26 April 2023.
[18] Forbes. BlackRock's Fink Calls For Energy Pragmatism, Omits ESG From Annual Letter. 27 March 2024.

Lost in all this is the factual reality of ESG investing. This report analyzes the actual performance of, and returns to, investors from ESG-related funds and investments, examines the fund flows into and out of these funds, and regional differences and their implications. It also explores trends in regulations and oversight of capital markets, as well as the perspectives and intentions of large investors and asset owners.

The Strong Performance of ESG Funds

Sustainable and ESG Funds Outperform Popular Perceptions

Despite the ongoing debates and challenging backdrop, sustainable funds outperformed and generated better returns than traditional funds in 2023.[19, 20] Sustainable funds had a median return of 12.6% versus 8.6% for traditional funds.[21] This outperformance was spread across both the equity and fixed-income funds asset classes. This was not an anomaly as sustainable funds have outperformed traditional funds' returns every year since 2019, except in 2022.

> **Sustainable funds have outperformed traditional funds' returns every year since 2019, with the sole exception of 2022.**

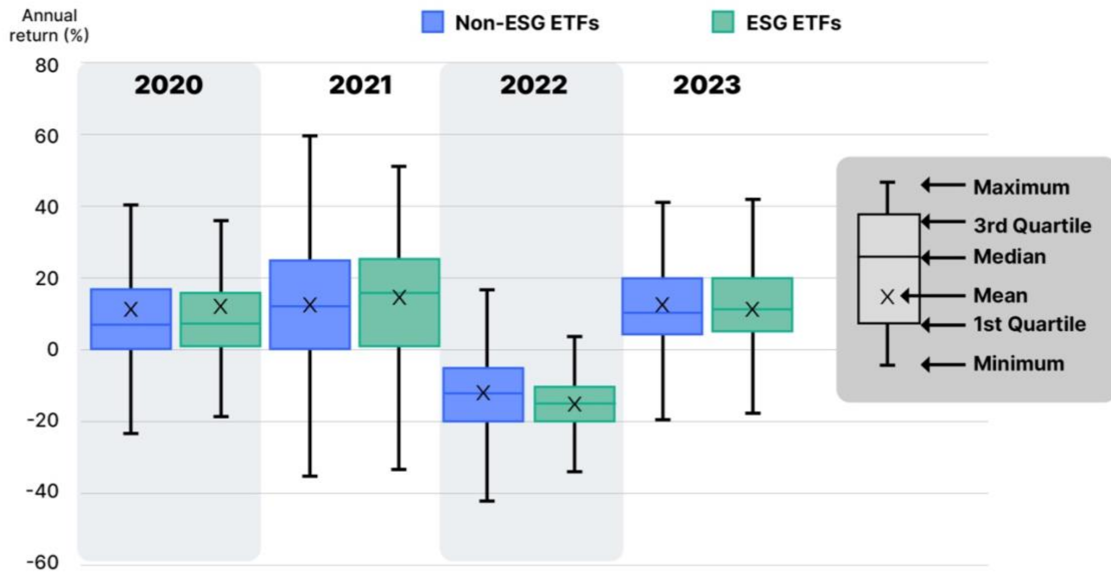
The most significant difference between the investment exposures of sustainable and traditional funds is the former's underweighting of the energy sector. Recent research by the Institute for Energy Economics and Financial Analysis (IEEFA) revealed that investing in traditional energy companies with fossil-heavy portfolios has generally been unprofitable for investors, except during rare events like the Russia-Ukraine war.[22] Barring such infrequent events, the sustainable funds' underweighting of energy stocks in their portfolios has mostly helped them outperform traditional funds.

The picture is similar for ESG ETFs when compared with their traditional counterparts, although the differences are less pronounced. ETFs, often referred to as passive funds, typically track an underlying benchmark index rather than actively betting for or against stocks. ETFs have become an increasingly popular choice for institutional as well as individual investors to gain market exposure. This has been the fastest growing area for funds; starting from a low base, ETFs now account for over 20% of total sustainable assets under management.

[19] Morgan Stanley. Sustainable Funds Outperformed Peers in 2023. 29 February 2024.
[20] "Morningstar classifies a fund as sustainable if '...in the prospectus or other regulatory filings it is described as focusing on sustainability, impact investing, or environmental, social or governance (ESG) factors. Funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a nonbinding way are not considered to be a sustainable investment product.'" Morgan Stanley. Sustainable Reality. Page 2.
[21] Morgan Stanley. Sustainable Funds Outperformed Peers in 2023. 29 February 2024.
[22] IEEFA. Passive investing in a warming world. 08 February 2024.

In 2023, ESG ETFs had both average and median returns of 10.5%, slightly higher than the median return of 10.1% for traditional ETFs, but below their average return of 12.5%. Like sustainable funds overall, sustainable ETFs also outperformed their traditional counterparts in 2020 and 2021, only failing to do so in 2022.[23]

Figure 1: Annual Returns - ESG and non-ESG ETFs

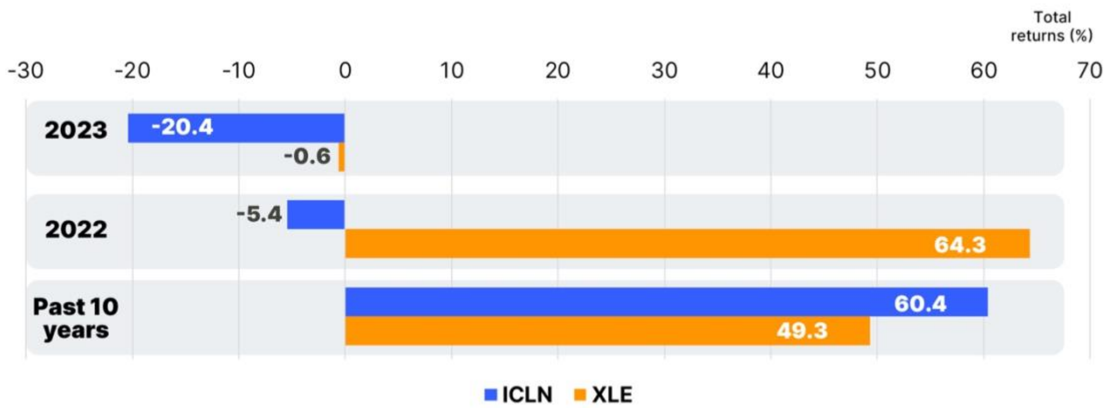


Note: Chart includes both equity and fixed-income ETFs / Religious ETFs and commodity ETFs are excluded.
Source: "Sustainable Reality" – Institute for Sustainable Investing, Bloomberg NEF, Bloomberg Intelligence.

When examining the performance of the clean energy sector, which is heavily involved in climate mitigation and sustainability (in terms of investee stocks/companies), compared to the fossil fuels sector, the results vary depending on the timeframe. The ICLN ETF, which tracks the S&P Global Clean Energy Index composed of clean energy stocks, is compared with the performance of the XLE ETF, a traditional energy/fossil proxy that tracks the Energy Select Sector Index.

[23] Morgan Stanley. Sustainable Funds Outperformed Peers in 2023. 29 February 2024.

Figure 2: ICLN and XLE Total Returns



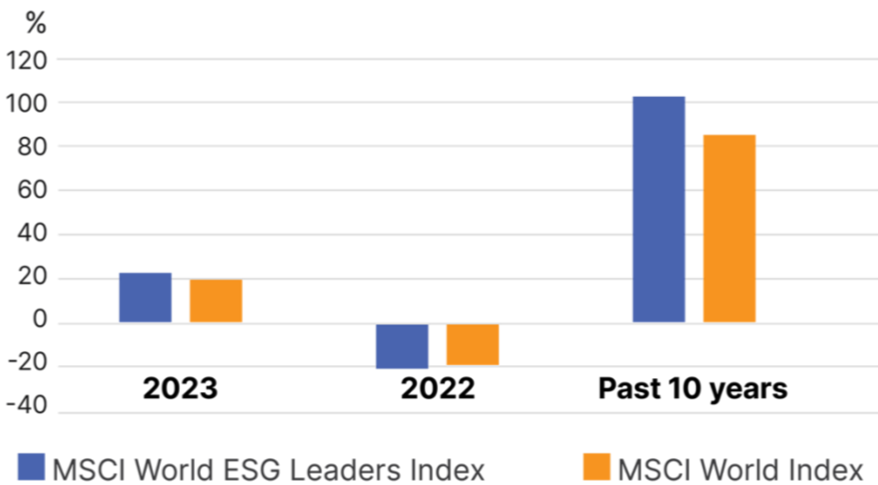
Note: ICLN is an ETF that tracks the performance of S&P Global Clean Energy Index. XLE is an ETF that tracks the performance of the S&P Energy Select Index.
Source: Bloomberg.

In terms of annual performance, 2023 was challenging for the global clean energy sector, and by extension, the ESG/sustainability sector. Over the past two years, the ICLN underperformed when compared with the traditional energy sector. However, three points are worth noting (see Figure 2). First, although the ICLN fell by 20% in 2023, the XLE or traditional energy sector ETF also declined by 1% during that year. Both underperformed the broader market or the S&P500.

Second, in contrast, the ICLN outperformed the S&P500 by a healthy 13% in 2022, falling only 5% compared to an 18% decline in the broader market. The overall market decline was largely due to Russia's invasion of Ukraine, which also caused energy stocks to surge by 64% due to war-related windfall profits - reversing a decade of underperformance.

Third, over a longer comparison period, the performance of clean energy stocks is more favorable. Despite the war-related boost in 2022, traditional energy stocks failed to match the performance of clean energy stocks over the past decade (May 2014 - May 2024). During this period, ICLN rose by 60%, outpacing the energy sector's 49% gains and doing so without the volatile swings seen in the energy sector ETFs.

Figure 3: ESG and Traditional Index Performance



Source: Bloomberg

Thus, the negativity around clean energy and arguments in favor of fossil fuel stocks appear to be a case of recency bias. As shown by the data above and the figure below, clean energy stocks performed well even when the broader market fell in the immediate aftermath of the Russia-Ukraine crisis and the subsequent wave of inflation. This was evident in 2022 and again in the early part of 2023 when interest rates initially remained relatively stable.

This is despite the fact that most companies focused on the energy transition have significant long term investment plans with corresponding borrowing needs. As the Federal Reserve raised rates from 0% to 5.25%, long-term interest rates also surged. According to some calculations, 2022 is considered the worst year ever for bonds in the U.S.[24]

However, this initial resilience was undermined by a second period of the Fed tightening from late June to the end of October, which saw rates increased by a further 100 basis points. This led to additional near-term dips in profitability and weakened balance sheets for many companies in the sector. Markets were spooked, which caused investors to sell off positions while taking a short-term view. As a result, after holding up relatively well in early 2022, the ICLN fell by 29.3% while the MSCI World Index dropped only 6.2%, resulting in the underperformance of over 2,300 basis points during these four months (see Figure 4).

With interest rates likely nearing their peak, the outlook is improving for the sector, and consequently for funds investing in these companies.

[24] CNBC. 2022 was the worst-ever year for U.S. bonds. How to position your portfolio for 2023. 07 January 2023.

Figure 4: Clean Energy Stocks Hit Hard by Rising Interest Rates in 2023

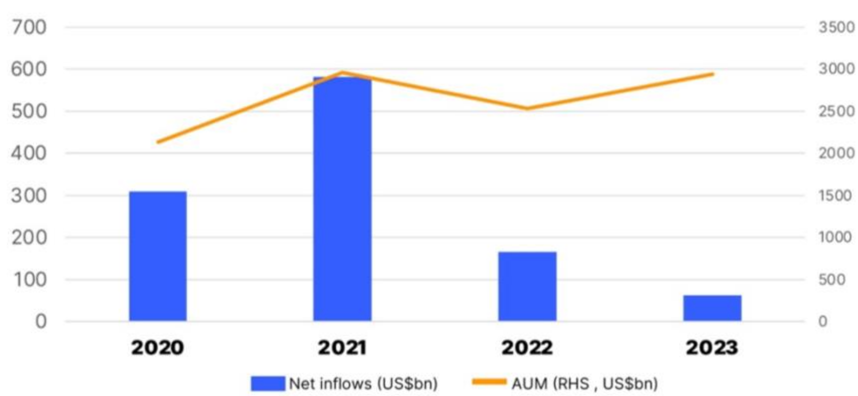
Source: Bloomberg

Fund Flows: The Story and the Real Numbers

Flows and (Analytical) Flaws

At first glance, the data below suggests that net inflows (the value of funds bought *minus* the value of funds sold) into sustainable funds peaked in 2021. Although assets under management are higher now, according to Morningstar, the scale of increase has shrunk each year for the past two years.[25] While this may seem like a stark slowdown, organic ESG fund growth remains positive.

Figure 5: Inflows and Assets of Sustainable Funds



Source: Morningstar

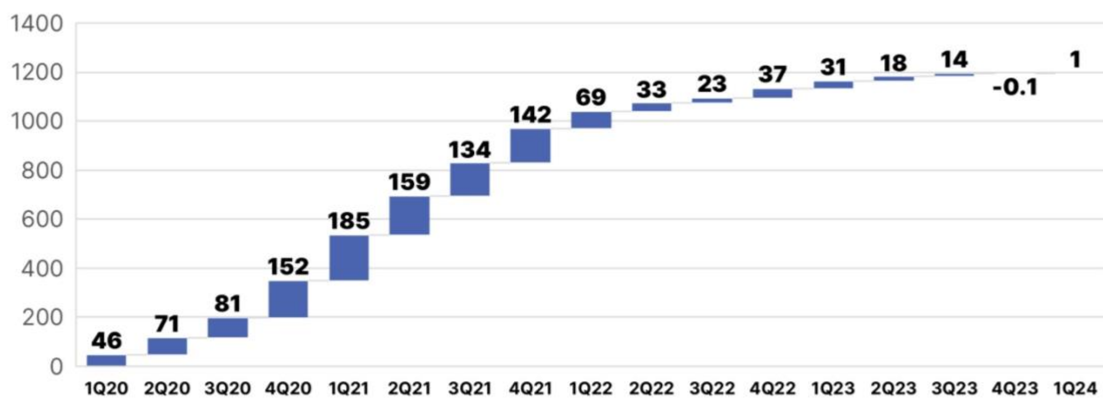
[25] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.

Although much lower than the previous year, net inflows were 2% of the starting fund base. This growth, while not high, surpasses the overall organic growth for the funds industry, which was a meager 0.17%.[26] This was the lowest inflow into funds in general for any year in the past fifteen years, except for 2008 and 2022, which were marked by a financial crisis and the energy prices crisis sparked by the Russian invasion of Ukraine, respectively.

Even with a sharp slowdown and while facing criticism, the ESG/sustainable fund industry still managed to grow faster than the overall fund industry, accounting for 6.6% of total funds by the end of 2023.[27] By the end of 1Q2024, sustainable funds had assets under management just below US$3tn.[28] Note that AUM is a combination of net inflows/outflows *plus* the market effect, i.e., the rise or fall in the prices of the investments held by the fund.

Breaking the flows down by quarter reveals some signs of a slowdown in the inflows to sustainable funds. While 2023 was positive overall, the fourth quarter saw the first-ever net outflow of funds, with investors withdrawing a modest US$88mn from the asset class. The trend reversed in 1Q2024, with Morningstar's global universe of sustainable open-end and exchange-traded funds seeing nearly US$900mn in net new money flowing in. However, this quarter's inflows were still relatively insignificant in the context of the nearly US$3tn in sustainable assets managed by the funds industry, while the broader funds universe saw growth of 0.5%.[29]

Figure 6: Global Sustainable Net Fund Flows (US$bn)



Source: Morningstar

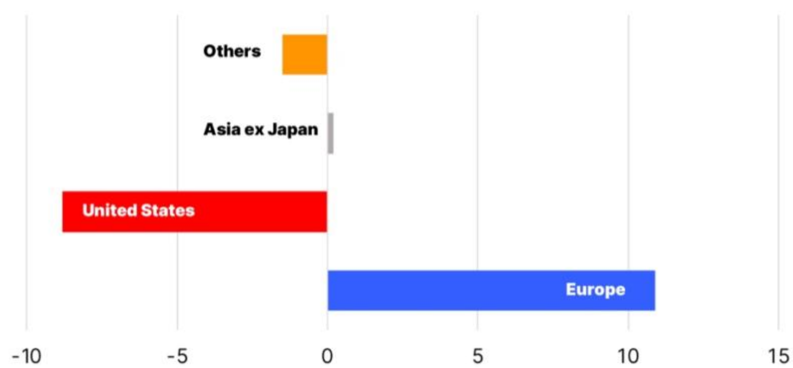
While a broad view of the flows into sustainable funds may suggest a slowdown, a more detailed analysis of the regions illustrates that this is far from signaling the sector's impending demise.

[26] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.
[27] Morningstar. 2024 Global Fund Flows.
[28] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.
[29] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.

Regional Disparities – Flows are Weakest in the U.S.

Using a regional lens, a more nuanced look at the AUMs and flows into sustainable funds reveals significant differences between the regions. The following chart showing flows for 1Q2024 by region is particularly illustrative.

Figure 7: Sustainable Fund Flows for 1Q2024 – Net Inflows of US$900mn



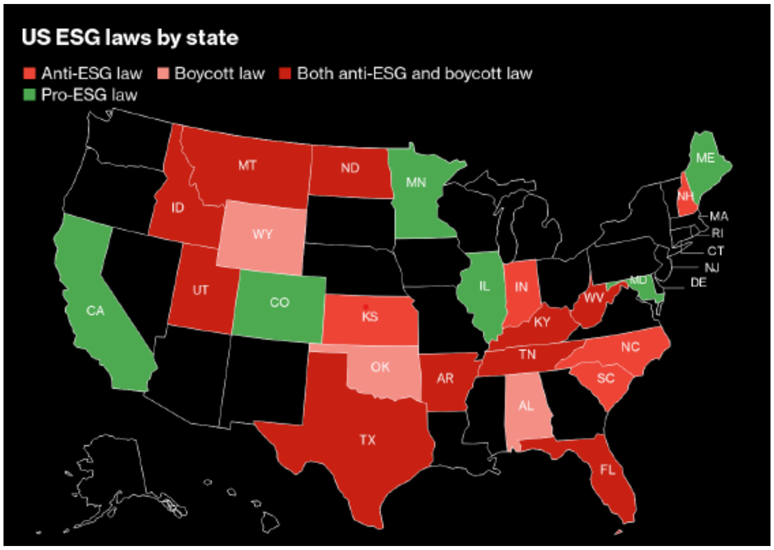
Source: Morningstar

The headline figure of US$900mn in inflows this quarter conceals a much more complex reality. Europe, which has widely adopted sustainable funds, saw an inflow of nearly US$11bn into this asset class. In contrast, the U.S. experienced a significant outflow of US$8.8bn from these funds. This divergence highlights notable regional differences in sustainability investment preferences.

To put this in perspective, the US$10.9bn inflows into European sustainability funds, according to Morningstar, were more than double the previous quarter's subscriptions. In a diametrical opposite, the US$8.8bn outflows from U.S. domiciled funds represented the worst quarter ever for sustainability funds in the U.S.

Much of the debate surrounding ESG originates from the U.S., where the topic has become politically divisive. As of the last count, 18 U.S. states had enacted anti-ESG or boycott laws, with another eight having similar laws in the pipeline. On the pro-ESG side, six states have enacted laws, with four more forthcoming. The anti-ESG laws are of two types – they either restrict asset owners, typically state government linked pension funds, from considering ESG factors in their decisions, or prohibit certain institutions advocating for ESG from doing business in the state.

Figure 8: Map of U.S. States and ESG Laws

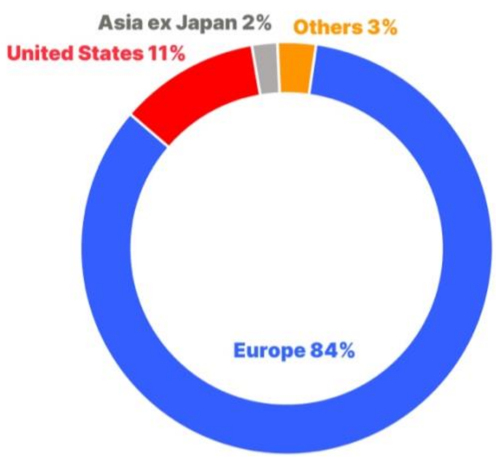


Note: Pro-ESG laws include divestment laws. Data as of March 2024.

Source: BloombergNEF; State legislatures

In this context, it is worth noting that the U.S. never embraced sustainable investing to the same extent as Europe, which may result in different impacts. The global landscape of sustainable funds is dominated by Europe, which accounts for 84% of the funds under management in this category.

Figure 9: Regional Split of Sustainable Assets Under Management (AUM)

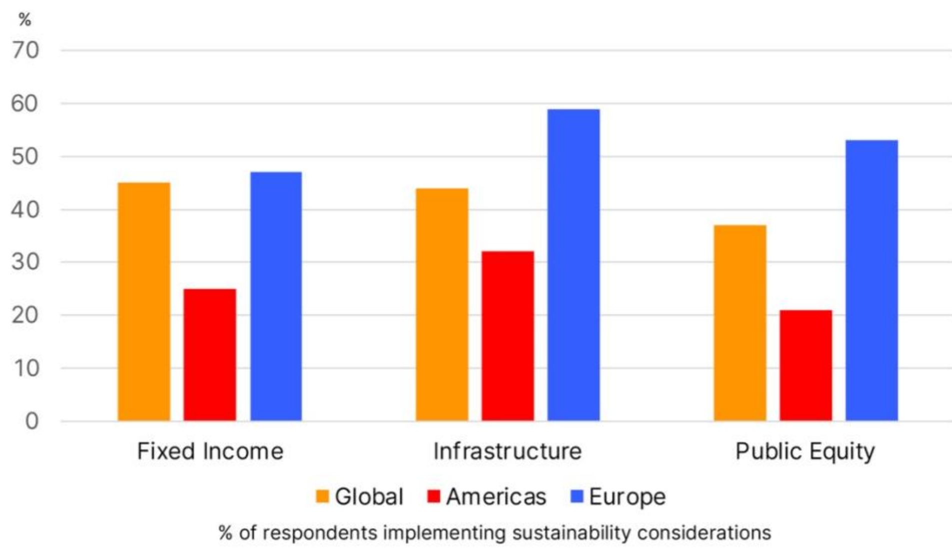


Source: Morningstar

The difference extends beyond the quantum of investment flows. U.S. fund houses appear to demonstrate a weaker commitment to ESG compared to their European counterparts. A February 2024 Morningstar analysis rated a third of the 97 fund houses as a “Leader” or “Advanced” in integrating ESG. However, only nine of the 42 U.S. fund houses fell into these categories. Half of the U.S. funds were rated as “Basic”, and 29% were classified as having “Low” ESG integration.[30]

A FTSE Russell survey of 350 global asset owners also showed significant regional variations in the implementation of sustainability considerations.[31] Europe led the Americas in terms of sustainability incorporation across all major asset classes such as equity, fixed-income, and infrastructure.

Figure 10: Sustainability Considerations Across Asset Classes and Regions %



Source: LSEG

Europe’s Distinct Commitment to ESG Investing

The quarterly data highlights Europe’s more positive stance toward ESG investing, making it the world’s largest market for such funds. The region has generally favored sustainable funds over traditional funds in recent years. Notably, sustainable funds attracted over a quarter of the net inflows into European funds, even during the last quarter when the broader market sentiment turned favorable towards Europe.

In 1Q2024, sustainable funds saw inflows of US$10.9bn, while traditional funds attracted US$41bn. This was only the third instance in the past three years where quarterly inflows into conventional funds exceeded those into sustainable funds. This followed the fourth quarter of 2023, when conventional funds lost, or saw outflows, of US$24bn, while sustainable funds gained US$4.9bn in fresh investments. For 2023, European sustainable funds had inflows of US$76bn, whereas conventional funds saw outflows of US$50bn.

30 Morningstar. Morningstar ESG Commitment Level Landscape. February 2024.
31 FTSE Russell. Asset owners commit to maturing sustainable investment strategies.

It is worth noting that Morningstar's criteria for classifying a European fund as sustainable are stricter than merely requiring the fund to be an Article 8 or Article 9 fund. While over 99% of the Article 9 funds are categorized as sustainable, only 30% of Article 8 funds meet the criteria.

Although ESG flows have slowed compared to previous years, this should be viewed in the context of a maturing industry. This slowdown may also reflect a shift into traditional funds from other asset classes to gain broader exposure to European investments, rather than a move away from sustainable assets.

Sustainable Finance Disclosures Regulation

The Sustainable Finance Disclosures Regulation (SFDR) are part of the rules governing the mutual fund industry in the European Union (E.U.). Effective since March 2021, the SFDR applies to all funds sold in the E.U. It mandates that financial market participants (FMPs) and financial advisors to disclose, at both the entity (e.g. fund management company) and product (e.g. mutual fund or ETF) levels, how they integrate sustainability risks and principal adverse impacts into their investment decision-making processes. Additionally, it introduces further product disclosures for financial products making sustainability claims.[32]

The regulation's objective is to provide investors with transparency about the sustainability risks in the fund's investments and investment process that may affect the value of their investments. It also aims to inform investors of the adverse impacts such investments may have on the environment and society.

In the broader context, the SFDR seeks to ensure that the financial system contributes to the E.U.'s climate and sustainability targets. Additionally, the SFDR "also aims at strengthening investor protection and making it easier for investors to compare financial products and services on their sustainability claims, with a view to guiding their investment decisions".[33]

The SFDR's existence and active implementation demonstrates that sustainable and ESG considerations are intended to be fully integrated and incorporated into the operations of the financial sector.

In the E.U., ESG and sustainable funds are typically categorized into two groups called Article 8 and Article 9 funds, while those not considering any sustainability characteristics in their investment process are classified as Article 6 funds. Article 9 funds focus on investing in companies that promote sustainability, such as those involved in the energy transition. Article 8 funds are those that actively consider or promote sustainability factors in their investment process, even though they may not necessarily invest solely in such companies.

The SFDR is complemented at the corporate level by the E.U. Taxonomy, which is a classification system that defines the criteria for economic activities aligned with a "net zero trajectory by 2050 and the broader environmental goals."[34] European corporates are required to report on their operations according to the Taxonomy, enabling both the financial sector and the real economy to share a standard definition of environmentally sustainable activities.

[32] European Commission. Sustainability-related disclosure in the financial services sector.
[33] European Commission. Summary Report of the Open and Targeted Consultations on the SFDR assessment 14 September 2023 - 22 December 2023.
[34] European Commission. EU taxonomy for sustainable activities.

Positive Contributions from Asia to 1Q2024's Inflows

Asia, excluding Japan, saw an inflow of US$622mn in 1Q2024, reversing the outflow of the previous quarter. These positive flows were primarily concentrated in Taiwan, while funds in Hong Kong and India experienced outflows. In 2023, Southeast Asia attracted US$324mn, a jump of 11% compared to US$291mn inflows in 2022.[35] China, Taiwan, and Singapore led among the ex-Japan markets in Asia last year with US$4.8bn of new inflows.[36]

Strengthening Regulatory Tailwinds

Regulators are increasingly focusing on climate risk, with Europe leading the charge for more transparency, clearer rules, and more robust reporting on climate and ESG matters. Increasingly, funds are also expected or required to do the same. This trend benefits the funds industry, as money typically flows towards products where standards are better defined, and there is a distinct demand for such investment products.

To remain competitive, global fund houses, including those in the U.S., must adapt to this shift despite internal debates. Many large funds sell their units worldwide, and many American companies operate globally, so changes in regulations elsewhere will impact how they view and report their investments and operations.

Recent initiatives have emphasized the disclosure of climate-related metrics by corporates, making it easier for funds and investors to understand the climate impacts of their investments.

In the U.S., the Securities and Exchange Commission (SEC) has adopted less stringent climate disclosure rules requiring companies to disclose their Scope 1 and Scope 2 emissions. Initially, the SEC proposed that companies disclose all emissions, including Scope 3 emissions, or emissions in the company's value chain, such as those of its suppliers and the emissions created using a company's products.[37]

However, after intense industry pushback, the SEC proposed the current, less stringent rules in March 2024. Despite potential litigation due to the current political climate and opposition from fossil fuel interests, this move towards greater transparency will help funds better discern the climate impacts of their investments.[38]

[35] The Business Times Singapore. Net inflows into South-east Asia ESG funds up 11.2% in 2023. 04 March 2024.
[36] Morningstar. Global Sustainable Fund Flows: Q1 2024 in Review.

[37] More on the Scope 1, Scope 2, and Scope 3 emissions, and their calculations can be found in the Greenhouse Gas Protocol. The GHG Protocol Corporate Accounting and Reporting Standard.
[38] U.S. Securities and Exchange Commission. SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures for Investors. 06 March 2024.

In the E.U., the Corporate Sustainability Reporting Directive (CSRD) requires businesses to report their environmental and social impacts and how their ESG actions affect operations. Effective from 2024, the directive starts with large companies and progressively includes smaller ones, including non-E.U. corporates with substantial sales in the region. Large companies are defined as those that meet two of the following three criteria: more than 500 employees, a turnover of greater than EUR40mn, and assets exceeding EUR20mn.[39]

As companies will have to declare sustainability information in more standardized formats, it will become easier to track and manage investments in the sustainability sector. This will provide greater support and operational and investment clarity to such funds. The SFDR related to funds are also likely to be tightened soon, with a focus on enhancing transparency and reducing greenwashing. The initial public comment period ended in late 2023, and the E.U. issued a consultation summary report in May 2024. Although not yet finalized, the new regulations will likely set higher limits on investments in companies with taxonomy-aligned activities for funds considered under SFDR's Article 8 and Article 9.[40]

Regional Approaches in Asia

In Asia, Singapore has announced mandatory reporting of climate metrics for listed corporates, aligned with the International Sustainability Standards Board (ISSB) framework, to be phased in from 2025 to 2026.[41] Unlisted corporates with over US$1bn in revenue or US$500mn in assets also fall under the scope of this requirement. Malaysia has started consultations on ISSB-aligned rules, and the central bank, Bank Negara, has announced enhanced methods for banks to conduct climate stress tests on their portfolios.[42]

In South Korea, the regulator has reiterated its decision to require corporates to make disclosures using an ISSB-based framework. Similarly, the Reserve Bank of India, the country's central bank, has proposed mandatory climate risk disclosure for banks.[43, 44] Both these measures are set to begin in 2026. Chinese stock exchanges are also planning mandatory ESG reporting for listed companies starting in 2026.[45]

In Singapore, the Environmental Risk Management (ERM) reporting norms required by the Monetary Authority of Singapore (MAS) for funds available for sale are progressing quickly. A PriceWaterhouseCoopers (PwC) survey conducted in the third quarter of 2023 showed that an

[39] Worldfavor. CSRD timeline: what you need to report and when. June 2023.
[40] European Commission. Summary Report of the Open and Targeted Consultations on the SFDR assessment 14 September 2023 - 22 December 2023.
[41] Accounting and Corporate Regulatory Authority (ACRA). Climate Reporting and Assurance Roadmap in Singapore.
[42] Securities Commission Malaysia. ACSR Invites Public Feedback on Proposed Use of ISSB Standards in Malaysia. 15 February 2024.
[43] IAS Plus. Korea consults on sustainability disclosure standards based on the ISSB standards. 02 May 2024.
[44] Responsible Investor. Indian central bank unveils mandatory climate disclosure rules for banks. 01 March 2024.
[45] China Briefing. China's Stock Exchanges Announce ESG Reporting Guidelines for Listed Companies. 18 March 2024.

overwhelming majority of financial sector players are adhering to MAS ERM requirements, confirmed by discussions with large funds.[46, 47]

Fund management companies have established policies and frameworks to manage environmental risks for their portfolios. As required by the regulator, consideration of environmental risk impacts on portfolios and formal reporting to senior management are now standard for most asset managers. Most respondents have initiated using quantitative tools for climate scenario analysis, while some have also started getting external assurance on their disclosures.

These developments suggest that ESG is likely to be more, not less, relevant and crucial to investment decision-making and operations. This is regardless of the unpredictability of fund flows and political pressure.

Asset Owners are Integrating ESG More, Not Less

While asset managers navigate market uncertainties and swings in funds' preferences, asset owners are increasingly integrating ESG and climate considerations into their investment processes. The top 100 asset owners, mainly sovereign wealth funds, pension funds, insurance companies, university endowments, and philanthropic/not-for-profit foundations, were estimated to account for about US$23tn in investments as of end 2022.[48]

A recent survey by the organization Principles for Responsible Investing (PRI), which represents over 5000 asset owners and asset managers globally, found that 59% of asset owners are likely to use scenario analysis to assess the resilience of their investment strategies under specified climate scenarios, compared to 34% for asset managers.[49] Higher percentages of asset owners (compared to managers) also reported using the Paris Agreement to identify sustainability outcomes, prioritizing collaborative engagements, and providing regular reporting on climate and ESG issues. The level of ESG integration is also high across asset classes, with increasing ambition and action on responsible investing, leading to more comprehensive assessments of asset managers' responsible investing practices.

Similarly, a survey by FTSE Russell of 350 global asset owners showed that 80% of respondents implement and evaluate sustainable investments. In Europe, Middle East, and Africa (EMEA), and Asia, this figure rises to 90%. Over 50% of respondents cited member demands (such as those from pension funds) and the need to mitigate long-term investment risks as reasons for focusing on

[46] Monetary Authority of Singapore. Guidelines on Environmental Risk Management for Asset Managers. 08 December 2020.
[47] PwC Singapore. From reality to ambition: A review of current progress and the journey ahead - Environmental risk management for banks and asset managers.
[48] Wealth Briefing Asia. Sovereign Wealth Funds Reach Record Share Of Asset Ownership. 29 November 2023.
[49] Principles for Responsible Investment. Global responsible investment trends: Inside PRI reporting data. 20 March 2024.

sustainable investment strategies. Additionally, 79% of respondents in the PRI survey are now identifying sustainability outcomes linked to their investments alongside financial outcomes.[50]

Asset owners typically outsource a portion or all of their investment funds, to be managed by asset management companies. Therefore, it is in the interest of asset management companies to align their operating principles with their clients' and asset owners' expectations.

Conclusion

While ESG investing is facing challenges, ESG funds have generally delivered respectable returns and outperformed traditional funds in recent years. The year 2023 was particularly difficult for the more pure play or narrowly focused sustainability funds, but overall, sustainable funds have shown superior investment performance compared to traditional funds. This challenges the credibility of arguments against ESG investing.

In recent months, although there has been a dip in fund flows into the sustainable asset class, regional variations are evident. Europe remains a leader in ESG, with 84% of sustainable AUM, while U.S. politics and actions have significantly impacted sentiment towards the asset class.

In Europe, ESG flows have slowed compared to previous years, which can be seen as a sign of a maturing industry and a shift into traditional funds from other asset classes to gain broader exposure to European investments. Sustainable investment flows in the U.S. will likely remain under pressure until the November elections and possibly longer, depending on the outcome.

The narrative suggesting a decline in all ESG investing is simplistic and misleading. Regulations requiring more disclosures related to climate, sustainability, and ESG, as well as further actions by financial markets and corporate players, continue to advance. While there are regional differences in the comprehensiveness of these regulations, large parts of the financial and corporate sectors should be prepared for more extensive reporting requirements. These regulations will impact all who conduct business, not just those domiciled there. Hence, corporate and financial market players are likely to continue to focus on improving their outcomes.

Finally, most of the largest asset owners, such as sovereign wealth funds and pension funds, are universal asset owners seeking long-term performance, and understand the importance of incorporating sustainability outcomes and considerations into investment analyses. They are likely to continue doing so, regardless of short-term market fluctuations or political pressures.

[50] FTSE Russell. Asset owners commit to maturing sustainable investment strategies.

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