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Have ESG funds flows reached a tipping point?

Professor Campbell R. Harvey

Global sustainable funds, as identified by Morningstar, rose to a record US$ 2.2 trillion in the second quarter of 2021, up from US $1.7 trillion a year earlier, or growth of 35% in a year.

In Australia, this number is even higher as a result of the flood of new environmental, social and governance (ESG) strategies launched in the past year. According to Morningstar's *Sustainable Investing Landscape for Australian Fund Investors* report for Q2 2021, assets in Australian sustainable investments were AU$33.42 billion on 30 June 2021, a 66% increase from a year earlier.

In light of this significant growth, in partnership with [US research and forecasting firm] Good Judgement, Man Group asked its clients to provide their opinions on the potential for continued growth of the ESG movement, choosing to focus on a relatively near-term horizon—the end of 2021. (The terms ESG and sustainable were used interchangeably here, while recognising the distinction between the two and the necessity of eventually establishing this distinction in the industry.)

An inflection point

It is clear that we have reached an inflection point in the public debate surrounding climate change—the Paris Agreement and the COP26 summit in Glasgow have seen coordinated global action to reduce carbon emissions.

Financial services have been at the forefront of the move to net zero, with massive inflows into sustainable funds in Europe and gathering momentum elsewhere. It seems reasonable to suppose that the momentum, already sizeable, will continue.

So it was that none of the forecasters believed that sustainable funds would decline in the coming months, with a not insignificant proportion—almost 40%—suggesting that the sector would see growth of between 34–44% in a mere two quarters (see Figure 1 on the next page).

Looking at the reasoning that Man Group's clients gave for their optimistic predictions regarding the continued growth of sustainable funds, similar reasoning cropped up again and again. President Joe Biden's green infrastructure plans were mentioned, as was COP26. There was focus on the fact that the US still represents a relatively small proportion of global sustainable funds under management, giving significant room for further growth in the world's largest investment market.

There is, though, a note of caution to be struck here. Man Group asked the question with half an eye on the fact that the record numbers in the second quarter of 2021 were largely a facet of the seemingly inexorable upward rise of stock prices. In fact, there was a marked decline in inflows into sustainable funds in the second quarter worldwide, as shown by Figure 2.

US versus Europe

This decline was driven by a number of factors. Firstly, we are yet to see proof that the US is indeed going to follow Europe and go all-in on sustainable funds. The US market is well behind Europe both in terms of the breadth and sophistication of products on offer and in terms of regulation. Indeed, while some have been focused on President Biden's green credentials, it is a legacy of the Trump era that has most impacted the take-up of sustainable funds in the US.

The ruling by the US Employee Retirement Income Security Act of 1974 (ERISA) [reported in Morningstar's, *Sustainable Investing Landscape for Australian Fund Investors* report for Q2 2021] in November 2020 that pension funds could not consider ESG factors when judging whether an investment was suitable has been diluted by the Biden administration but not abandoned altogether. There is, as one pension fund trustee put it, "murkiness" about the official line on ESG.

Europe is also facing regulatory challenges. The enactment of the EU's Sustainable Fund Disclosure Regulation, or SFDR, is something Man Group wholeheartedly supports. It is a sign of an industry that wants to be taken seriously, and necessary for the establishment of investor trust in sustainable products.

But these rules, which seek to ensure that sustainable funds are genuinely sustainable, rather than mere greenwashing, have seen a significant drop in the number of funds listed as 'sustainable'. Quietly, fund managers stripped the term ESG from almost US$3 trillion of funds in the first half of 2021 (Bloomberg Intelligence).

Then there is the question of the broader markets, including Australia. ESG funds have benefited from the outperformance of growth stocks in the past 18 months, given the significant overlap between ESG leaders and the growth factor.

Some believe that ESG outperformers should actually offer lower returns than their broader peers, given that ESG is a risk factor, and poor performance should confer a risk premium to investors. This is by no means a wish to attempt to call the market here, but merely pointing out that ESG leaders have had a near-perfect run in the past 18 months, and we should not expect this to continue indefinitely.

Conclusion

It will be fascinating to see where sustainable funds in 2021 end up. It is easy to envisage a scenario where, notwithstanding the headwinds mentioned earlier, investor capital continues to pour into sustainable funds, with the media and political noise around COP26 pushing refusniks over the line.

But lower growth or even a decline in global sustainable funds need not be seen as a problem. The narrowing of definitions is something that needs to happen for ESG to be broadly accepted—greenwashing and the lack of consistent and coherent ESG data are two of the impediments most commonly cited by investors yet to commit to ESG.

So even if the growth of ESG funds drops off a little in the months and years ahead, we should see this as a sign of increasing maturity and the acceptance that achieving positive ESG outcomes requires more than merely sticking a label on funds whose real mandate lies elsewhere.

Growth without purpose and impact means nothing, and the growth we see from here on in needs to be in products that will genuinely contribute towards a more sustainable future. **FS**

The quote

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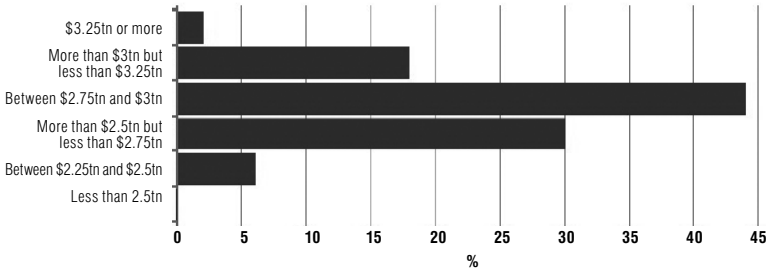
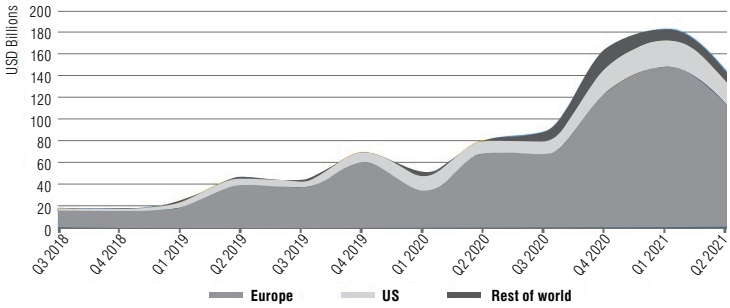
Figure 1. What will be the total value of assets under management* by global sustainable funds at the end of 2021?



* *According to Morningstar*
Source: Good Question [Man Group's partnership with the Good Judgement Superforecasting team]/Good Judgement and Man Group
Note: Survey was conducted between 1–30 September 2021

Figure 2. Flows into global sustainable funds



Source: Morningstar; as of 30 June 2021