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Office 1754 - 182-184 High Street North, East Ham - London E6 2JA UK
Tel: +44(0)7723012060
Email: contact@gre-enterprise.org
Web: https://gre-enterprise.org/
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The Plight of ESGs: The Decarbonisation Dream Delayed

Manya Hussain
King's College London

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Despite environmental, social and governance (ESG) investing being a source of enormous growth in recent years, it is becoming increasingly likely to hinder the decarbonisation agenda. This is rather concerning as governments race towards reducing emissions; the Paris Agreement aims towards carbon neutrality by 2050. However, the combination of surging oil prices, cost pressures for research, and hits to big-growth stocks that bolster investments' outperformance obstructs this decarbonisation dream. With investor inflows cooling, ESG funds face an ever more uncertain future in 2022.

To put it simply, ESG investments are underperforming. One of the most popular ESG funds- the iShares MSCI USA ESG Select ETF (SUSA)- decreased by nearly nine percent in 2022: a value worse than the S&P 500's year-to-date loss. The iShares MSCI global energy producers exchange-traded fund increased by 37% by December 29, exceeding the largest US ESG fund- the $31.8 billion Parnassus Core Equity fund, which spiked by 28%. To make matters worse, Exxon stock has increased by 30% from last year- a ground-breaking feat against the S&P 500's 6% decline year to date and its 13% accumulation over the past year. Increasing oil prices pose a paramount threat to ESGs and their consistent requirement to remain relevant with outperformance. So long as oil outperforms, ESG will remain precarious.

The initial outperformance ESG had begun to dwindle in 2021. However, the Ukraine-Russia conflict has inflated the price of oil, further straining ESG investments that generally underweight fossil fuel businesses. This has adverse effects on Japan's Government Pension Investment Fund (GPIF), the world's largest pension fund with $1.7 trillion of assets, and other worldwide pension funds that incorporated hardline ESG policies. The possibility of ESG harming investment return and profitability is rendering it lacklustre. A survey of wealth managers evidenced that ESG usage dropped to 28% this year compared with 37% in the Bank Of America's 2021 survey. The strong oil price recovery is a probable reason for investors decreasingly perceiving ESG as the honeypot of excess returns compared to last year.

Furthermore, high energy prices result in Exxon and other Big Oil companies accumulating piles of cash. Shareholders are reaping increasing dividends from the best energy stocks, which is especially endearing against today's climate of high inflation and low bond yields. Investors are rather bullish on corporations such as Exxon. In April 2022, a barrel of oil cost $20; however, today, Brent crude oil is priced upwards of $90. This is despite the volatility in oil prices following the emergence of the Omicron coronavirus variant. To aggravate this plight further, JP Morgan reveals that global oil demand is expected to exceed 2019 levels by March 2022 and is on track to maintain this rise in 2023. Demand for oil has climbed as economic activity ramps up and the global economy emerges from the shackles of the pandemic. Meanwhile, renewable energy failed to meet the needs of innumerable consumers last winter; ESG initially overperformed only due to natural energy underperforming in 2020.

ESG is not sitting on the large piles of cash enjoyed by oil. Instead, the Federal Reserve's promise to raise interest rates (in response to the 40-year high CPI inflation) will impact the stocks further and ultimately levy trillions of bonds from its balance sheet. The main adversaries include rapidly growing technology companies that deteriorate when interest rates rise. Snap Inc. and Netflix Inc. have declined by 33% and 27% respectively, and both hold respectable rankings on ESG metrics. Given that ESG funds trade at an elevated price-to-earnings ratio compared to the market as a whole, investors are more vulnerable to volatility and devalued returns than if they had invested in unthemed index funds.

However, it is impossible to deny that sustainability is indispensable for investment strategies, thus, a reversal and a shift away is unlikely. For example, even if strong performance of certain energy and resource companies is observed, these companies will be viewed as uninvestable due to their negative ESG impact. Additionally, the state of oil does not alter long-term fundamentals: its widespread use will eventually decline and government regulations will deter investors from it. Nonetheless, markets can remain irrational to a greater extent than one can stay solvent. To the extent that oil outperforms, ESG will remain in the crosshairs.

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