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The Evolution of ESG in the US—Reflections on 2022

January 2023

As investors who have been using ESG and impact information to analyze investments for some time, 2022 stands out as a year in which ESG moved beyond becoming mainstream to becoming reviled by some, and more deeply embraced by others.

The politicization of ESG — at least in the US — closely coincided with the run-up to the mid-term elections in November of this year. While values-oriented investing has always intersected with politics, it was in 2022 that we saw politicians and pundits warning of the dangers lurking behind 'woke companies' and railing against ESG as anathema to returns-maximization. Propping up these extreme views are two undercurrents that we should not shy away from: 1) allegations that ESG is arbitrary at best and social engineering at worst, and 2) performance concerns.

One phenomenon driving the former is the conflation of ESG and impact. An example was the outrage at Tesla being kicked out of the S&P500 ESG Index. This enraged many a comment-maker in the Wall Street Journal because they could not separate the unassailably 'green' nature of Tesla's products (impact) from the fact that the company has a very poor ESG profile — questionable worker safety, allegations of racial discrimination, and historically, very limited transparency on its own environmental footprint…not to mention a CEO who one might argue routinely steps across ethical and even legal lines. Put differently, ESG and impact are not the same — this is true in their objectives and their outcomes. A lack of appreciation for this nuance has led skeptics to question its validity.

The fact that ESG ratings from major data providers don't match[1] is another source of consternation and, in the eyes of some, another reason that ESG information is supposedly arbitrary and should not play a role in financial analysis. While we don't use third party ratings at Radiant, we are happy to go on record as saying that we find most ratings to be very well reasoned, created by deeply knowledgeable groups of people. The fact that they don't agree doesn't surprise us in the least as there are scant few things that we do agree on in investing! Analysts routinely disagree on where earnings are headed, investment managers disagree on definitions of 'quality' and 'value', economists even disagree on the nature of our current economic environment.

There is no need to have close agreement on what makes a 'good' or 'bad' ESG company. [And frankly we'd all be better off thinking of companies as shades of grey, as opposed to

[1] This is the 'aggregate confusion' problem demonstrated by Berg et al at MIT in 2019.

good/bad]. As active investors, we believe that there will be rewards for those willing to roll up their sleeves and do the hard work of really digging into E, S and G concepts as they help us more robustly understand the true set of threats and opportunities facing companies. The fact that some will come to a different conclusion after doing their own hard work is just fine — disagreement a market makes! In no way does this negate the value of the information or lessen the role for ESG and impact analysis in investing.

As for performance concerns, the false dichotomy of 'returns or sustainability' does still exist in the eyes of some. Over the last year there has been a specific focus on Energy, and in this context, by 'Energy' we mean fossil fuels. Those who would lead others to believe that ESG inputs are value-destroying point to the dangers of missing out on the current Oil rally and/or being a subversive attempt to destroy the US' fossil fuel infrastructure. It is true that some prominent ESG-integrated strategies have avoided Oil and felt the performance sting in 2022 as shares of Big Oil surged.

Putting aside the obvious confusion of an ESG-effect versus an industry-effect, many long-horizon investors believe that fossil fuels are simply not where the future lies – that other cleaner, more efficient energy sources represent a better long-term investment. There is no doubt that fossil fuels will continue to rally in fits and spurts, but getting in on the 'bottom floor' of companies that will be tomorrow's leaders is the very essence of investing. The question is really one of horizon[2]. So, 2022 was the year in which the politicization of ESG was patent. A shame, given ESG analysis simply gives us more information with which to evaluate companies. Radiant, for one, won't say no to more information!

It was also a year of positives. Among them, three developments that lead us to believe that those committed to ESG and impact are coming at the subjects with more nuance and purpose. The first is a welcoming of 'impact' into public equities, and an explicit seeking out of impact-oriented equity strategies. The days of 'impact' as being the sole purview of private equity seem to be behind us as large investors seem to be adopting an impact mindset for all asset classes. This is gratifying as it aligns with our own belief that we must marshal the heft and breadth of the listed equity market if we are to really drive the changes needed to improve the aggregate efficiency of our economy.

During a recent trip to Europe and in recent meetings with foundations and family offices in the US, it has been made clear to us that some investors are now wanting to move explicitly toward impact, focusing on the effects that companies have on their environmental and social ecosystems. In no way does this represent a turning away from ESG, rather an additional requirement that investee companies must be positively aligned to one or more of the UNSDGs.

[2] And as an aside, we need to re-define 'Energy'! If we rely on the GICS classification system (as many do), most green energy names and green energy enablers would be categorized as Industrials or Technology.

Next, we are seeing more and more interest in 'S' concepts and an increasing awareness of the intersectionality between social and environmental challenges. While likely accelerated by COVID (and its many knock-on effects) we are now having more and more conversations with clients and prospects about the changing way we work, human rights and the 'just transition'.

We think this is exceedingly important as it is very unlikely we will achieve a green energy transition, for example, without training, mobilizing, and retaining skilled workers. Further, we believe that corporations have a role to play when it comes to thinking about those who will be negatively affected by evolutions in energy sources or automation. The time to think about 'S' issues is now if we hope to see any forward progress on the biggest challenges of our time.

And a final positive in 2022 – the SEC! An unlikely sentiment from an asset manager to be sure, but the SEC's focus on ESG (specifically its obvious aim of discouraging greenwashing) is not only necessary in an industry that has clearly gotten ahead of itself with respect to 'green' marketing claims, but a sign that the incorporation of ESG and impact information is not a fleeting fad or a practice limited to a small segment of investment management.

Regardless of where the SEC requirements land, we believe that their focus is indicative of the permanence of ESG as part of a wide variety of investment practices. We see this as an important evolutionary step for the US regulator, and a net positive for those depending on US investment management firms for their savings and retirements.

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