BEYOND the BACKLASH

2023 was the year of the backlash for ESG. Here's our perspective on

8 KEY CRITICISMS

driving most of the debate, to help companies move beyond it in 2024.

By **LUCY PARKER JON MILLER, JOSEPH DOYLE** & **ZAMZAM OSMAN.**

ESG HAS BEEN HAVING A ROUGH TIME LATELY. A SUSTAINED backlash is under way—primarily in the US and in some other major markets such as the UK. Following years of rapid growth and hype around all things ESG, this shift has created uncertainty for many companies. • While many of the criticisms are based on real concerns, the real picture for companies tends to be much more nuanced than such critiques suggest. One thing is clear: Backlash or not, from climate change to inequality, the fundamental issues that have driven interest in ESG are directly linked to company performance and will only continue to intensify. This means engagement with social and environmental issues will become more, not less, critical to business resilience and long-term value creation.

ILLUSTRATION: DAVID PLUNKERT

THE CRITICISMS:

1 "ESG is a financial flop—the returns are not there"

Loud is the narrative that the financial performance of ESG funds' is weakening amid high inflation, high interest rates, market uncertainty, energy anxiety, war and political backlash.

- "ESG funds certainly perform poorly in financial terms."—*Harvard Business Review*, March 31, 2022.
- "ESG outperformance narrative 'is flawed', new research shows."—*Financial Times*, May 3, 2021.
- "The only healthy endgame for ESG is another acronym: RIP. And it will not be a moment too soon."—Aswath Damodaran, finance professor at NYU's Stern School of Business.

OUR PERSPECTIVE: A key challenge to ESG investing is the varied availability of relevant, consistent and predictive ESG data. This means ESG returns and risks may not be easily quantifiable—leading to many different takes on the correlation between ESG integration and performance. Fundamentally, it comes down to a question of short-term versus medium- and long-term perspectives—and returns.

As environmental and social issues continue to intensify, they will become increasingly critical to business resilience. Incorporating ESG factors will therefore be key to positive risk-adjusted returns over the long term. As McKinsey underlines, "what some critics overlook is that a precondition for sustaining long-term value is to manage, and address, massive, paradigm-shifting externalities."

Beneath the noise, many investors buy into this logic:

- Despite outflows, global sustainable funds grew 15% in 2023 over the previous year, according to a report from the Morgan Stanley Institute for Sustainable Investing. The report finds these funds also outperformed all other asset classes for the year with median returns of 12.6% compared to 8.6% for traditional funds.
- Sustainable bond sales saw the most active January since the inception of the green debt market: "Global sales of green, social, sustainability and sustainability-linked bonds totaled $149.5 billion," Bloomberg finds.

90

PERCENT OF S&P 500 COMPANIES NOW PRODUCE SOME FORM OF ESG REPORT, ACCORDING TO McKINSEY.

- In the US, 81% of institutional investors plan to increase their allocations to ESG products over the next two years, almost on par with Europe (83.6%), PwC reports.
- The *Financial Times* adds: "Many investors think that the US Inflation Reduction Act will help sustainable stocks to do well over the coming years."

2 "Companies are stepping back from ESG—as if from a fad"

In the third quarter of 2023, mentions of DEI initiatives and sustainability on US-listed companies' earnings calls decreased by 31% year-over-year—the fifth consecutive quarter of decline, according to Forbes.

OUR PERSPECTIVE: While companies are becoming more considered in their communications on ESG issues, evidence suggests that where there is a clear, material link to value-creation initiatives, actions and investments are continuing apace.

In 2022, PwC found 87 FTSE 100 companies use ESG in at least one of their incentive plans. Forty-nine have an environmental metric in the bonus structure and 54 have a social metric. Ninety percent of S&P 500 companies now produce some form of ESG report, according to McKinsey. And 87% of corporate leaders believe ESG initiatives are "very" to "extremely" important to their businesses' long-term success, says EY.

3 "ESG ratings are simplistic, confused and inconsistent"

Critics of ESG point out that a single company can receive wildly different—and in some cases head-scratching—ratings. A tobacco company can rate higher than EV-pioneer Tesla, for example. When S&P Global dropped ESG scores from debt ratings, replacing a numerical score with a short narrative text, some commentators said this shows ESG ratings "are not that reliable," according to the *Financial Times*.

OUR PERSPECTIVE: ESG is a developing field, and these are intrinsically complex topics to measure. On top of this, ESG ratings have been developed very fast. It's not surprising that they might lack the clarity and rigor applied to long-established financial metrics. But ratings aren't the only form of ESG information. Companies must undertake materiality assessments, seek feedback from investors and disclose relevant information for investors regarding risk exposure. In any case, given the pressing need for investors and companies to understand the risks related to environmental and social issues, it is very likely that frameworks and data will mature fast.

87 PERCENT OF CORPORATE LEADERS BELIEVE ESG INITIATIVES ARE "VERY" TO "EXTREMELY" IMPORTANT TO THEIR BUSINESSES' LONG-TERM SUCCESS, SAYS EY.

4 "ESG runs counter to fiduciary responsibility"

You've heard this before. It's an argument expressed eloquently by political writer Peter Roff in *The Times Record*: "If… fund managers use their positions to push policies that work against their ability to obtain the highest return on investment for their shareholders, they are abusing their power and turning their back on their fiduciary responsibility."

OUR PERSPECTIVE: Legal opinion holds that integrating ESG considerations into decision making and investment analysis is clearly permissible and indeed may even be necessary.

In a 2005 report for the United Nations Environment Programme Finance Initiative, global law firm Freshfields Bruckhaus Deringer concluded that "Conventional investment analysis focuses on value, in the sense of financial performance ... [T]he links between ESG factors and financial performance are increasingly being recognized. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."

5 "ESG is politically motivated ideology"

ESG is a political position typically associated with the left.

OUR PERSPECTIVE: In response to this challenge, businesses should be clear that commercial imperatives, not political ideology, drive their engagement with ESG issues. Business action on climate is motivated by financial, operational and market considerations. On the one hand, the increased frequency of natural disasters driven by climate change can disrupt supply chains and cause massive damages. On the other hand, the global response to climate change is dramatically shifting the business environment. To give just one example of each:

- The insurance giant Munich Re saw losses of $120 billion from natural disasters in 2022, exceeding their $100 billion benchmark for the second year running. The company noted that "climate change is taking an increasing toll. The natural disaster figures for 2022 are dominated by events that, according to the latest research findings, are more intense or are occurring more frequently. In some cases, both trends apply."
- Even as the country continues to grow in fossil

fuel energy supply, China looks set to double its renewable energy capacity by 2025, reaching its 2030 goal five years ahead of time, according to the report by Global Energy Monitor.

- The Inflation Reduction Act (IRA) is already profoundly changing the US energy industry, according to ING, with $271 billion of investments announced during the first 50 weeks. Goldman Sachs estimates that total US investment unlocked by the IRA could reach $3 trillion.
- The EU is set to mandate that all major companies publish climate transition plans, outlining how they will deliver on their net zero targets and support the economy-wide transition to net zero. The UK government has already done this.

Similarly, business engagement with the "S" in ESG is driven by commercial considerations. Data collected by Open For Business (see Page 59) shows that commitment to inclusion, whether LGBTQ+, gender, ethnicity or other facets of DEI, is not "woke ideology," but rather well-established best practice for running a productive, innovative workplace.

Economies—both at the national and city-level—and companies have better economic outcomes when they implement policies of inclusion and non-discrimination. For instance, a recent analysis of the MSCI World Index by the *Financial Times* found that companies with more gender-balanced workforces outperformed their least-balanced peers by as much as 2 percentage points annually between 2013 and 2022.

ECONOMIES—BOTH NATIONAL AND CITY-LEVEL—AND COMPANIES HAVE BETTER ECONOMIC OUTCOMES WHEN THEY IMPLEMENT POLICIES OF INCLUSION AND NON-DISCRIMINATION.

6 "Climate action is anti-consumer and anti-growth"

Corporate environmental commitments, in particular climate-related goals, are being dismissed as "woke," and contrary to the interests of consumers or the economy: "It's time that businesses that are out of step with the sentiments of most Americans pay a price for their standing up for woke special interest instead of consumers," Leonard A. Leo, co-chair of the Federalist Society, wrote in *The Washington Post*.

OUR PERSPECTIVE: For every challenge that places ESG as anti-growth and anti-consumer, there is analysis showing climate action driving falling costs for consumers. There are many commentators in the financial community highlighting that it unlocks huge growth opportunities for companies. For example:

- The trend in falling renewable energy prices is remarkable, and many consumers are already feeling its benefits. The International Energy Agency (IEA) estimated that EU electricity consumers are expected to save €100 billion during 2021–2023 thanks to additional electricity generation from newly installed solar PV and wind capacity.
- The drive to improve energy efficiency to reduce carbon emissions is also producing strong cost savings. For example, since 2010 gains in energy intensity have averaged 1.7% a year, saving about 10 times as much primary energy as solar and wind

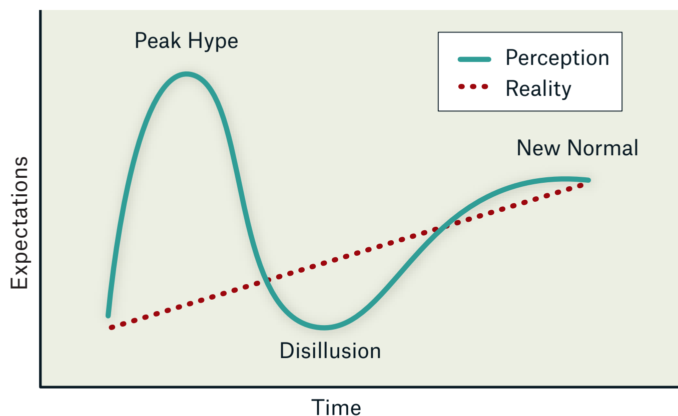
THE FUNDAMENTAL DRIVERS OF ESG REMAIN, AND ARE INTENSIFYING

MAJOR SOCIAL AND ENVIRONMENTAL ISSUES have become critical issues for business and are now key to business resilience and license to operate (see page 21).

It's not hard to understand why; the evidence is mounting for all to see. Weather events are hitting critical supply chains and making business planning extremely challenging. Climate change will have cost companies $1.3 trillion by 2026, according to Forbes.

If current trends continue, such costs may soon come to seem small: Swiss Re estimates that one in five countries are at risk of their ecosystems collapsing, spelling catastrophe for food and water security—and cost volatility.

When considering the ESG backlash it's helpful to recall the "hype-backlash" cycle developed by Gartner Group to describe the dotcom boom and bust.



As a simple illustration, the green line captures the swings in the conversation and debate around ESG that many have experienced in recent years, while the dotted red line reminds us of the general upward trend in business practices.

We are undoubtedly past "peak hype" on ESG, where expectations exceeded reality following many years of progress on sustainable business. We may now be in a period of general disillusionment, marked by disagreement and confusion. But E, S and G activities in business will continue to respond to fundamental shifts in the global economy, and become increasingly core to driving successful business performance.

As Brunswick's Pru Bennett and Rory Macpherson argue on page 16, "with a rise in investor scrutiny, it follows that material ESG factors are no longer peripheral concerns, but are at the heart of business strategy and the board agenda."

The factors driving performance on ESG issues are ultimately about delivering long-term, sustainable profitability, managing risk and adapting to a shifting landscape of opportunities. As the hype falls away, we expect the field to mature and define a "new normal."

GRAPHIC: PETER HOEY

added, according to IEA's data. This ultimately helps cut bills for both companies and customers. The trend is set to accelerate in the years ahead as more renewables are brought onto the system, creating a virtuous circle.

- Mark Carney, former Governor of the Bank of England, founder of the Glasgow Financial Alliance for Net Zero, and the UN Special Envoy on Climate Action and Finance, has described net zero as the "greatest commercial opportunity of our time." Explaining this remark, he says: "Climate change is an existential threat. We all recognize that, and there's increasing urgency around it. But the converse is, if you are making investments, coming up with new technologies, changing the way you do business, all in service of reducing and eliminating that threat, you are creating value. Companies, and those who invest in them and lend to them, and who are part of the solution, will be rewarded. Those who are lagging behind and are still part of the problem will be punished."

7 "ESG has no meaningful impact on the issues"

Some critics say ESG allows leaders to pat themselves on the back for results they haven't really achieved. As *The Economist* put it in late 2022, "Most companies can win the gains of appearing green while avoiding the cost of decarbonising by paying lip-service to green goals."

OUR PERSPECTIVE: The actions that companies take within their ESG strategies are typically not at a scale or substantive enough to make a dent on the social and economic challenges we face today. Again, this is a question of maturity. As companies move to adopt ESG, their approach tends to mature in three stages:

- Baseline ESG is where companies begin to grapple with this increasing demands from investors. It's the start of the journey. It involves an assessment of the material risks associated with societal issues, and a commitment to metrics, targets and transparency on key societal issues.
- Companies move to Strategic ESG, becoming more proactive. They set a roadmap including the capital expenditure and investment involved in stepping up to ESG issues and the returns for doing so. They focus on innovating products and practices, and long-term supply chain resilience. They build ESG issues into their corporate strategies.
- Impact ESG moves beyond measuring risks and opportunities to also accounting for the impact of business operations and strategies on the issues themselves. In other words, they are looking at how ESG works both ways—double materiality, in the jargon. This is being incorporated in the regulation in the EU.

Data shows that commitment to inclusion, whether LGBTQ+, gender, ethnicity or other facets of DEI, is not "woke ideology," but rather well-established best practice for running a productive, innovative workplace.

8 "Companies talking about purpose have 'lost the plot'"

Critics of ESG are also likely to take issue with "corporate purpose," which has become a recent theme of the ESG discussion. The criticisms are broad: that articulating purpose beyond profit is a distraction from the shareholder; that it is sloppy thinking; that it is disingenuous. "A company which feels it has to define the purpose of Hellmann's mayonnaise has in our view clearly lost the plot. The Hellmann's brand has existed since 1913 so we would guess that by now consumers have figured out its purpose (spoiler alert—salads and sandwiches)," said an investor in Unilever (owner of the Hellmann's brand) in the UK newspaper *City AM* last year.

OUR PERSPECTIVE: Many will recognize validity in these criticisms—but that does not invalidate the notion of "corporate purpose." Following clear principles, and linked closely to a company's core business, defining a purpose can help drive effective corporate culture, governance and performance:

- Focus also on the how. To many, purpose is all about "why we exist." But differentiation often comes from how you deliver. ESG is concerned with being clear that how you deliver does not have significant external costs for society and the planet.
- Think of "purposes"—not just a singular purpose. Companies play different roles in the lives of different stakeholders. They provide livelihoods for employees, products and services to customers, and profits to shareholders. It can be simplistic to reduce this down to a single purpose statement. What can be more useful is to instead describe broadly the role in society that a company plays. Working to improve environmental and social impacts may be one of the purposes the company commits to, but that does not make it *the* purpose of the company.
- Remember, purpose is not set in stone. Knowing that purpose is not immutable is empowering. Purpose can evolve as the world evolves. Markets get disrupted, sectors become redefined and the needs of stakeholders change over time—and so the opportunity to create value inevitably changes, too. Thinking of purpose as a future-facing trajectory frees a company to redefine what it wants to be today—and tomorrow. ◆

JON MILLER is a Partner and founder of the Open for Business coalition. **LUCY PARKER** is a Senior Partner and, with Jon, leads Brunswick's ESG & Sustainable Business practice. Jon and Lucy are co-authors of *Everybody's Business: the unlikely story of how big business can fix the world* and *The Activist Leader.* **JOSEPH DOYLE** is a Director and **ZAMZAM OSMAN** is an Account Director at Brunswick. All are based in London.