2024 Outlook: Responsible Investing

By: John Streur | December 6, 2023

Market Decoupling of "E, S and G" Factors Likely to Accelerate in 2024

KEY POINTS

1. The shakeout in the responsible investment industry that began in late 2022 is driving specialist firms to increasingly incorporate financial viability into the analysis of corporate climate and social business objectives.

2. As both specialist firms and mainstream investors have moved towards more intensive and granular ESG research, a consensus is building around the importance of human capital management. In particular, a greater focus is being placed on workforce diversity in differentiating a company's potential for value creation.

3. Decarbonizing the global economy is proving to be a difficult task because the cost of transitioning from fossil fuels to clean energy is currently higher than originally anticipated.

What we are seeing

Free-market capitalism depends on voluntary, market-led solutions based on the actions of investors, corporations, and their Boards as opposed to government-mandated investment and management decisions. As we look ahead into 2024, we see that free-market capitalism faces a challenge in dealing with climate change, while initial progress is being made in improving corporate diversity. We believe these different results are due to economic realities that will continue in 2024.

Two ESG themes will dominate markets in 2024

Many investors, no matter how they label themselves or their products, are increasingly interested in the specifics of how companies create and manage their workforce and in how companies will decarbonize their operations and products. These two themes, for very different reasons, will play larger roles in capital markets in 2024 than in years past. As this occurs, we expect a shift in ESG scoring that will make it easier for investors to focus on the specific issue that matters the most to them.

Drive to improve DEI widespread

During the past three years, the business case for diversity, equity and inclusion (DEI) in the workplace has been well documented and an increasing number of corporations have begun to voluntarily provide information about the diversity characteristics of their workforce. The research shows, on balance, that improving a company's diversity may lead to improved financial value creation for investors. After years of evidence, a large enough percentage of investors, management teams and corporate boards now accept that improving DEI is a net positive financially and the drive to achieve real improvement is taking hold. We expect this to increasingly be seen as an important investment factor and the companies that make the greatest strides to continue to demonstrate strong value creation.

Economic headwinds stifle climate change progress

Significant progress was made during 2023 in mobilizing capital for clean energy projects and in corporations providing data around their carbon emissions and emission-reduction goals. However, the financial returns associated with offshore wind projects, as well as the capital spending requirements to rebuild entire industries to operate on clean energy, resulted in cancellation of some high-profile wind energy projects and pushback on many industry goals for converting to clean energy. The driver for these project delays is economic reality — the potential returns for some decarbonization projects are low or negative.

This is where financial viability analysis is most important and where the nexus of responsible investors and mainstream investors must focus throughout 2024. We are beginning to see governments take action to create carbon pricing systems, carbon taxes, carbon border tariffs, and other approaches to incentivize the development and deployment of clean technologies and renewable energy. How the economic challenge of decarbonization is met — through government policy and regulation versus through voluntary, market- led solutions and voluntary carbon markets — will be a major focus going forward.

Shifts in ESG scoring and de-aggregating E, S and G

We expect to see leading responsible investors split ESG ratings into individual environmental, social and governance sub-categories rather than relying on a one-size-fits-all ESG score. This would allow for more granular research on financial impacts of E, S or G exposures as well as detailing differences between company's management of these specific exposures. Importantly, this approach also recognizes that strength in managing one area of exposure within a company does not "net out" weakness in another area. Good diversity cannot solve for a weak approach to climate risk and each must be understood from an impact and value creation perspective.

Bottom line

Taken together, we expect the changes described above will strengthen the discipline of ESG research and improve capital market function by producing more accurate and detailed analysis of financial impacts related to specific ESG exposures and company-level differences in managing relevant exposures. We believe this will serve responsible investors by helping to better identify company impacts that may be improved through investment decisions to provide capital to one company versus another. It will also serve mainstream investors motivated primarily by near-term returns to allocate capital to companies best positioned to create financial value through superior management of material ESG factors. We expect a growing percentage of mainstream and responsible investors to find this nexus, resulting in increased market differentiation between companies with financially viable approaches to managing their most material ESG factors.

Risk Considerations: *Investing involves risk including the risk of loss. There is no guarantee that any investment strategy, including those with an ESG focus, will work under all market conditions. Investors should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.*

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