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Common Ground Between Anti-ESG Politics and Responsible Investors

By: John Streur | October 2, 2023

Washington - "Anti ESG" stories have been prominent for several months in the United States and we are also beginning to see written policy agendas and proposed legislation. As a global leader in Responsible Investing, we believe it is important to listen carefully to both sides of the ESG debate and eliminate the noise at the extreme. When we focus on what is actually being proposed, shared principles stand out that offer the potential to help evolve and improve responsible investment implementation. Frankly, the debate highlights opportunities to strengthen ESG investing, improve market function and solve long standing problems associated with weak definitions of "ESG" in the investment context.

Recently, I spoke on a Ropes & Gray webinar with expert panelists who dissected the ESG debate at the state political level.¹ Perhaps surprisingly given the political rhetoric, there is common ground related to the use of financially material ESG information in investment research and decision-making processes. Some of the proposed legislation seems to stress that state investment funds should not allow the use of "non-pecuniary ESG considerations" to be used to advance policy agendas and potentially diminish financial returns.

We agree with this key point.

Financial materiality is essential

The concept that corporations should disclose material information so that investors may base decisions on financially relevant factors has been present in SEC regulations for decades. In fact, the SEC issued guidance in 2010 regarding the disclosure of climate risks by corporations based on the financial materiality of that information.² The SEC followed up with a sample letter to companies in 2021.³

All parties seem to share common ground related to the use of financially material ESG information in investment processes, and for good reason: it matters to long-term value creation and risk management. This common ground provides a strong foundation that should allow us to work collaboratively to improve investment outcomes.

Notably, strengthening corporate disclosure related to material ESG exposures based on industry specific and investor useful metrics is something the International Organization of Securities Commissions (IOSCO) supports. In June 2023, The International Sustainability Standards Board (ISSB) issued its first IFRS disclosure standards for the disclosure of sustainability related financial metrics by corporations. In July 2023, IOSCO announced its support for this, which is indicative of the utility of financially material sustainability information in providing improved transparency and strengthening capital market function worldwide.⁴

The current situation

In contrast to the rhetoric, we have not observed many investment management firms making decisions based on anything other than pecuniary or financially material factors while managing institutional assets. Concessionary return - taking a below-market return to achieve another outcome - is generally the domain of philanthropic organizations and dedicated "impact investors." It's not something we expect to see in a state pension fund and our own ESG research and investment process focuses on long-term performance first and foremost. At Calvert Research and Management, our ESG research process is built around the concept of identifying material ESG exposures and analyzing how specific companies are managing those exposures. While our clients may choose to direct a portion of their assets to concessionary returns, we at Calvert seek to secure competitive financial returns through investments in companies that are managing material ESG exposures adequately with a focus on long-term value creation.

Companies need to react to evolving environmental risks, social trends and changes that are happening in the world around them, but this has always been the case. The investment manager's role is to use financially-material ESG information in the traditional investment process. This was a fundamental portion of my testimony to the US Senate Committee on Banking, Housing and Urban Affairs in 2019.⁵

The divestment debate

Divestment from specific companies or industries is another concern for states that perceive ESG as a threat to industries critical to their economy or constituents. Divestment occurs when an investor commits to not own certain companies as a matter of policy, as opposed to a temporary decision to avoid a company for fundamental, ESG or valuation concerns. For Calvert, divestment doesn't make sense because it ignores the fact that companies evolve and change over time. As investors, we want to participate in positive change as opposed to simply avoiding companies that are part of a perceived problem on a permanent basis. The reality is that these companies may have an opportunity to evolve and address issues that have been problematic in the past. This may allow them to become less problematic or even develop a

solution that could lead to stronger performance in years to come.

This approach requires deeper research and may mean encouraging companies to update business strategy. For example, a fossil fuel business could develop a revolutionary concept that could lead the transition to a clean energy future. Analyzing companies on a continuous basis and making decisions based on the most comprehensive and up to date information available is the only viable approach to responsible asset management and long term value creation. Calvert believes that this includes evaluating financially material ESG information and recognizes that successful companies will evolve over time based on industry and global norms.

Defining our terms and process

The investment management industry has done a poor job of clarifying the term "ESG". We need to create a strong definition of ESG as it relates to financial materiality, define how that is integrated into the investment process and outline how managing ESG factors contributes to competitive returns. This will likely create greater clarity for investors, better articulate desired investment outcomes and clear the path for a constructive and transparent discussion with both sides of the debate.

Creating and adhering to a stronger definition of "ESG" in the investment field will require investment managers to document and defend their process regarding the research and use of ESG information. This is already considered best practice in the responsible investing segment.

Bottom line: It's important to respect and listen to both sides of the debate and to focus on outcomes within the investment management industry that are consistent with long term value creation and the concept of participating in positive change. Although this debate has created some unattractive rhetoric at the extremes, this is how our system works. It is a system we strongly value and believe in and we welcome the conversation - all of our objectives should be to strengthen markets, improve outcomes for all stakeholders and optimize value creation.

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1. *Navigating State ESG Investment Considerations-battle lines are drawn, Ropes & Gray, July 14, 2023.*
 2. *Securities and Exchange Commission Guidance Regarding Disclosure Related to Climate Change, February 8, 2010.*
 3. *Securities and Exchange Commission, "Sample Letter to Companies Regarding Climate Change Disclosures."*
 4. *"IOSCO endorses the ISSB's Sustainability-related Financial Disclosures Standards," July 25, 2023.*
 5. *Testimony of John Streur, President and CEO, Calvert Research and Management before the United States Senate Committee on Banking, Housing and Urban Affairs, April 2, 2019.*

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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