What keeps ESG INVESTORS AWAKE at night?

Staying at the frontier of ESG and impact investing means asking questions about the relationship between valuations and external factors like climate change, geopolitics and inequality. Companies need to keep pace and see their ESG performance as part of a bigger picture.

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Much has been said and written of late about ESG investing, its shortcomings and weaknesses as well as misinterpreted intentions of this investment philosophy. Amid the noise, however, it remains anchored to an underlying premise: companies that manage relevant and material environmental, social and governance (ESG) aspects of their business operations as well as how they manage what they produce, provide and sell will have a significant impact on their long-term valuation. As such, it will also impact their long-term financial performance, given that valuation is mirrored in that performance over time.

Given this premise, we can reflect on what the frontier of ESG and impact investing will look like out to 2030. Why 2030 instead of 2024 or 2025? Well, the semi-long-term view is far more important than a short-term, incremental, two-steps-back-one-step-forward view, which will be the play in the next couple of years.

Here are questions ESG & outcome investors are asking with that perspective: how could geopolitical competition over energy resources and ideologies of control that frame dominant responses to climate change be challenged and overcome? We have already seen this at the latest COP in the United Arab Emirates — what does this mean for sectors, markets and people that will be affected by this competition? How have mainstream economics and neoliberal responses to climate change (carbon markets and a broader financialization of the environment) become so pervasive, and what opportunities are there for alternative or complementary approaches? Both in terms of the definition of returns, outcomes and the current valuation of companies and their impact on their value going forward? How could approaches that rapidly reduce energy-related emissions be realized? What is the impact on sectors and markets given their different maturity as well as capabilities to reduce this? Where are the breaking points? How can high-carbon lifestyles and visions of incremental mitigation be rapidly replaced by sustainable alternatives and profound system change? What sectors, subsectors, markets, products and services will be impacted, and what potential systemic solutions are available?

Beyond all the articles and all the conferences and all the debate on what needs to be done or not, one thing is certain: the center of gravity of all ESG & outcome investments is the actual companies these investments are made in and the interplay with these questions. It is not disclosure; it is not Scope 3 slicing and dicing; it is not ESG ratings; and it certainly is not SFDR classification (although this one is related to disclosure only). Regulators can regulate disclosure as much as they want, but if the real economy does not shift, disclosure becomes a theoretical exercise.

As we think how this economic shift may occur, the energy transformation will for sure reshape geopolitics in the 21st century along with demography, inequality, urbanization, technology, military capability and domestic politics in major states. Fundamental changes are taking place as renewables move to the center of the global energy landscape. Technological advances and falling costs have made renewables grow faster than any other energy source because they are now cost-competitive with fossil fuels in the power sector, even before considering their impact on air pollution and climate change. Energy lies at the heart of human development. It is a critical factor in economic activity and essential for the provision of human needs, including adequate food, shelter and healthcare.

Inequality, on the other hand, is all about the distribution of power and resources, the rights people can exercise and the opportunities they can access. Since the Covid-19 pandemic, wealth inequality has escalated, further distorting power dynamics and impeding progress on reducing poverty in all its forms. Economic inequality is closely linked to political inequalities, creating a self-perpetuating cycle that reinforces division in society as the poorest people have less influence over political decision-making than the wealthiest. No single measure captures all aspects of inequality, no single dataset provides comprehensive and timely data to underpin all inequality measures. The world is vastly unequal, where extreme wealth coexists with extreme poverty. The poorest 50% shares just 8% of total income; the richest 10% earns over 50% of total income. Capital gains, not income, play a central role in this context.

So, the message is clear. For all the pledges for 2030, we need to see reality for what it is: the underlying business models are not fundamentally changing (and those that do change, a limited number, tend to be at smaller and less influential companies); growth is still generally not decoupled from CO_2 emissions; and growth projections of companies are still not aligned with their strategic sustainability goals. Disclosure, meanwhile, becomes a haven for endless pages of numbers and stories that mean nothing since these are not linked to the core business of companies, their products and services.

Corporates need to understand that there are three core elements that will shape ESG and impact investments until 2030 and beyond: energy, geopolitics and inequality. And in this regard, governance becomes – as it should have been long before – a core measurement for investors to understand and analyze the true performance of companies in relation to “externalities management”.