



ESG: Is Green Really Green?

by Angelo Desouza

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Introduction

ESG investing, spotlighted by the UN's 2004 "Who Cares Wins" report, has roots tracing back to the 1960s' anti-Apartheid movement.

With its dramatic growth and soaring Assets Under Management, the rise of "greenwashing" casts shadows, challenging investors to discern the true colour of "green" in today's investment landscape.

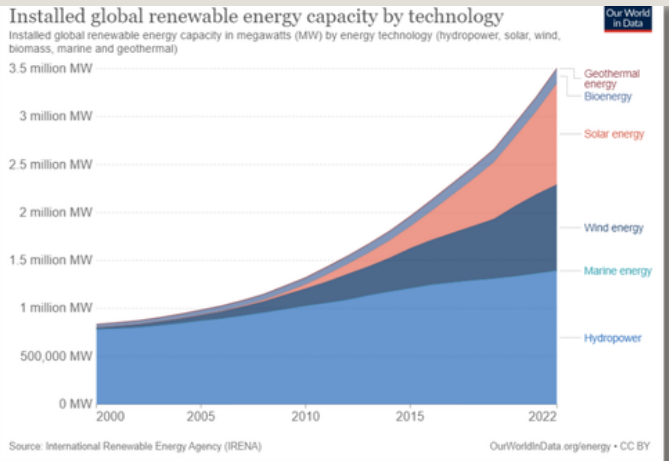
The growth of ESG

ESG is a broad term encompassing sustainability, social responsibility and governmental policy; KPMG published a report illuminating that ESG-focused essays experienced an average CAGR of 27% in global AUM between 2015 and 2021. Currently, the value of ESG ETF assets worldwide is 403bn USD, and Europe is the largest region for sustainable assets.

Regions	Growth 2015-2017	Growth 2017-2019	Growth 2019-2021	CAGR 2015-2021
Australasia	14%	14%	31%	9%
Canada	29%	33%	289%	37%
Europe	25%	32%	114%	23%
Middle East & Africa	82%	44%	-16%	14%
South & Central America	60%	30%	154%	32%
USA	24%	44%	135%	27%
Asia ex-Japan	-11%	49%	-15%	2%
Japan	36%	191%	545%	71%

In the past ten years, there has been a significant increase in the demand for sustainable investments worldwide, thanks to the global shift towards renewable energy and greater social-environmental regulations, the graph below shows the growth of global renewable energy since 2000.

Starting from 2018, large companies with over 500 employees or €500 million annual turnover are required to comply with the EU Non-Financial Reporting Directive (NFRD), which mandates the disclosure of information on environmental and social matters. Additionally, the EU Green Deal was launched in 2019, with the aim of reducing net greenhouse gas emissions by 55% (compared to 1990) by 2030, and achieving climate neutrality by 2050.





In 2020, the FCA updated their TFCF (Task Force on Climate-related Financial Disclosure), requiring financial institutions and corporations to report on sustainability. Similarly, EU and non-EU firms with activities in the EU file annual sustainability reports by the CSRD (Corporate Sustainability Report Directive) enforced in January 2023. The CSRD can be seen as an amendment of the NFRD, approximately quadrupling the number of firms under sustainability compliance. The US has no legal requirements for ESG reporting. However, the SEC (Securities and Exchange Commission) has proposed climate-risk disclosure requirements that would take effect as of 2024.

A PwC survey of UK consumers found that 67% of respondents stated that ESG considerations are important for them. Moreover, data from workviva highlighted that Germany had the greatest number of respondents who agree that investors should put pressure on companies to be more transparent with their ESG data at 71% followed by USA, France and UK at 64%, and 59% respectively.

The first socially responsible index was launched in 1990 by MSCI (Morgan Stanley Capital International) and now has over 1,500 equity and fixed income ESG and Climate Indexes. Currently more than 90% of S&P 500 companies and 70% of Russell 1000 companies publish ESG reports.



Between 2014 and 2020, the S&P 500 Index outperformed the S&P 500 ESG Index, and the S&P 500 ESG has a higher concentration of technology securities. However, in 2021, the S&P 500 ESG began to outperform by four points on average, with the technology sector being one of the top-performing sectors during the coronavirus pandemic.

Furthermore, evidence (from Nasdaq) for the bias of ESG ratings comes from the controversial contrast in several oil gas companies, such as Shell and Exxon Mobil, having higher or similar ratings to Tesla - An automotive firm that produces Electrical Vehicles - an essential requirement for society as we transition to prioritizing renewable energy.

It has been argued that these companies have more substantial social and governance factors than Tesla. However it would be apparent to any jury which of these three firms which is most adept at reaching the targets of the Green New Deal based on the nature of their products.



This discrepancy in ratings from the data firm S&P Global implies that a fair weighting to a firm’s overall environmental impact is not used in the measurement methodology and, more importantly, that ESG ratings can be easily politically manipulated to allow polluting companies to be part of a “green” ESG fund and acquire more capital.

What is Greenwashing

Greenwashing can be defined as conveying a false impression or using misleading information to convince investors or other stakeholders about the environmental merit of a product or service. The term originates from 1980, when a hotel industry falsely encouraged the reuse of towels as part of a broader environmental strategy when it was done to reduce their overheads.

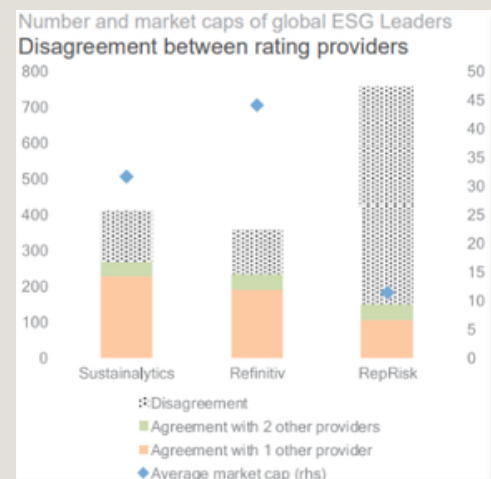
When looking at day-to-day consumer products, greenwashing mainly occurs from unsubstantiated claims that attract an individual's attention—for instance, stating that a water bottle is “80% more recycled than before” when, in reality, the manufacturer has only increased the recycled content from 1% to 1.8%. Although this is technically not a lie, such a message implies that the bottle contains more recycled plastic.

However, in the context of businesses and ESG funds, greenwashing is harder to pinpoint, and ESG Ratings have substantial difficulty in providing accuracy and reliability for investors.

ESG Scoring System and Green Washing

According to the ESMA (European Securities and Markets Authority), there is no “official or common definition” of ESG ratings. However, for this article, ESG ratings can measure how well a firm or security/fund performs concerning environmental, social, and corporate governance. ESG risk ratings are the most commonly used to assess entities’ exposure to ESG risks and how they are managed. In contrast, ESG impact ratings measure the impact of entities on ESG factors.

Furthermore, ERM (Environmental Resources Management) studies found over 600 ESG ratings and rankings globally in 2018, and data from KMPG and SSgA indicate that there are between 125 and 150 rating providers as well as the large discrepancy in the number of ESG ratings, research into the Divergence of ESG Ratings has found that only 60% of ESG ratings are correlated. For perspective, more than 99% of credit ratings from the most prominent agencies are correlated. Thus demonstrating the need for measurement standardisation to give fair and reliable ratings for all ESG-related entities.





When exploring corruption in the ESG scoring System, McDonald is a prime example. In 2021, they produced 53 million metric tons of carbon, greater than countries such as Portugal or Norway. The MSCI reduced the weighting of its carbon emissions and focused instead on its new recycling initiatives: installing recycling bins in the UK and France. Ironically, this act would have been a requirement regardless of upcoming regulation changes. Such “upgrade Factors” for S&P 500 companies (as investigated by Bloomberg) between 2020 and 2021 included 51 uses of the corporate behaviour factor, and only 1 of the 155 rating upgrades was a reduction in Carbon Emissions.



Implications of Greenwashing

The repercussions of greenwashing reverberate throughout the fabric of sustainable investing and climate action. It goes beyond mere misrepresentation, striking at the very heart of efforts to combat climate change and achieve a more sustainable future. By perpetuating false narratives of environmental stewardship, greenwashing not only deceives investors but also hampers progress towards meaningful change.

Greenwashing takes on multifaceted forms, from vague sustainability claims to misleading labels and exaggerated environmental benefits. These tactics not only mislead investors but also erode trust in companies' genuine sustainability endeavors. Moreover, greenwashing diverts attention and resources away from legitimate environmental solutions, impeding the urgency and ambition required to address the climate crisis effectively.

Greenwashing poses a significant threat to climate initiatives, undermining the credibility of net-zero commitments. Combating it demands regulatory oversight, industry standards, and investor education, alongside initiatives like the High-Level Expert Group's recommendations and the UN's framework. Ensuring genuine sustainability progress requires continuous vigilance and cooperation.

In conclusion, the implications of greenwashing are profound and wide-ranging, touching every aspect of sustainable investing and climate action. By raising awareness, promoting transparency, and holding companies accountable, we can mitigate the harmful effects of greenwashing and accelerate the transition to a more sustainable future for generations to come.

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