TAKING ESG INVESTING MAINSTREAM

ESG-BASED ASSETS UNDER MANAGEMENT REACH $36 TRILLION

Incorporating ESG factors into mainstream investing has grown on an absolute level, but relative adoption remains low against the entire market. While it takes time for markets to adjust, part of the reason for the delayed integration is the asymmetrical approach to investing for value and investing for values. This is changing. With reliable data as a backdrop, solid analytics can create signals and metrics that incorporate into mainstream investment strategies.

Uptake of Environmental, Social, and Governance (ESG) factors into investment considerations has increased significantly in recent years. Ranging from a younger generation of investors, increased activism, and even ERISSA changes that allow for ESG to be part of an investment strategy, several developments are behind this surge. Political posturing has slowed down ESG-based investing a bit this year, but overall indications suggest that the trend will continue into the foreseeable future.

And yet, ESG and sustainable-based investing remain mostly niche. Total ESG-based assets under management (AUM) reached $36 trillion at the end of 2022. While that number seems eye-popping, it represents a little under 18 percent of all investments, and is only expected to increase to about 21 percent of AUM by 2025.

Several factors play into this. There is little consistency around ESG investing, for one. Reporting requirements are different by locality, and none exist yet in the U.S., though the SEC will be releasing its final rule later this year. This inconsistent data creates difficulty in calculating metrics and impact, and complicates apples to apples comparison.

Further, ratings agencies dominate the market, forcing investors to adopt the subjective interpretations of the respective vendor to make investment decisions that include ESG factors. These agencies often reach wildly disparate conclusions. Even within the inconsistency and subjective world of ratings, the data used to drive the ratings is stale and inaccurate far more often than is tenable for investors to use reliably.

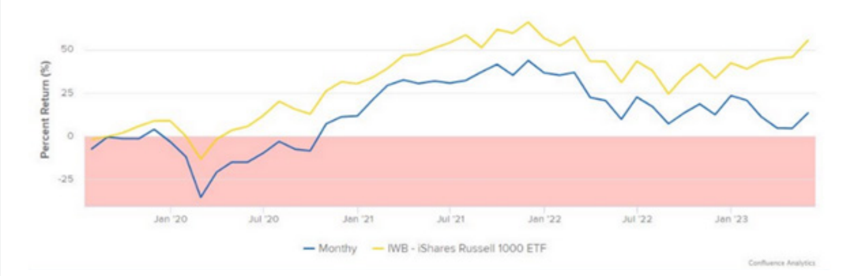
With subjective ratings and unreliable data as the foundation of ESG investment strategies, it is very difficult for a market to develop that can propel ESG into a mainstream consideration for all investors. Instead of alpha and returns, investors are worrying about greenwashing accusations and lawsuits.

Using reliable ESG data, however, opens possibilities for market-driven investment considerations, leading to outcomes that both make money and support investor values. For example, with good data and a little bit of technology for verification, investors are able to incorporate Scope 1 and Scope 2 emissions reduction as part of a meaningful investment strategy that ultimately seeks financial returns. Or, again with reliable data, investors who want to pursue a long-term investment strategy that includes dividends while also supporting companies that are pursuing sustainable operations, can do so with a climate-adjusted yield metric.

Eventually, bringing ESG factors into investment decisions as a routine part of every investment strategy will require not only good data, but the analytics to take advantage of that data in a way that meets every investment objective. The ability to successfully analyze data, identify signals, and apply that information to investment decisions that lead to positive returns is complicated in any situation; it is a significant hurdle to overcome when using ESG signals for something like tapping potential targets to short.

Confluence Analytics has released its 3Q23 Short Report. Built on OWL ESG's data, the Confluence Analytics Short Model portfolio would have produced roughly 1500 bps returns this year to date. Using ESG-based signals that incorporate corporate carbon emissions and social factors, the short model portfolio has successfully predicted stocks that are likely to decline, at a success rate in line with normal investor expectations.

SHORT MODEL PORTFOLIO OUTPERFORMING



An equally weighted portfolio of companies that rank at the bottom half of the intersection of our Carbon Signal 3 and Social Rank (blue line.) This portfolio has underperformed, both since inception, and particularly, YTD.

Short Model up 0.93% vs benchmark (Russell 1000 ETF) up 16.59% YTD.

To be very clear, this is not investment advice.
But that's the point. All investment involves risk.

In fact, this is the basis of the investment market. Money is lent with some degree of predicted risk, and the greater the risk, the greater the expected return. Investors apply all sorts of different tricks, analyses, predictive methods, and other sorts of voodoo to try and guide investments and underlying strategies. Further, many investors have a set of values or intentions beyond pure financial returns. This is the foundation on which sustainability-based or green investment firms or products are built.

Short-selling, or short-based trading, means predicting a stock that is going to go down and putting money on the line to bet against it. If done incorrectly, it can be incredibly expensive. If a share goes the wrong way dramatically, the trader with the short bet can be on the hook for a lot of money. This is exactly what happened in the Wall Street bets GameStop situation with Melvin and Citadel.

ESG-based investing has always been about driving specific changes to corporate behavior revolving around social and environmental issues. If investors cannot align this focus with real financial returns in line with market expectations, then ESG will remain a niche part of investment portfolios. Using ESG data to identify forward-looking signals is powerful because it fits within the ambit of what mainstream investors require to adopt or modify an investment strategy.

By defining analytic tools—like ESG signals for shorting or carbon-adjusted yield for long-term investors—it is natural, and often beneficial, to incorporate ESG into mainstream investments. This is how ESG becomes a normal part of market forces and integrates into the market at scale.