RBC Global Asset Management

ESG Outlook 2023

January, 2023

Reflecting on 2022 when it comes to all things environmental, social or governance (ESG) or responsible investing (RI), the conclusion probably reached by some would be 'glass half full' while for many, I suspect it would be more 'glass half empty'.

The optimists out there would point to the continuing mainstreaming of ESG into financial markets and its infiltration into the wider societal consciousness. Other positives to take would be the increased focus on how companies should be minimizing their impact on society and the environment ('double materiality'), and not just on how to minimize social and environmental impacts on a company's bottom line ('single materiality'), as well as a greater focus on nature and biodiversity as systemic risks.

But for many, it is likely that 2022 will be remembered as a year of unfulfilled potential and missed opportunities. The Russia/Ukraine war has resulted in an energy crisis, potentially hindering efforts to mitigate climate change. The resulting energy shock meant shifts in policies tilting away from energy transition and more towards energy security concerns when the conflict should be proof of the need for acceleration of net zero efforts. As such, the global UN conference (COP27) failed to fully live up to the expectations from the previous year. Additionally, we have seen other ESG impacts from the invasion, including human rights issues and rising food costs.

Combined with other factors such as the global economy recovering from the Covid-19 pandemic and rocketing inflation, resulting in a 'cost of living' crisis, the 'S' is still firmly in view. ESG regulations were also a significant theme for 2022, with attention on the challenges of 'how' to address the 'what' of ESG regulations from financial institutions or companies to ensure compliance with those already in place or preparing for those forthcoming. Concerns about the validity of ESG claims (so called 'green-washing') also came to the fore, feeding into broader scrutiny of ESG/ RI investing itself.

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Key ESG themes and trends for 2023

As our thoughts turn to 2023, what can we expect when it comes to ESG? We are told this is the 'Decade of Action', and that the window is closing. In a year of the 'polycrisis', for 2023, some key areas to watch are as follows:

Climate change – the need to get back on track

The world needs to continue tackling climate change. This means refocusing back on the energy transition. The COP28 global stock-take UN conference to come later in the year needs to be a direct trigger for raised ambition for governments, which will also feed into continued corporate efforts. In addition to decarbonisation, there should also be more activity around the themes of climate financing, adaptation and ensuring a just transition in emerging markets and for vulnerable communities globally. Reform and advancement of carbon markets will be critical to enable different actors to fully leverage the full range of climate solutions in a credible way. The sustainable bond or ESG bond market will continue to see growth as issuers look to tap capital markets to access funding to finance their climate efforts in light of the scale of financing required.

Nature & biodiversity – now firmly on the agenda

The recognition of nature and biodiversity as systemic risks and their interconnectedness to climate change saw this become the breakthrough ESG theme of 2022. The global biodiversity conference in December 2022 (COP15), in what has been called a 'Paris moment for nature', achieved the Kunming-Montreal Global Biodiversity Framework, taking forward the commitment to protect 30% of land and sea by 2030 (the so-called '30x30' agenda). So, in 2023, expect to see companies, financial institutions and governments talk more – and take more steps – on nature and biodiversity. This will span topics of deforestation most visibly and see increasing emphasis on 'natural-based' solutions. We are likely to see increasing commitments and actions building over the course of this year. Many of these covering disclosure, data and analytics have been in development over the past couple of years, informed by learning from efforts to address climate change, so helping to scale up action faster.

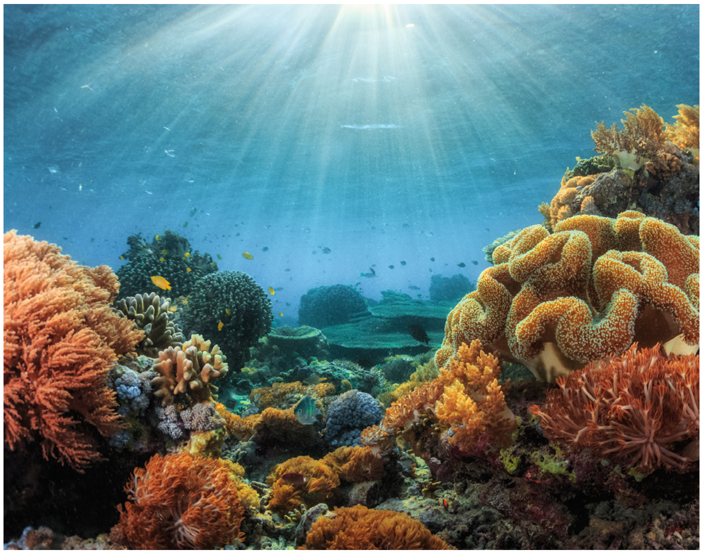
The 'S' of ESG – the 'cost of living' crisis will increase social and political unrest

Governments and policymakers face increasingly difficult decisions and potential trade-offs between supporting vulnerable households in the wake of the 'cost of living' crisis and addressing their debt burden which grew due to Covid-19. We have already witnessed social unrest with worker strikes across the public sector. Workers also risk losing their employment as many consumer-facing industries suffer from slower spending and higher input costs. Meanwhile, the Russia/Ukraine war has strained global supply chains putting corporate financial sustainability at risk.

ESG regulation – is getting even more technical, detailed and complex ... but still unclear whether it will deliver

Whilst European ESG regulatory developments continue to dominate much of the headlines, this year we expect a further broadening of geographical focus. The US and UK, among others, are expected to define their ESG regulatory framework when it comes to the 'what' and 'how' of ESG/RI investing. The hope from companies and financial institutions is that there will be a harmonisation and standardisation of ESG approaches across the different jurisdictions. But whilst we may see some of this happen, the reality is that the regulatory landscape will likely continue to be fragmented, making it challenging for global firms to operate.

Getting the balance right in terms of being principles-based or prescriptive is proving difficult, and risks being divisive at a time when the industry should be coming together. The compliance and regulatory burden may create challenges for those smaller players who can often be the source of innovative investment solutions in the sector. But it's clear, there is a need for more quality data and analytics to help companies and investors prove their ESG/sustainability credentials. As issuer ESG scores and ratings gain greater popularity as the basis to determine the investable universe for financial products, the market will continue to shake up the ESG vendor landscape. This, in turn, should bring greater regulatory scrutiny on them as the influence of their output grows. Regulation will also be focussed on tackling 'green-washing'.



Increasing focus on stewardship activities

ESG regulations, as well as wider efforts to address ESG and sustainability impacts, will continue to drive the demand for data and analytics to help stakeholders (including investors) better understand risk exposure as well as performance outcomes. Active stewardship will move further into the spotlight. With investors being scrutinized on the ESG credentials of their holdings and any claims being made to contribute to sustainable real-world outcomes, expect to see investors in turn, increase the interrogation of issuers on the quality of the issuer's ESG efforts. Engagement activities may ratchet up also with the trend of investors stepping up such efforts as opposed to taking an exclusionary/divestment approach to investment.

ESG reputation/performance starting to matter?

With the other developments outlined in play, such as the greater scrutiny of the investor's portfolio ESG credentials, 2023 could be the year where we start to see ESG impacting an issuer's ability to tap markets for funding, and/or increase the cost of doing so, in a notable way. If we do, and the rubber starts to hit the road, then the market will see clearer differentiation of issuers on ESG grounds. Regulatory interventions are rightly looking to address 'green-washing' as good intentions are not sufficient. But there also needs to be the recognition that there are different - and valid - intentions and approaches when it comes to ESG, and this is to be expected given different investor requirements, expectations and different regulatory requirements.

Real-world outcomes - turning words into action

Attention will remain on contributing positively to the 'real economy' outcomes. With the increased push to shift capital towards more sustainable activities and greater demand from consumers and investors. 2023 has the potential to see a more meaningful, and much needed, allocation of assets towards this area. But data and analytics are essential to help companies and investors show credible evidence of their contribution to real-world outcomes.

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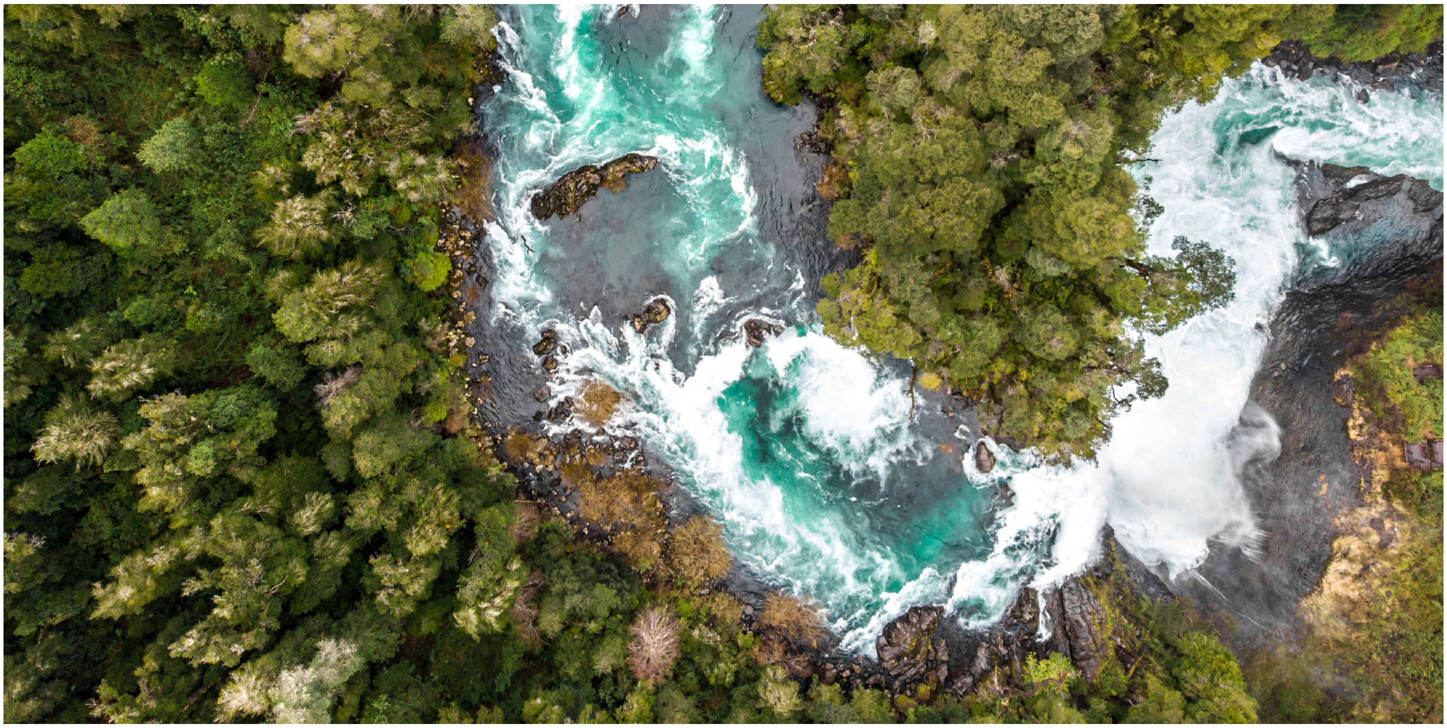
ESG itself will remain in the spotlight

2022 saw the legitimacy and credibility of ESG and RI approaches and financial ESG products themselves being questioned in some circles, as well as increased polarisation and politicisation. Increased ESG regulations have contributed to this scrutiny, as they have added a level of technicality and highlighted the complexity of how ESG/RI can be applied. 2023 will see this theme continue to play out in the market. Whilst debate and reflection are to be expected and welcomed and it is proof that the ESG/RI field has become mainstream, this needs to be conducted constructively and not conflated with other matters. Rising above the noise, the ESG/RI industry needs to ensure it is transparent and responsible in its conduct.



A busy and tough year ahead for ESG

2023 will be another busy and challenging year in the ESG/RI world. The many tailwinds in play as 2022 ended, will continue into, and some deepen this year. This makes the outlook challenging economically and when it comes to all things ESG. There will continue to be a lot of noise and confusion - the task is to maintain focus and keep the end goal in sight, which is integrating material ESG considerations to help meet client objectives.

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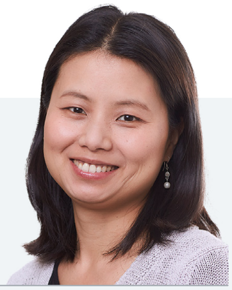
Many of these challenges could – and should - be translated into ESG opportunities if they are taken to increase the case to accelerate rather than delay action. It's clear that our future will be shaped by how we respond to the many near-term problems and balance this with more longer-term ones, which will have impacts on issuers and how they will perform. We believe that ESG considerations continue to be an important driver of long-term investment returns from both a risk mitigation and opportunity perspective. Beyond this primary driver, incorporating ESG into investment practice may have the ancillary benefit of contributing to safeguarding our common future.

Author



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My-Linh joined BlueBay in July 2014 and heads up the incorporation of ESG across the firm's investment assets. She is a portfolio manager for the BlueBay Impact-Aligned Bond Fund. My-Linh has over two decades of experience working in the ESG investment industry, having previously been at Schroders Investment Management Ltd where she was an ESG Analyst and prior to that, an Associate Director – SRI Research at Henderson Global Investors. She holds a Masters in Leadership for Sustainable Development from Middlesex University/Forum for the Future, a Masters in Environmental Management Systems & Auditing as well as a degree in Environmental Sciences, both from the University of East Anglia.

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