ClearBridge Investments

ESG in the Political Spotlight

6 February 2023

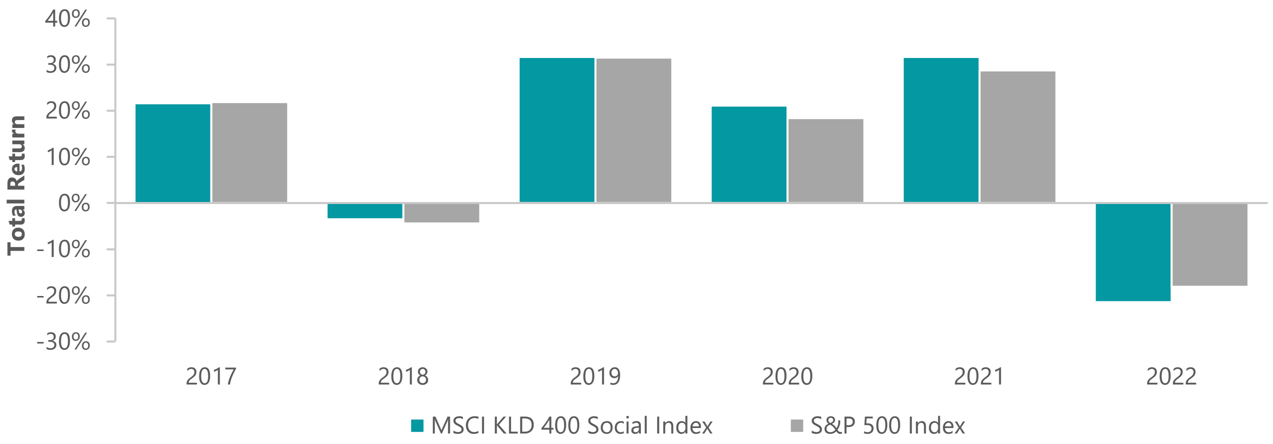
Key Takeaways

- Hyperbolic rhetoric has caused public confusion about the merits of ESG investing and whether it is an appropriate consideration for fiduciaries, with exclusion of investment products that consider ESG analysis in some states reducing the options retirement plans are able to offer employees.
- ClearBridge has found that by integrating ESG analysis into our fundamental research process, we are able to develop a more holistic view of risks and opportunities and thus improve our ability to select stocks likely to outperform over the long term.
- We view incorporation of ESG as a critical part of our fiduciary duty to prudently manage our clients' capital with the goal of long-term value creation, and believe transparency and providing our clients with investment options that align with their goals, objectives and values is both good business and beneficial to client outcomes.

Clarifying Myths and Realities about ESG Investing

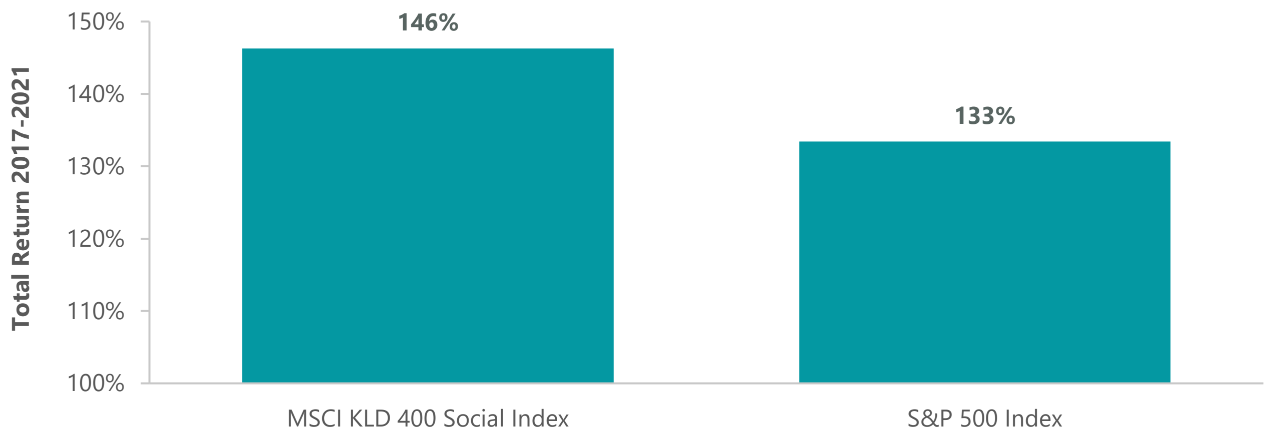
It's no surprise that after many years of success in both investment performance and asset gathering, ESG investing would face some normalisation. 2022 proved to be a difficult year for ESG strategies, as many growth companies with strong ESG characteristics suffered in an inflationary and rising interest rate environment. Conversely, industries that ESG investors de-emphasise, particularly fossil-fuel-related companies, outperformed by a wide margin. In 2022, the MSCI KLD 400 Social Index of highly rated ESG companies underperformed the S&P 500 Index by over 300 bps (Exhibit 1). In the five previous years (2017–21), the KLD 400 outperformed the S&P 500 by over 12.9% on a cumulative basis (Exhibit 2).

Exhibit 1: Energy-Driven Market in 2022 Flips Script



As at 31 December 2022. Source: ClearBridge Investments, FactSet.

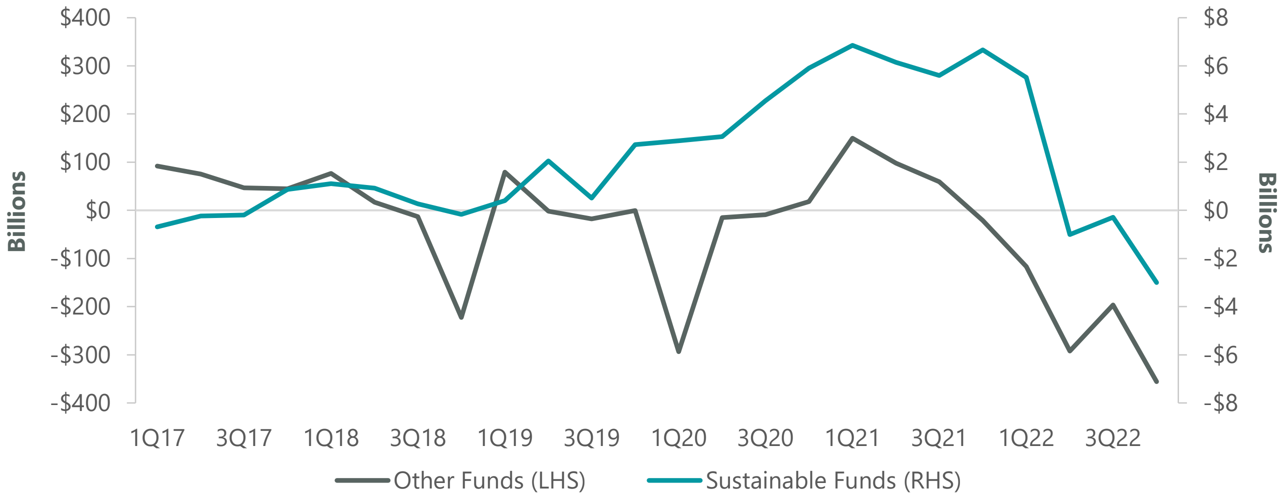
Exhibit 2: ESG and Broad Market Cumulative Performance 2017-21



As at 31 December 2022. Source: ClearBridge Investments, FactSet.

In this environment, inflows into ESG funds have understandably slowed, although they have slowed significantly less than into other funds (Exhibit 3). From recent peak inflows in the first quarter of 2021 to the end of 2022, proportionally, flows for sustainable funds by prospectus have dropped 1.4x, while flows for other funds have dropped 3.4x.

Exhibit 3: Quarterly Asset Flows of Sustainable and Other Funds



As at 31 December 2022. Source: ClearBridge Investments, Morningstar (includes U.S. open-end funds labeled "sustainable funds by prospectus," not including money market, fund of funds or feeder funds).

At ClearBridge we believe companies with high-quality financial characteristics and those that have adopted advanced ESG practices are well-positioned to outperform through full market cycles — in fact, we have found a clear positive correlation with our internal ESG ratings and investment performance.

This suggests that by integrating ESG analysis into our fundamental research process, we are able to develop a more holistic view of risks and opportunities and thus improve our ability to select stocks that will outperform over the long term. As stewards and fiduciaries of our clients' capital, it is incumbent upon us to responsibly manage their assets to create sustainable long-term value. And as institutional investors in public equities, we also have a responsibility to uphold market integrity and minimise systemic risk, including risks associated with environmental and social challenges faced by society.

Despite the inherent logic in this approach, ESG investing has attracted attention from politicians who have attempted to delegitimise ESG as promoting a liberal agenda. During the previous presidential administration, ESG factors were targeted by the U.S. Department of Labor as being an inappropriate consideration for pension plan fiduciaries and a new rule forbid consideration of non-pecuniary factors in selecting retirement plan investments. This unsurprisingly had a chilling effect on retirement plans' willingness to include investment strategies that incorporated the consideration of ESG factors in the investment process, in effect reducing consumer choice to invest in ESG-integrated investment products.

In November 2022 this policy was reversed by the Biden administration, which acknowledged that climate change and ESG factors can be relevant to risk and return analysis, and therefore are appropriate considerations for fiduciaries. Many states, however, have taken the position that ESG investing is designed to advance a social and environmental agenda, with some governors referring to it as "woke capitalism." This politicisation and hyperbolic rhetoric have caused public confusion about the merits of ESG investing and whether it is an appropriate consideration for fiduciaries. Exclusion of investment products that consider ESG analysis also serves to reduce the options that retirement plans are able to offer employees.

ESG Analysis Consistent with Fiduciary Duty

We hope to be able to clarify some of these questions, at least as it relates to the investment process at ClearBridge and how we approach our fiduciary duty. As a signatory of the Principles for Responsible Investment (PRI), a United Nations–founded organisation promoting responsible investing, we agree with the PRI assessment that the fiduciary duties of loyalty and prudence require the incorporation of ESG issues. The three main reasons for this are: 1) ESG is an investment norm, with PRI signatories exceeding 5,000 organisations and $121 trillion of AUM as of September 2022; 2) ESG issues are financially material, with general acceptance that ESG should be seriously considered in any prudent investment process; and 3) policy and regulatory frameworks increasingly require ESG incorporation, and failing to do so could lead to negative legal consequences.

In a recent article in the Harvard Law School Forum on Corporate Governance, attorney Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz, argues that ESG "is inherently apolitical… consideration of ESG principles is not only sensible business strategy, but also is necessary to ensure long-term sustainability and value creation, and to fulfill the fiduciary duties owed by the board and management to the corporation and to shareholders."[1] As investment managers, we similarly view incorporation of ESG as a critical part of our fiduciary duty to prudently manage our clients' capital with the goal of long-term value creation.

Offering Investors Options and Freedom to Choose

Lastly, we believe transparency and providing our clients with investment options that align with their goals, objectives and values is both good business and beneficial to client outcomes. ClearBridge offers a range of investment products in a variety of vehicles including mutual funds, ETFs, UCITs, Collective Investment Trusts and separately managed accounts. While all of these are managed using our fundamental research process integrating ESG analysis, some are distinguished by an emphasis on companies we deem to have stronger ESG profiles. For example, some strategies may not invest in companies that have been identified as having a significant ESG issue(s) and therefore have been assigned our lowest ESG rating. Other strategies use ESG analysis as a source of alpha and risk mitigation, integrating it into fundamental analysis, but are not as stringent in excluding lower-rated companies. One strategy, focusing on companies considered to be leaders in their sustainability profiles, will invest primarily in companies with our highest ESG ratings and will avoid companies deemed to have particularly negative environmental or social impact, or poor corporate governance.

1 Martin Lipton, Wachtell, Lipton, Rosen & Katz, "Understanding the Role of ESG and Stakeholder Governance Within the Framework of Fiduciary Duties," Harvard Law School Forum on Corporate Governance, 28 November 2022.

We believe offering this wide variety of investment product solutions empowers investors to choose more precisely how their capital is invested. After all, it is entirely an investor's prerogative to decide where and where not to invest. Rather than exemplifying a pernicious "woke capitalism," offering investment options that respond to investor demand is entirely aligned with a free market.

At the same time, the rise in popularity of ESG has led to legitimate concerns about greenwashing. New regulatory oversight that attempts — in good faith — to provide rigor and transparency to ESG investing, and to protect investors from dubious ESG claims, will enhance the maturity and long-term health of ESG investing. As a firm that has integrated ESG into the investment process for 35 years, and that manages client assets with high fiduciary standards and responsible stewardship, we welcome transparency and clear disclosure that helps clients distinguish between authentic practitioners and those with less rigo

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- 24 years of investment industry experience
- Joined ClearBridge Investments in 1999
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