KEYNOTE INTERVIEW

The shift to a long-term mindset

ESG investment requires a focus on long-term value creation for both business and society, says Ernst & Young LLP Americas Climate Change and Sustainability Services managing director Chris Hagler

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Q What is the correlation between ESG and returns? How sure are we that there is no negative impact, and what evidence is there that ESG practices actually improve performance?

While impact investment has been around for a long time, until very recently it has been a relatively unexplored niche. Now investing for an ESG impact is pervasive, but many of these ESG-oriented private equity funds and exchange traded funds are still nascent. And so, the ability to prove a positive correlation between ESG and returns remains in the early stages. After all, the results of impact investing are long term by their very nature. If you are focused on social impact – improving diversity or reducing inequalities, for example – that is not going to happen overnight.

The ability to measure these things will therefore also take time. Having said that, we have carried out a thorough assessment of academic literature relating to ESG investment, and while it is difficult to identify a causal relationship, there is almost no evidence of a negative impact on financial performance, and evidence supporting a positive correlation between ESG investment practices and returns is very strong.

Q Is that something that the limited partner community has now fully accepted?

I believe it is. I think that the limited partners we have today are very different from the limited partners of the past. Of course, everyone is investing for financial returns, but overwhelmingly, LPs are not comfortable with generating those financial returns at the expense of a negative social or environmental impact. They also increasingly recognize that good ESG can actually bolster performance.

Q Are investors still primarily focused on the environment, where it is relatively easy to tick a box with renewables or energy efficiency plays, or are they incorporating a broader definition of ESG investment into their allocation models?

I think investors' understanding of ESG is definitely broadening. You are right; it started with the environment, because it is easier to get your arms around clearly defined sectors such as renewables or green infrastructure, compared with investments tackling social challenges such as diversity and inequality. But I certainly think that LPs' interpretation of ESG investment is widening.

Q From a US perspective, in particular, is ESG still primarily thought of in terms of risk management, or is it now being used as a lens for viewing positive investment opportunities and for driving value creation?

In corporate America, broadly, our observations are that almost every company now appreciates the risk management piece of ESG. They appreciate the risk that climate change presents to their businesses, in particular, and recognize that it is just good risk management – or good business sense – to focus on that aspect of environmental best practice. Then there are the more advanced organizations that have had ESG on their radar for some time. Those businesses are now shifting toward an understanding that ESG can actually represent an advantage for the company. That mentality is particularly prevalent in the consumer products space, but you also see it in the automotive industry and a whole host of other areas. Corporates are saying that yes, ESG is an important risk mitigator, but it is also a positive driver of revenues.

In the private equity world, meanwhile, the shift we have seen, even just in the past couple of years, has been extraordinary. The risk management component of ESG is still deemed critical, of course, but increasingly we are also seeing private equity funds set up dedicated impact vehicles in response to investor demand. They are using ESG to manage the downside but at the same time developing new funds to take advantage of an exciting opportunity.

> *"Evidence supporting a positive correlation between ESG investment practices and returns is very strong"*

In fact, EY's *2021 Global Private Equity Survey* found that 47 percent of investors plan to either increase or significantly increase their ESG investment over the next two to three years, while a similar figure, 48 percent, believe there are currently not enough ESG offerings to meet their needs. The potential that this space represents for private equity is enormous.

Q How would you describe the breadth of ESG-driven or impact strategies that are coming to market?

Quite apart from the impact vehicles being launched by many of the mega-firms, there are myriad smaller vehicles tackling the whole spectrum of societal and environmental challenges that the world is facing today. We have seen examples of funds that are specifically focused on driving racial equality, for example, by supporting entrepreneurs and organizations that are managed and run by people of color. We have seen funds with strategies as specific as how to build back better after natural disasters or even funds focused on improving the environmental, social and human rights impact of specific industries, such as hospitality. There is really no limit to the range of global challenges that require solutions, nor to the passion and talent of the people creating these funds.

Q Do you believe the new Biden administration will bring fresh momentum to the adoption of ESG practices and to ESG investment opportunities in the US?

The new administration has clearly indicated the importance that it is placing on climate change and racial justice, in particular. Every single major government department, from Housing and Urban Development to Transportation and Defense, has someone who is exclusively focused on climate change and how climate change objectives can be integrated into policies. Having the federal government so clearly pushing this agenda would seem to signal a huge demand curve and therefore a huge opportunity for investors in this space.

Q Do you believe we will ever reach the stage where impact ceases to be a distinct investment practice but rather the expected norm?

That is a difficult question to answer, but it is certainly a laudable objective and would be our hope. What I can say is that we are working towards an era where everything is simply classified as information – rather than either financial or nonfinancial information. That would be a huge step forward.

Q What is the most important shift in mindset that will be required to make that happen?

I think it is vital that people fully appreciate that ESG investment is a longer-term play. A focus on creating long-term value for businesses and for society is the key to ESG investing. That is fundamentally different to the quick turnarounds and rapid returns that have characterized a great deal of decision-making in the past.

Q Does that mean that the traditional 10-year private equity structure is poorly suited to ESG investment?

I think private equity is ideally suited to help drive some of these transformations. Ten years is a significant improvement on the quarterly reporting requirements of the public markets, after all. ■