

NAVIGATING THE ESG BUBBLE: THE DEAL WITH DATA

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Despite recent headlines and heightened regulatory scrutiny about greenwashing, ESG remains on the forefront of investors' minds. As demand for ESG continues to grow, finding "good" ESG companies is taking center stage. But could this search for "good" companies lead to an ESG bubble as an ever-growing volume of investors pile assets into a still-limited number of companies meeting stated ESG criteria?

Let's take a look at how this could play out:

Strict regulatory guidelines related to ESG goals are taking shape. Stemming from the Paris Agreement, which aims to reduce greenhouse gas emissions and limit global warming to 1.5 degrees Celsius per year, as regulations expand and become more stringent, demand for ESG investing increases, yet the market segment of companies able to meet those standards remains limited. For example, a focus on sustainability has expanded the demand for companies with policies and operations aligned with the "E" in ESG, which typically means investors are seeking exposure to firms with a demonstrable commitment to net-zero carbon emissions. But the number of companies currently able to meet the strict regulations for net-zero is quite small. When assets in search of ESG pour into that limited subset of companies, their prices become inflated and valuations naturally rise. And we know that when demand greatly exceeds supply, companies become overvalued. With enough investors chasing the same firms, a bubble could emerge. And even without bubble-levels of craziness, extended valuations among ESG firms are likely to serve as performance headwinds.

Similarly, aligning with Europe's prescriptive Sustainable Finance Disclosure Regulation (SFDR) indicators for sustainability can lead to a relatively small number of investment options given their narrow definitions. The limiting nature of this taxonomy could precipitate a scenario of an ever-increasing amount of assets chasing a static number of investment opportunities.

So how are investors expected to navigate a scenario in which third-party classification of ESG companies can lead to investing in overpriced stocks? Having an investment partner who can identify attractive ESG investments while paying attention to the value of ESG firms, rather than investing based solely on ESG metrics, is a good start. Investing in "ESG at a good price" rather than "ESG at any price" lessens the potential issues of crowding into stocks.

Let's take the example of limiting emissions. Rather than solely investing in firms categorized as already meeting net-zero emissions goals, a manager with a data focus can create screens for companies that have set targets and have taken steps to decarbonize. Utilizing "glidepaths" and models to determine whether firms are decarbonizing at a rate that puts them on a trajectory to meet set emissions targets can be useful. But as these approaches and definitions of alignment become increasingly more common, this can lead to a large degree of overlap and potential crowding, again leading to overvaluation. Instead, screening for recent behavioral changes that have resulted in decreased emissions by a company that would otherwise fall into the "high carbon emitter" category allows the inclusion of companies that are on track to meet net-zero targets. Investing in companies coming into alignment with ESG goals can lead to lower overall carbon emission portfolios than by relying only on ESG index constituents.

Data screening, scalability, and a discerning approach to stock classification help to identify differentiated opportunities that indexing or fundamental investing would likely miss. This broader scope of opportunities provide for portfolio construction across a truly global ESG universe. By employing a differentiated stakeholder framework not bound by strict definitions, quants establish a holistic approach to analyzing companies' management and operations, their interaction with stakeholders, and their exposure to risk. This approach can serve an important role in uncovering value in the ESG space while navigating a potential bubble in ESG investing.

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