



ESG: Risk management or a green bubble?



Author(s)
Lloyd McAllister

Published
June 23, 2023

Leng
4

A political debate

We watch with amazement as the US twists itself in politicized knots over investment and ESG. The ongoing Department of Labor (DOL) rule drama symbolizes this, where polarized politicians are debating whether it is acceptable for fund managers to potentially consider financially material ESG issues in their investment decision making.

Imagine yourself as fund manager, sitting down with a pensioner who worked hard all their life to create a savings pot and then telling them that you lost them money because you were forced, by law, to not consider the following in your investment decision making:

- The potential impacts of an evolving environmental regulatory landscape on company revenues;
- The potential impacts of low customer satisfaction on revenue generation;
- The potential impacts of low employee satisfaction on talent retention, productivity and strikes;
- The potential impacts of non-executive directors who are too busy to hold company management to account.

These kinds of ESG issues are clearly financially material and important to consider in any investment process that is focused on understanding risk. Despite all the media noise around the DoL rule, it has actually always been clear in Trump and President Biden's respective legal wordings that any factor can be considered in an investment so long as it is relevant to risk and return analysis¹.

It was the 2020 Trump rule that called out ESG factors being subject to enhanced fiduciary scrutiny which caused the perception in chilling effect around ESG considerations in an investment process.

Divergent approaches to ESG definitions

The main source of confusion in the press and between politicians in debates seems to stem from not distinguishing between ethical, sustainable, impact investing and ESG integration. Typically, the phrase ESG integration is used to describe a long-established and widely practiced investment approach which uses ESG information as an alternative dataset (compared to just using traditional sources of information such as the financial accounts or industry reports) to better understand the risk and return characteristics of a security.

The United Nations Principles for Responsible Investment report on fiduciary duty re-affirmed the position that the consideration of ESG within investment is part of fiduciary duty although recognized that this is based on the premise that the ESG considerations are financially material².

Of course, there can be subjectivity as to the extent to which an ESG issue is financially material. By the same token, there can be subjectivity over the extent to which a currency depreciation, an economic cycle or a liquidity issue can be material to a security price. This is what creates a market – different competing views and interests.

Where it becomes murkier is when the investment approach is focused on not only using ESG as an information set to improve risk and return understanding, but also to avoid significant harms or gain additional exposure to positive impact companies, for instance in sectors such as education, healthcare or clean energy. This may be linked to financial risks or opportunities but may also already be priced in or simply a stylistic investment wish of the end client.

ESG considerations across the board

These days ESG integration has become so widespread within the asset management industry that when explained properly, the response from fund managers and analysts is usually along the lines of “of course we do that”.

A detailed global study that represented \$31trillion of assets found that 82% of investment managers use ESG information in their investment process, the majority doing so because they believed it was a driver of investment performance or an area of client interest³.

There are also reasonable concerns that ESG as a concept is causing green bubbles in valuations-given the increasing asset owner interest in ESG, the increasing level of government regulation on ESG such as the EU SFDR and the fast-moving clean technology innovation that is attractive from a growth investment style perspective.

The crux of the concern is that a wall of “ESG money” will flow into a small number of securities considered “ESG”. Indeed, even organisations like the central bank for central banks - the Bank for International Settlements - said in September 2021 that “ESG assets valuations might be stretched.”⁴



The bubble hypothesis refuted, but under scrutiny

However, an analysis of price to earnings and book ratios doesn't support the idea of a green bubble. For instance, the average price to earnings (PE) ratio of the MSCI ACWI is 35. For top scoring ESG stocks it is the same, at 35⁵. In fact, for lower rated ESG stocks, the average PE ratio is 42, indicating higher market prices for poor ESG performers. A similar story can be found on price to book measures, with the MSCI ACWI at 6.2, high ESG scorers at 5.7 and low ESG scorers at 4.9⁶. This implies that middling ESG scorers are being priced highest with lower prices for high and low ESG scorers and clean tech companies. One area of higher PE ratio compared to the MSCI ACWI is in a clean technology focused index, providing some evidence of investor willingness to pay higher prices for long duration green growth prospects.

These varied valuation characteristics struggle to convince us that a systemic green bubble exists. While regulation like the EU's SFDR and increasing client interest in ESG means there could theoretically be greater demand in securities which are aligned with these interests, the regulations are so broadly worded and clients interests within ESG so varied, it appears that there isn't enough focus at present to create a bubble. It is a fair concern to have though and so worth ongoing monitoring.

¹<https://corpgov.law.harvard.edu/2023/02/02/esg-investing-after-the-dol-rule-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights/>

²Fiduciary Duty in the 21st Century, the United Nations (2016).

³Why and How Investors use ESG information: Evidence from a Global Survey by Amel-Zadeh and George Serafeim; Financial Analysis Journal (2018).

⁴<https://www.reuters.com/business/sustainable-business/global-markets-bis-esg-urgent-2021-09-20/>

⁵Source: Carmignac, MSCI, March 2023.

⁶Source: Carmignac, MSCI, March 2023.

Sustainable investing: our conviction

Our mission is to create value for our clients and positive outcomes for society and the environment

[Learn more](#)



Marketing communication. Please refer to the KID/KIID, prospectus of the fund before making any final investment decisions.

This material may not be reproduced, in whole or in part, without prior authorisation from the Management Company. This material does not constitute a subscription offer, nor does it constitute investment advice. This material is not intended to provide, and should not be relied on for, accounting, legal or tax advice. This material has been provided to you for informational purposes only and may not be relied upon by you in evaluating the merits of investing in any securities or interests referred to herein or for any other purposes. The information contained in this material may be partial information and may be modified without prior notice. They are expressed as of the date of writing and are derived from proprietary and non-proprietary sources deemed by Carmignac to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by Carmignac, its officers, employees or agents.

Past performance is not necessarily indicative of future performance. Performances are net of fees (excluding possible entrance fees charged by the distributor). The return may increase or decrease as a result of currency fluctuations, for the shares which are not currency-hedged.

Reference to certain securities and financial instruments is for illustrative purposes to highlight stocks that are or have been included in the portfolios of funds in the Carmignac range. This is not intended to promote direct investment in those instruments, nor does it constitute investment advice. The Management Company is not subject to prohibition on trading in these instruments prior to issuing any communication. The portfolios of Carmignac funds may change without previous notice. The reference to a ranking or prize, is no guarantee of the future results of the UCIS or the manager.

Morningstar Rating™ : © Morningstar, Inc. All Rights Reserved. The information contained herein: is proprietary to Morningstar and/or its content providers; may not be copied or distributed; and is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

Access to the Funds may be subject to restrictions regarding certain persons or countries. This material is not directed to any person in any jurisdiction where (by reason of that person's nationality, residence or otherwise) the material or availability of this material is prohibited. Persons in respect of whom such prohibitions apply must not access this material. Taxation depends on the situation of the individual. The Funds are not registered for retail distribution in Asia, in Japan, in North America, nor are they registered in South America. Carmignac Funds are registered in Singapore as restricted foreign scheme (for professional clients only). The Funds have not been registered under the US Securities Act of 1933. The Funds may not be offered or sold, directly or indirectly, for the benefit or on behalf of a «U.S. person», according to the definition of the US Regulation S and FATCA. The risks, fees and ongoing charges are described in the KID (Key Information Document). The KID must be made available to the subscriber prior to subscription. The subscriber must read the KID. Investors may lose some or all their capital, as the capital in the funds are not guaranteed. The Funds present a risk of loss of capital.

The Funds' prospectus, KIDs, NAVs and annual reports are available at www.carmignac.com, or upon request to the Management Company. Carmignac Portfolio refers to the sub-funds of Carmignac Portfolio SICAV, an investment company under Luxembourg law, conforming to the UCITS Directive. The French investment funds (fonds communs de placement or FCP) are common funds in contractual form conforming to the UCITS or AIFM Directive under French law.

In the United Kingdom: the Funds' respective prospectuses, KIDs and annual reports are available at www.carmignac.co.uk, or upon request to the Management Company, or for the French Funds, at the offices of the Facilities Agent at BNP PARIBAS SECURITIES SERVICES, operating through its branch in London: 55 Moorgate, London EC2R. This document was prepared by Carmignac Gestion, Carmignac Gestion Luxembourg or Carmignac UK Ltd. FP Carmignac ICVC (the "Company") is an Investment Company with variable capital incorporated in England and Wales under registered number 839620 and is authorised by the FCA with effect from 4 April 2019 and launched on 15 May 2019. FundRock Partners Limited is the Authorised Corporate Director (the "ACD") of the Company and is authorised and regulated by the FCA. Registered Office: Hamilton Centre, Rodney Way, Chelmsford, Essex, CM1 3BY, UK; Registered in England and Wales with number 4162989. Carmignac Gestion Luxembourg SA has been appointed as the Investment Manager and distributor in respect of the Company. Carmignac UK Ltd (Registered in England and Wales with number 14162894) has been appointed as a sub-Investment Manager of the Company and is authorised and regulated by the Financial Conduct Authority with FRN:984288.

In Switzerland: the prospectus, KIDs and annual report are available at www.carmignac.ch, or through our representative in Switzerland, CACEIS (Switzerland), S.A., Route de Signy 35, CH-1260 Nyon. The paying agent is CACEIS Bank, Montrouge, Nyon Branch / Switzerland, Route de Signy 35, 1260 Nyon.

The Management Company can cease promotion in your country anytime. Investors have access to a summary of their rights in English on the following links: [UK](#) ; [Switzerland](#) ; [France](#) ; [Luxembourg](#) ; [Sweden](#)