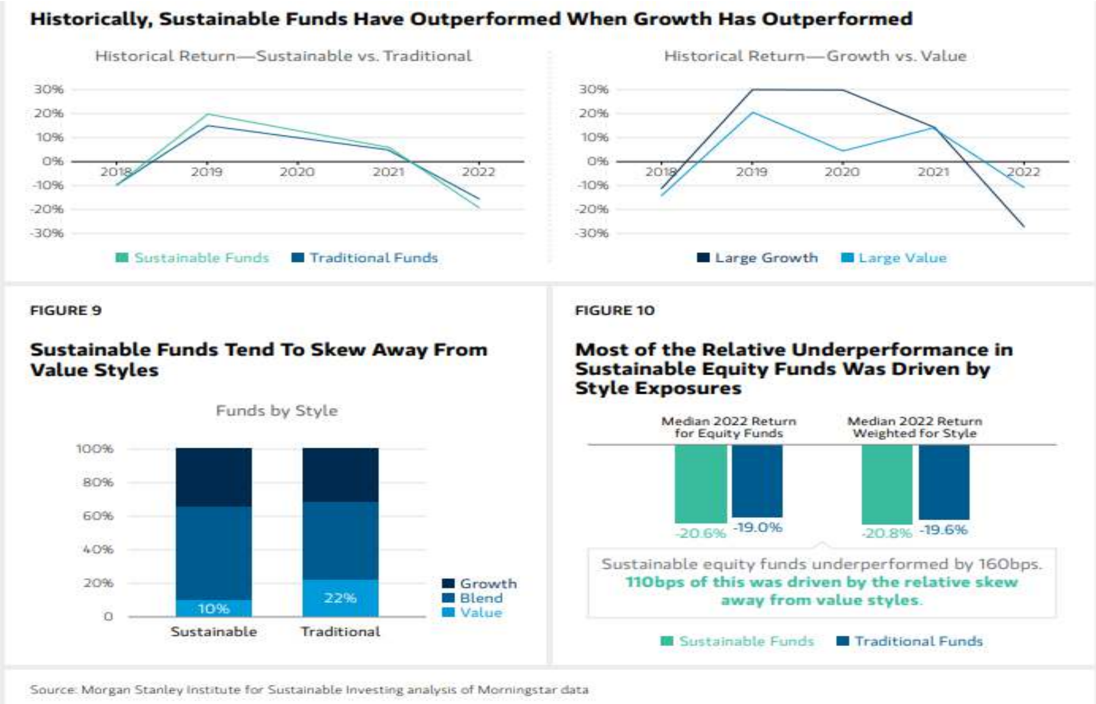
Sustainable Investment Performance 2022 and Investing Trend for 2023

Environmental, social, and governance (ESG) investing has gained popularity in recent years with hundreds of investment funds established to focus on firms specifically adhering to ESG principles. It was hoped that this type of investing would attempt to make a positive impact on the world in addition to providing a return. Whether those entails making investments in renewable energy sources, abiding by net zero disclosures, or being aware of greenwashing, sustainable investing faced some significant difficulties in 2022. ESG issues continue to be a top priority for businesses and investors in light of the unusual market conditions and ongoing global challenges. Expectations have increased among all stakeholders as businesses throughout the world have integrated sustainability into their business models, established emissions goals, and stepped up their efforts in the area of governance. The U.S. political environment brought conflicting viewpoints to the forefront and intensified discussions about fiduciary responsibility in the corporate and asset management arenas against a backdrop of worsening macroeconomic and turbulent markets. One thing appears more solid amidst geopolitical ambiguity: regulation. While the SEC has proposed its own legislation for U.S. firms, Europe has been leading the pace by demanding mandatory disclosures by businesses and investment managers.

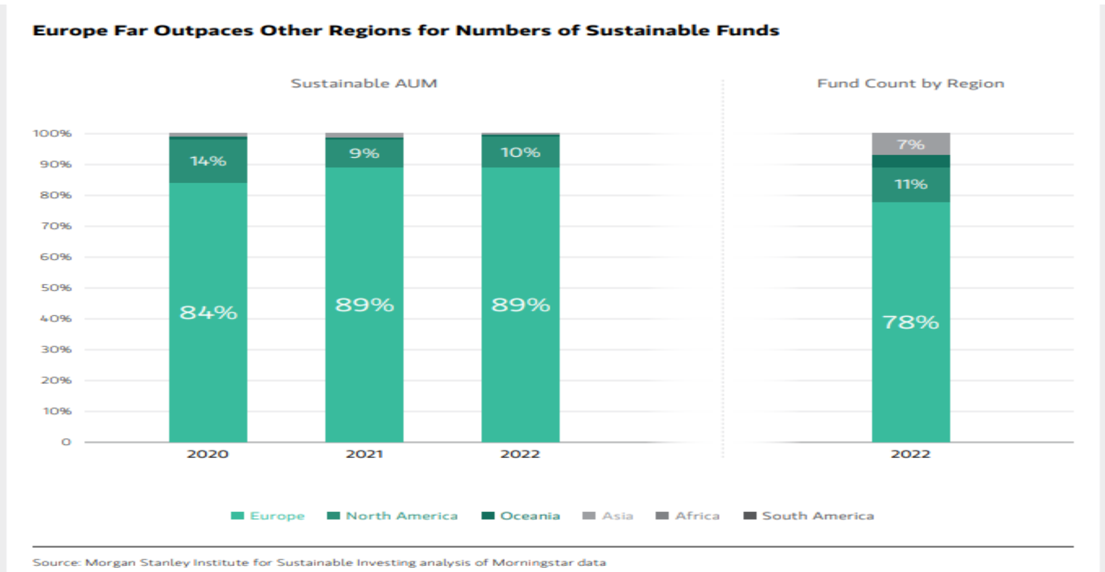
The conflict between Ukraine and Russia impacted global energy markets. And as a result of UK and EU sanctions on Russia's energy supplies, less environmentally friendly energy sources like nuclear energy and even contentious techniques like fracking have to be used. The oil giants BP and Shell raked in high profits. In August 2022, 6 months after the war began, BP and Shell posted 21% and 29% gains respectively in that period. In addition to market difficulties, ESG also faced criticism. A significant occurrence was the state of Florida withdrawing $2 billion from BlackRock in November of last year. The largest divestment by a state that disagreed with the world's largest asset manager was made, in this case opposed to the policies of environmental, social and corporate governance (ESG). Investors continued to invest in sustainable funds last year despite these pressures, albeit at a reduced rate. Morningstar reports that global sustainable funds drew $22.5 billion in net new capital globally in the third quarter of 2022, down from $33.9 billion in the prior quarter 2. Nonetheless, sustainable funds performed better as compared to the larger market, which over the same time period saw net withdrawals of $198 billion.

The macroenvironment and the current energy crisis may continue to present difficulties for ESG fund performance. As ESG funds typically underweight traditional energy companies while overweighting the technology sector, in 2022, high fossil fuel prices had a negative impact on the performance of these funds. The possibility of underperformance in all investments should serve as a constant reminder to investors. Sustainable and ESG strategies are similar. But long-term investors should prioritize their goals. Sustainability is about the long term.

While traditional funds had prolonged outflows, sustainable funds saw net positive fund flows of $115 billion since 2018 (around 3% of 2021 year-end assets under management). According to Morgan Stanley AUM for sustainable funds reached around $2.8 trillion by year's end, increasing from 4% to 7% of total AUM five years earlier. The demand for sustainable funds was greatest in Europe, which accounted for 89% of sustainable AUM and nearly all of 2022's net inflows. In 2022, a sharp increase in interest rates caused falls in both bonds and stocks, a behavior not experienced in 150 years. Long-duration bonds, which are more susceptible to an increase in interest rates, were not as popular with investors as short-duration bonds. As a result, throughout equity markets, value (stocks trading at a discount) outperformed growth (which gives priority to long-term potential), while high-quality, short-duration fixed income beat out low-quality, long-duration bonds.



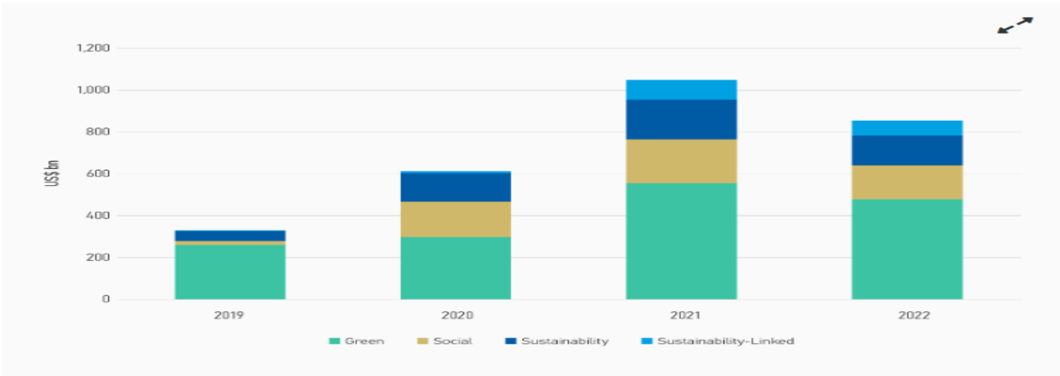
With 89% of sustainable AUM domiciled in Europe, the region continues to outperform other regions in terms of sustainable AUM and fund counts. The remaining areas account for less than 2% of the overall sustainable AUM, with North America coming in second with about 10%. Europe accounts for more than two-thirds of all global sustainable funds, with North America (11%) and Asia (7%), following.



Over the past two years, there has been an explosion in the growth of impact or labelled bonds, which include green, social, or sustainability-related bonds. Impact bond issuance surpassed $1 trillion in 2021, more than double the $326 billion issued in 2019 and up more than 68% from the $606 billion issued in 2020. The issuing of green bonds has, however, slowed down so far in 2022 due to inflation and rising interest rates.

The bond market has experienced an extraordinarily turbulent year in 2022. The overall market trend caused the absolute worldwide supply of Green, Social, Sustainable, and Sustainability-Linked Bonds (also known as "Sustainable Bonds") to fall short of $850 billion in new issuance, or nearly a fourth below 2021 levels. Nonetheless, relative to other bonds, labeled bonds kept moving in the direction of becoming more common, reaching about 30% of the total amount of new issuance for EUR IG and EUR HY.

Labelled Sustainable Bond Issuance, 2019-2022



Source: Environmental Finance Data

Sustainable Bonds continue to be a useful instrument for fixed income portfolios to invest in sustainability goals like climate change mitigation and adaptation, equity, and job creation, with a predicted 2023 comeback to $1 trillion tagged issuance. Policy initiatives like the UK Transition Plan, EU Taxonomy and Carbon Border Adjustment Mechanism (CBAM), and the US Inflation Reduction Act, among others, further stimulate this.

Sustainable equity funds may tilt more toward value than they have in the past if sustainable solutions, such renewable energy or clean technology, become more material for corporate earnings in the short term. For instance, in early 2025, renewables are anticipated to surpass coal as the primary source of electricity production globally, making clean energy a more immediate investment opportunity. As a result, a potential shift toward value and shorter duration in fixed income is also possible. Furthermore, sustainable funds are becoming more willing to take into account companies' rate of change toward sustainability goals, which means they may embrace a wider universe of businesses and industries that are working toward improved sustainability.

After a challenging 2022 for sustainable investment, caused in part by energy fallout from the Russian/Ukrainian conflict, there are indications that sustainable investments will take on a considerably greater significance in 2023. It was unusual to have negative returns from the bond and equities markets under the challenging circumstances of last year, and it would be much more unusual to see a repetition of these returns in 2023. So, despite the challenging macroeconomic environment, there are good reasons for investors to remain upbeat as 2023 gets started. In 2023, among deflation, stable to declining real bond yields, China's re-opening, and rising investment in green and infrastructure assets. Current sustainable financing instruments like green and social bonds and project financing for renewable energy sources are projected to keep expanding. But, in order to implement new technologies and create new business models, this enormous change toward a low-carbon global economy will call for extraordinary collaboration and innovation across the economy. To expand deep impact solutions with long-term commercial potential, creative finance mechanisms that bridge funding gaps and involve philanthropic groups, governments, companies, and investors will need to work together in the same direction.