MARKET SPOTLIGHT—DECEMBER 2022

The dawn of a new environmental day?

In terms of the economy and markets, 2022 may not be remembered with much fondness. This month's *Market Spotlight* runs counter to this trend, closing out the year on a high note with a focus on environmental, social, and governance (ESG) investing.

As challenging as it may have been at times, we may one day look back and say this was the year things changed. This was the year—highlighted by the passage of the Inflation Reduction Act in the U.S.—when we started to take meaningful steps toward mitigating the effects of climate change.

Aaron White, Vice-President, Sustainable Investments, starts us off by examining the backlash against ESG investing. This backlash, he argues, could pay dividends in the long run.

Finally, Montreal played host this month to the 15th meeting of the Conference of the Parties to the UN Convention on Biological Diversity (COP15). Nick Ciaravella, Associate, Sustainable Investments, outlines why biodiversity is essential to the global economy.

The backlash against ESG investing

Aaron White
Vice-President, Sustainable Investments

The last several months have witnessed a growing backlash against ESG investing from governments and regulators around the world, particularly in the U.S. In the long run—and if dealt with correctly—this backlash should better help individual investors to make a positive impact on both the environment and their portfolios.

The politics of ESG

Taking their lead from Florida and Texas, several states have instituted laws targeting ESG and how it's used by institutional investors. In Florida, legislation was enacted that compels the state's fund managers to prioritize returns over ESG considerations when investing state funds. While in Texas, local authorities are barred from doing business with banks that have adopted ESG policies that spurn Texan fossil fuel companies.

Both initiatives politicize ESG investing. They also create confusion about the intent of the many forms of ESG investing, lumping them all into one category.

To address this confusion, the ESG investment community needs to redefine ESG and better understand how investors are considering non-financial risks in their assessment of companies. It needs to recognize that ESG investing is intended primarily to make better financial decisions. By doing so, it can counter the perception that ESG investing is solely about affecting change, regardless of the impact on financial returns.

Wiping away the greenwash

ESG investing was also tainted this year by a few bad actors professing to be responsible investors when in fact they weren't. In one case, an investment manager changed the objectives of a fund without any previous ESG objectives to one with ESG objectives but retained the previous fund's performance track record. In another case, an investment manager's marketing material claimed that all holdings in a fund had undergone proprietary ESG assessment, but an audit revealed this was not true.

In consequence, regulators are increasingly taking enforcement action against such instances of greenwashing. They're also looking for greater transparency on both the ESG objectives and processes that an investment manager employs, as well as evidence that the manager adheres to them.

Most enforcement actions have taken place in the U.S. and the E.U. However, the Canadian Securities Administrators (CSA) and the Ontario Securities Commission (OSC) have made it clear they're looking for the same degree of authenticity here in Canada. *(Continued on next page)*

The backlash against ESG investing (continued from first page)

An opportunity to clarify its value

Rather than being disheartened by it, the ESG investing community needs to see this backlash as an opportunity to clarify its value proposition.

ESG investing can help environmentally minded investors do what they feel is right. It can also help them reduce their portfolios' exposure to areas of the economy that are especially susceptible to extreme weather events.

It's true that ESG investing at times has been co-opted by investment firms that use it simply as a marketing tool, but this has sounded alarms that will only result in increased transparency.

In the end, greater scrutiny will create a better alignment between a fund's stated outcomes and the objectives of its investors.

Biodiversity and the global economy

Nick Ciaravella
Associate, Sustainable Investments

The 15th Conference of the Parties (COP15) to the UN Convention on Biological Diversity (CBD) convened in Montreal from December 7 to 19. Delegates from more than 190 countries gathered to address what UN Secretary-General Antonio Guterres has described as "humanity's senseless and suicidal war with nature." Leaders from government, business, and other stakeholders discussed and developed strategies for protecting biodiversity and ensuring its sustainable use.

Biological diversity, or "biodiversity," is the variety of life on Earth. According to the United Nations, "Biodiversity forms the web of life that we depend on for so many things—food, water, medicine, a stable climate."

The global biodiversity framework

Every 10 years, the CBD negotiates a Global Biodiversity Framework. This sets a series of goals and targets for member nations to strive toward to help create a "nature-positive future" and halt the decline of ecosystems and wildlife.

This year's conference aimed to give biodiversity the same international attention as climate, with the goal to stop and reverse nature loss by 2030. More than half of the world's total gross domestic product, or $44 trillion, is moderately or highly dependent on nature and its services.[1]

Biodiversity conservation is important due to the direct impacts it has on the health and stability of natural systems and the economy. The loss of biodiversity can lead to a decline in these ecosystem services, which can have negative impacts on human health, food security, and economic activity. Risks to natural capital—such as deforestation or water scarcity—can ultimately manifest as investment risks for businesses. Examples include disruptions to natural resource inputs or litigation risks from unsustainable business activities. Prioritizing biodiversity can help to maintain the health and stability of natural systems and support the long-term sustainability of businesses and the economy as a whole.

Policy advocates have been calling for a 'Paris moment' on biodiversity, including the establishment of nature-positive frameworks and targets to support the global conservation of biodiversity. Early discussions at the conference centred on global land and water conservation efforts. The goal of protecting 30% of global land and water by 2030 became the benchmark target for various nations, including Canada.

The scale at which our global economy is dependent on nature highlights the need for biodiversity and natural capital to become a larger part of the sustainability conversation. The climate crisis cannot be stopped without addressing biodiversity loss. Businesses, policymakers, and other stakeholders must consider both climate and nature when proposing and advancing policy responses.

[1] WEF, New Nature Economy Report, Davos, Switzerland, 19 January 2020.

568 | 12/2022