esgbook

Always check the label*

*** Why ESG and climate funds are not always what they seem.**

James Wilcock

Always check the label*

*Why ESG and climate funds are not always what they seem.

By James Wilcock

Introduction

Using ESG Book's recently launched Fund ratings which are applied to over 4,000 ETFs and more than 32,000 mutual funds, we explore how marketing claims and the labelling of funds can be inconsistent with the actual data behind a fund's investments. For this analysis, two groups of funds were selected. The first group contains any fund with 'ESG' in its name, and the second any fund with 'climate' within its name. These two groups contained 420 and 95 funds respectively, all of which have at least 68% market value coverage from ESG Book data.

Up to 40% of climate funds holdings are not Paris Aligned

Analysing the 95 climate funds, we find that none have holdings that are fully Paris Aligned according to ESG Book's Temperature Score. In fact, some climate funds have almost 40% of their weight invested in non-Paris aligned assets. This shows that with currently disclosed emissions data, these funds fail to meet a common presumption that a climate fund would at the very least invest solely in companies already aligned with a 'below-2 degrees' scenario. The fact that climate funds are missing this mark is even more pressing considering that the IPCC has detailed the clear differences between 1.5 degrees and 2 degrees warming, let alone above 2 degrees of warming.

On top of these findings, many of the climate funds analysed are still invested in the fossil fuel and mining sectors, in companies such as Shell, Exxon Mobil and BHP Group. Whilst there is a case to be made for including such companies into climate transition funds, these three energy majors are also included in funds stating that they are 'climate aware', 'climate care', or are simply 'ESG & Climate Funds'. These stock choices seem at odds with the definition of a climate fund, and demonstrate the need for greater transparency around the underlying climate performance of funds.

Many 'climate' funds are far less sustainable than their labels might suggest, regularly holding assets in non-Paris aligned assets such as fossil fuel and coal mining companies.

Sustainability funds failing to keep up standards

Analysing both climate and ESG fund groups together, we discover that a significant minority of ESG funds also perform particularly poorly in the climate dimension. Between these two groups, there are 73 funds which exceed the average emissions intensity ratio (EIR) of ESG Book's fund universe. Of these, 44 funds exceed 250 t/M$, averaging almost 30% higher than the universe as a whole. Furthermore, 15 of these funds exceed 400 t/M$ - over twice as high as the universal average - which would lead to an 'above-2' degrees temperature rise even if every single company was given the highest possible IEA benchmark of the Power sector.

To have an ESG or climate-labelled fund with such a high emissions intensity ratio should raise concerns, especially when many of these funds are passive in style with no active engagement with companies to reduce their emissions. The discrepancy between the leaders and laggards within these groups is further reflected in the Temperature Score distribution of ESG and climate funds. ESG Book's Temperature Score details the weight of each fund attributed to a particular temperature rise. Importantly, the score uses IEA sector benchmarks to assess assets' emissions performance, therefore accounting for – as an example - the power and utilities sectors having higher emissions before scoring any given company.

Overall, we see a far higher percentage weight in ESG and climate funds invested in assets on track for 1.5 degrees warming. ESG and climate funds have on average 30% of the fund aligned with 1.5 degrees, compared to just over 20% for all funds based on a 2050 timeframe, as seen in Figure 1. However, if we examine the bottom 20 funds in this group in terms of emissions intensity performance and compare their Temperature Score distribution, we see a very different picture appearing.

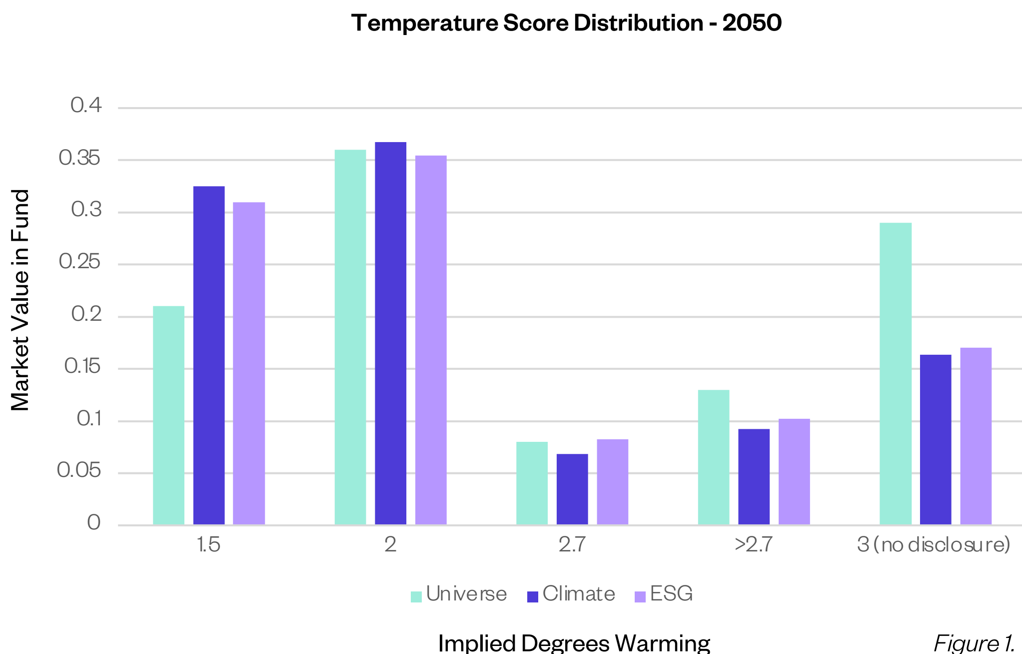

Figure 1.

Unlike most ESG and climate funds, the worst performing funds have less weight in lower temperature scores, such as 1.5 and 2 degrees Celsius, than the universal average as seen in Figure 2. In fact, these funds have almost a quarter of their market value on average invested into assets contributing to a temperature scenario of above 2.7 degrees by 2050, a scenario that has been widely predicted to cause widespread environmental degradation, with extreme global climatic events. These funds are also largely passive, with some stating that they are investing in companies with 'sustainable financial models'. The underlying data demonstrates the opposite.

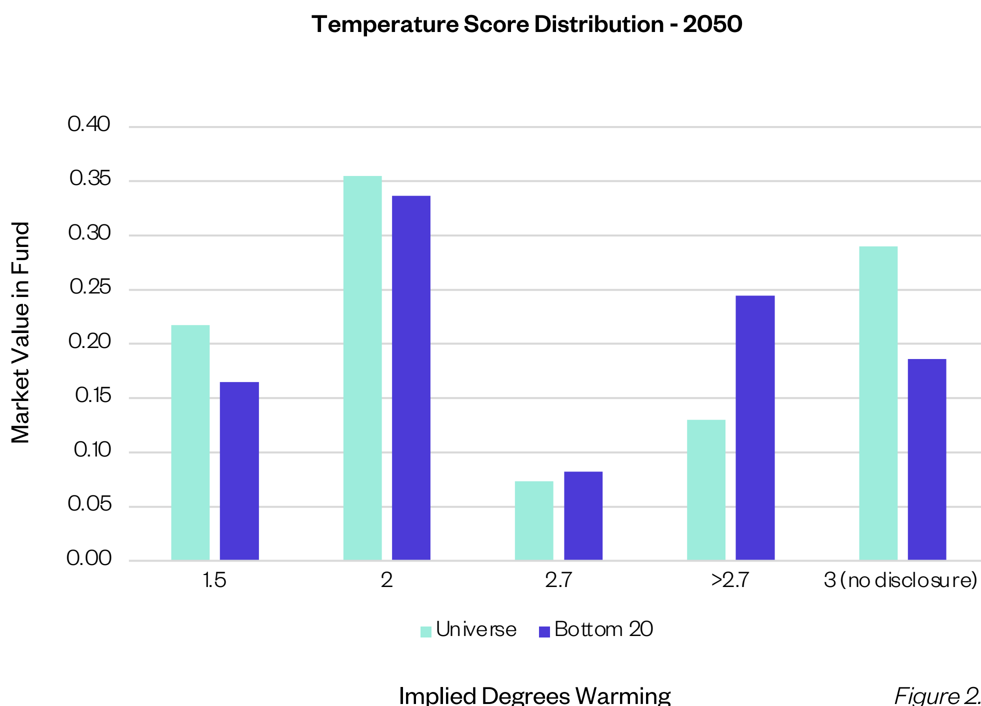

Figure 2.

Data and Regulation is required to separate fact from fiction

Overall, whilst most 'climate' and 'ESG'-labelled funds do currently meet expectations, regulators increasingly require these labels to be backed up by actual data. In May 2022, the US Securities and Exchange Commission proposed a range of new rules aimed at ensuring that ESG funds accurately describe their investments, which may require asset managers to disclose the greenhouse gas emissions of companies they're invested in. These proposed rules come off the back of recent new laws in Europe, the Sustainable Finance Disclosure Regulations (SFDR), where investments have to be labelled under categories according to the priority placed on sustainability. And in August this year, new European Union rules went into effect requiring asset managers to understand and act on the 'sustainability preferences' of retail clients.

This shifting regulatory environment should in theory, over time, provide greater confidence for investors that their capital in ESG and climate funds is allocated to companies that are genuinely aligned with a net-zero and sustainable future. As our analysis shows, however, it has never been more important to always check the label.

esgbook

For more information on our Fund Scores Solution, visit esgbook.com or call us on +44 20 7113 3503