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Investment Institute Sustainability

Sustainability in 2024: From net zero to a more holistic approach

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Key points:

- 2024 will be an extraordinary year politically, with more than 60 countries going to the polls – this will likely affect the course of sustainable finance, including potential polarisation around key ESG issues and climate policies
- Irrespective of the political context, the transition must still be the key focus, echoing COP28 in its call to support the shifting of the whole ecosystem
- Ecosystem vulnerability and biodiversity losses are set to rise up investors' agendas, more specifically water stress, waste and pollution while the food sector will see increased scrutiny
- Engagement wise, 2024 should mark a turning point in the field of climate while social and more specifically human and workers' rights should continue to gain attention, driven by a generally tense social backdrop and ramifications of transition plans
- Responsible investment is likely to broaden its lens, shifting from a net zero focus to a more holistic perspective of sustainability

The exceptional performance of energy stocks in 2022 could have been viewed by some investors as a sign that sustainability is, at times, at odds with financial success. But 2023 proved them wrong, with the sector underperforming the MSCI Europe Index.[1]

Even though 2024 is widely viewed as likely to offer a more favourable backdrop for markets and investments in general[2], including environmental, social and governance (ESG) related strategies, we believe that whatever the short-term financial performance, it just does not make sense to assume that sustainability and long-term performance cannot go together. We believe that sustainability is – and will be – a core driver of long-term success, and this acknowledgment was made several years ago when it became clear that poor governance was not compatible with a sound business profile.

Further work around environmental and social matters and what they mean for financial performance has since then been carried out. A recent analysis by MSCI found that that companies with higher environmental and social risk management and governance scores than their peer groups had lower stock-specific risks than their peers during the 2017-2022 period. [3]

Crucially, the lower risk profile did not just reflect what kind of ESG risks a company was exposed to, such as climate change, environmental regulation, or labour management issues. It also reflected how the company manages these risks itself.

In some geographies like the US, political polarisation around ESG is extreme and it could take some time before this backlash wanes. A shift to the Republican party at this year's US Presidential Election would certainly not be in favour of responsible investments - Donald Trump has explicitly announced he would scrap the green agenda in the Inflation Reduction Act were he to become President. However, at times when short-term performance can blur the picture in other geographies as well, it is important to remember what the data says.

The data supports investments in various sectors, without straightforward allocation or geographical bias as long as ESG risks are adequately tackled and managed.

Focus on transition

We believe that facilitating the transition to a lower carbon world is set to draw further attention from both responsible investors and regulators - echoing the call and outcome of last year's United Nations (UN) climate change conference, COP28.

Green investments are of course important, but what needs to be financed is the transition to a greener economy, and particularly investments which support the gradual shift of companies towards more sustainable business models.

However, from an investment perspective there is no market consensus around what could qualify as robust criteria for transition finance-labelled bonds, at either issuer or project level, that would allow companies in 'brown' sectors to raise capital to transition to greener activities. In that context, we believe that sustainability-linked bonds could be one potential route for investors to help meet those needs.

This is even more the case as companies in some sectors will have to contend with increasingly stringent emissions reduction policies that will raise operating costs going forward. The European Union's (EU) emissions trading scheme currently in place - covering electricity, heat generation as well as energy-intensive sectors such oil refineries, steel works and aluminium - will be extended to maritime transport in 2024, and to buildings, road and transport from 2026[4].

Impact on investments and engagement

This transition focus will bring multiple potential investment opportunities across many sectors including transportation, housing, food, construction and manufacturing. Infrastructure is also set to benefit amid the drive to treble the capacity of renewable energy - a key COP28 commitment.

This in turn will drive further scrutiny on engagement, echoing a broader request to prevent 'engagement washing'. Asset managers will have to share more about their assessment of transition plans, what they focus on and how they adjust their approach to different sectors, technological developments and regulations.

Overall, we believe the responsible investment industry is entering the second phase of climate strategies assessment, focusing on the deliverability of short-term targets and track records, while aligning capital expenditure programmes and management incentives on medium-term climate objectives.

As for the oil and gas industry, we expect the sector to encounter a renewed focus from both investors, and society more broadly, regarding companies' operational practices – especially methane, another area emphasised at COP28.

Climate-biodiversity nexus

Directly related to the transition, and echoing the interplay between climate and nature, we believe the integration of biodiversity and environmental considerations will continue to gain traction in 2024. This is of course supported by the recent release of the Taskforce on Nature-related Financial Disclosures (TNFD) framework, which encourages corporates and financials to disclose their most material risks, dependencies, impact and opportunities related to nature.

The sectors recognised by the framework as having the most impact on biodiversity – including food, oil and gas, chemicals, consumer staples distribution and retail metals and mining[5] - are the most obvious candidates for both engagement and issuance.

In terms of engagement, while deforestation is already well integrated by investors, we expect to see greater engagement on water stress, waste and pollution. This will come alongside regulatory developments which will put pressure on companies to reduce waste, plastic packaging and increase recycling. At the global level, 175 countries have agreed to develop a legally binding agreement on plastic pollution by the end of 2024[6].

The maturity of corporates is still quite low regarding their interactions with nature, and we believe investors have a role to play to share knowledge about the most material risks, both in terms of the most material activity and priority locations. Increasing granularity of disclosure is a must if data and risks and opportunity assessment is to be enhanced.

It remains to be seen whether the new Corporate Sustainability Reporting Directive (CSRD) which came into play in Europe on 1 January will draw the bulk of companies' attention, potentially at the detriment of biodiversity efforts despite the interoperability that TNFD is working on.

Better investment potential

Meanwhile, the greater the challenges, perhaps the greater the opportunities for companies to adjust their business models to more sustainable practises, encouraging solution enablers or innovation, that equity investors could potentially benefit from. Within fixed income, we believe that sustainability-linked bonds (SLBs) are a promising segment with regards to biodiversity, with companies in sectors including food and beverage, retail, and metals and mining putting in place targets and key performance indicators (KPIs) around waste and water.

We could still see more sovereign SLBs now that the International Capital Market Association has updated its KPI registry to accommodate sovereigns. More than 190 countries signed the Global Biodiversity Framework in December 2022 – by doing so, they committed to halting and reversing biodiversity loss by 2030, planned for $200bn of conservation financing per year, and will have to submit National Biodiversity Strategies and Action Plans towards meeting these goals.[7]

This may lend to future issuance of nature-related SLBs as the UN conference on biodiversity, COP16, in October this year is likely to trigger additional announcements.

Environmental pressure

Finally, environmental litigation is expected to remain part of the responsible investing landscape in 2024, in particular posing operational and financial risks for companies involved with per- and polyfluoroalkyl substances (PFAS), also known as forever chemicals.

Regulatory and consumer pressure is intensifying, exerting further pressure on upstream producers. Meanwhile, the lowering of limits and extending the scope of PFAS in water quality regulation is likely to prompt further litigation and make compliance and removal more costly.

Some companies have already borne the brunt of this, with material impact driven by litigation liabilities and remediation costs, and in some emblematic cases weighing on credit profiles. However, this mostly refers to legacy emissions of PFAS already restricted, meaning that tightening regulation may leave scope for more litigation and fines to come.

Food sector under the spotlight

This year should also see the food sector rise up investors' agendas in line with its contribution to environmental degradation and climate change. Regulatory scrutiny will play a role on that front, echoing COP28 which saw 134 countries, representing 70% of the world's land, integrating food into their national climate plans by 2025.[8] This suggests more policies aiming to address greenhouse gas emissions, fertilisers, chemicals and land use in the agriculture sector.

The EU deforestation rules which come into effect in late 2024 and which are aimed at banning the import of products that contribute to deforestation will also affect the food sector. Companies will face increasing operating costs to monitor and adjust their supply chains accordingly, while failing to do so will raise multiple risks.

These developments bring further opportunities for investors to help finance the transition to more sustainable food production and consumption, targeting various fields such as regenerative agriculture, vegetal proteins development, reduced water use and pollution, as well as greener and recycled packaging and waste reduction.

Workers' and human rights

Additionally, the integration of social considerations is bound to keep growing as a transversal theme, reflecting regulatory pressure such as the CSRD implementation in Europe as well as the development of due diligence regulations across regions. Both will contribute in our view to a gradual shift from a purely net zero focus to a more holistic perspective, aimed at ensuring that transition efforts are not made at the detriment of the planet and of people.

Scrutiny on workers' rights will span all sectors, particularly in those most affected by a profound change of skills, such as automotive where we are seeing a shift to electric vehicles. It has already triggered costly strikes in this sector especially in the US, illustrating the need to also involve public stakeholders on broader issues such as reskilling or training.

Living wages, working conditions, unionisation and social dialogue are structural issues that have been to some extent overshadowed by climate concerns until recently - but investors are starting to consider these more seriously, as echoed by a growing number of shareholder resolutions at company annual meetings.

Those resolutions do not yet tackle to a large extent the 'just transition' theme, but no doubt we will see more of this in due course.

Reputation risks are more than ever prone to translate into stock market risks, raising corporate spreads, now that we appear to be at the end of easy money.

In the same vein, we believe the focus on human rights will intensify further in 2024. In Europe, a further step was reached in December last year, with a provisional political agreement on the Corporate Sustainability Due Diligence Directive (CSDDD) that requires many companies in the EU and beyond to conduct environmental and human rights due diligence on their global operations and value chain.

While CSDDD still needs to be transposed into national legislations, there is no doubt the threat of financial sanctions (up to 5% of a company's global turnover) will be a strong incentive for companies to act. As of July 2023, a study by MSCI estimated that approximately 78% of the MSCI All Country World Index (by market capitalisation) was subject to at least one already enacted modern slavery-related regulation. [9]

We believe this means an increased need for qualitative assessment of the materiality of risks, in terms of economic activities and geographies. Data providers assessing compliance with international norms and standards can help investors to screen exposures and exclude obvious infringers in the field of human rights. However, data does not provide a qualitative review of controversies and of what is at stake. Ultimately, investors will have to take their own view around the severity of the cases, the red lines they have and ultimately, the need to exclude or engage.

We urge companies to demonstrate concrete evidence of how they address these topics, beyond merely stating they have codes of conduct or grievance mechanisms and instead show what they are doing on the ground to prevent, alleviate and remedy those risks. Technology giants will not be immune and will be facing increasing scrutiny into their practises as artificial intelligence further develops.

Shifting the lens

Although many uncertainties remain for 2024, from economic growth to the outcome of political elections (especially in the US) and prominence of geopolitics, one thing is clear - appreciating the full dimension of the transition is becoming a must, shifting the lens from a climate-only focus to a more holistic perspective including nature, biodiversity and people.

On that basis, engagement quality and effective impact are set to be equally scrutinised, as investors increasingly turn their focus away from simply net zero to a more holistic approach.

Finally, as the interplay between climate and biodiversity has been further elevated at COP28, we note Norway's 9 January announcement, which saw it become the first country globally to pass a bill to move forward with deep sea mining in Norwegian waters.[10]

Although the Norwegian government said it was being cautious and would only begin issuing licences once further environmental studies were carried out in order to apply the highest level of standards, the move is clearly at odds with the growing attention paid to the role of oceans in the fight against climate change and extreme weather episodes.

It is one thing pursuing the production of oil and gas given the world cannot do otherwise at this stage, but it is a different story opening another whole industry that by essence can only trigger a huge impact on an ecosystem we do not yet fully understand.

[1] MSCI as at 29 December 2023
[2] Research and Insights | AXA IM Core (axa-im.com)
[3] Research insight, How ESG Risk Management can impact Security Risk, MSCI, April 2023
[4] ETS 2: buildings, road transport and additional sectors - European Commission (europa.eu)
[5] Top10_biodiversity-impact_ranking.pdf (financeforbiodiversity.org)
[6] Nations agree to end plastic pollution | United Nations
[7] Kunming-Montreal Global Biodiversity Framework | UNEP - UN Environment Programme
[8] STATEMENT: 134 Countries Sign the Emirates Declaration on Sustainable Agriculture and Put Food High on the Climate Agenda at COP28 | World Resources Institute (wri.org)
[9] Forced Labor in Supply Chains: navigating the New Risk Landscape, October 2023
[10] Norway parliament approves highly controversial deep sea mining | CNN

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