Impact Cubed

EU TAXONOMY: AN ESG RED HERRING

If you've been following the European Union's sustainability efforts over the past 12 months, you're probably aware of the tussle over the bloc's green finance taxonomy.

Plenty of ink has been spilled on the virtues and pitfalls of the taxonomy – which defines what the EU considers a "green" investment. One of the biggest debates has focused on whether natural gas and nuclear should be included. The EU commission has now recommended including both in the green taxonomy and while it still can be turned down by EU Council or EU parliament, it looks unlikely.

Why would natural gas – a fossil fuel – be included in a green taxonomy? A lot of it has to do with stakeholders lobbying it should form a role as a "transition fuel". It's a lower emitting energy source than coal, the argument goes, meaning, while not ideal, its inclusion could help reduce carbon emissions until more renewables adoption is possible.

This whole green debate is a red herring. What it demonstrates is that any taxonomy, sustainable standard or green label is subjective. As such, they can be influenced by lobbying and outside opinion –from governments, industry interest groups or even the general public.

There is a relevant comparison here with ESG Ratings for investment products. As our own research and media reports have noted, subjective, opaquely constructed ESG Ratings don't offer any insight for investors on how their capital is contributing to more sustainable economies. Ultimately, investors want to know their money is making an impact, not whether their fund of choice has met someone else's requirement.

For example, our research on passive ESG funds shows:

- Despite the talk about ESG protecting investors' from the fiduciary risk of climate change, some passive funds marketed as ESG actually have higher carbon intensity than the market benchmark.

- Many of the passive ESG funds do well avoiding harmful products and services, but very few beat the benchmark on achieving good. For example, the market benchmark has more exposure to environmental solutions than most of the passive ESG funds we analyzed.

ESG labelling is also of limited value when fin-tech platforms are able to gather, sift, and report objective data on thousands of securities. And this data can be viewed at face value rather than being amalgamated for the sake of defining whether a security is "good" or "bad".

For example, a low-emitting company may be able to hide the fact its core product carries a public health risk if all data points aren't taken into account. See tobacco stocks, for example, some of which have made their way into highly rated ESG funds.

The conversation surrounding the EU's green taxonomy should also be seen as evidence that universal ESG standards – if they ever even arrive – are not a panacea. Unless everyone is using the same data and dismissing the influence of any outside interest, these standards will be skewed.

Anyone can define what's green. When the data is available, let's use it rather than following someone else's interpretation.

ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customised sustainable investing.

You can find out more about our data and portfolio models at www.impact-cubed.com and if you would like to contact us at info@impact-cubed.com we would be happy to hear from you.