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TRANSCRIPT

Windy ESG Labels

Featuring:

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Mike Disabato: What's up everyone and welcome to the weekly edition of ESG Now, where we cover how the environment, our society, and corporate governance effects and are affected by our economy. I'm your host, Mike Disabato. And this week we have two stories for you. First, we examine the routine, but intense scrutiny regulators are giving fund managers of ESG funds. And then we give you an update on the wind energy industry. Thanks as always for joining us, stay tuned.

Most people are exposed to ESG through the funds they invest in. We have all this data, all these ratings, all these metrics that can be used to profile the impact of an ESG risk factor on an individual company. But most of that sort of data are used by institutional investors that have consultants help create financial products and have a lot of assets under management. Whereas the average person also called retail investors, retail investors encounter ESG through the funds in their individual investment accounts, like a retirement account, like a 401k account. Where institutional investors have the tools to decide what they want to use ESG data for and create a fund that accomplishes that, retail investors choose a fund someone has already created and have to trust that it's doing what it says it's doing. The fund on the label is extremely important, especially for ESG funds.

Think of this like you think of food labels. If you buy a can of all-natural soup, you want it to have things like vegetables, broth, maybe some nice protein. You don't want to find out it's full of sugar and artificial flavorings that aren't listed on the food label. Same with ESG, if something says ESG is on it, I as a retail investor need to be able to trust that this fund incorporates ESG analysis into its investment process. I don't have the time or resources to disprove that claim if it's out there. But ESG isn't a molecule, it's an acronym and it is left to different subjectivities because of that. Financial market regulators know this and are working to figure out a way to ensure that what is on the ESG E10 matches what is inside. So they're doing what regulators do, they are starting to examine.

The news has reported on some of these examinations that have already been conducted such as the one at BNY Mellon, where the US SEC levied a fine of $1.5 million US because it found BNY Mellon investment advisor did not always perform the ESG quality review that it disclosed using as part of its investment selection process for certain mutual funds that advised. There are some ongoing examinations like the one reported on at Goldman Sachs Asset Management. There's even been one raid that's occurred at DWS in Deutsche Bank in Germany, by around 50 agents of Frankfurt's Public Prosecutor's Office, alongside German market regulator BaFin and the Federal Criminal Police Office of the region over allegations of misleading investors about green investments, the prosecutor said.

These all sound similar, but they're actually very different stories happening in very different regulatory jurisdictions. But what they do signal is the larger movement of regulators imposing more clarity around ESG in the financial markets. And they have their work cut out for them because as my guest and colleague Rumi Mahmood is going to tell you, there are a lot of ESG funds out there that aim to do

a lot of different things, and they will likely be part of a routine, but nonetheless detailed examination into their ESG investment processes by a regulator at some point in time.

Rumi Mahmood: So we estimate that there are just under 1,500 sustainable funds or ESG funds domiciled in the US. And they range quite a bit in scope, from ESG integration where the core objective really is to optimize risk-adjusted returns. And so the ESG is integrated to the extent that such considerations are financially material to the performance of the underlying companies. And then through values alignment where certain sectors or types of companies engaging in certain business activities or controversies are excluded. And then the integration approach can also include things such as various themes. So think of clean energy, clean water, or social and demographic themes, megatrends. Then on the very darker green side of the spectrum, there are funds that specifically have the goal of having a measurable environmental or social impact. So UN SDG-focused funds or Paris-aligned funds, aiming to have an emissions trajectory in line with the Paris Accord. So there really are a spectrum. And as I mentioned so far all these funds have operated in the US, without any real standardized reporting regime, or framework to adhere to.

Mike Disabato: And to be clear, these regulatory crackdowns haven't been due to the holdings these ESG funds have. As Rumi noted, ESG doesn't necessarily mean climate-friendly or socially progressive. It can, but it's not necessary. I can have an ESG fund with Microsoft or MasterCard as my largest holding, as long as that holding was selected using an ESG investment process that is transparent and actually in place. The problem is for retail investor the only way you really get to look into what is actually going on with that investment process is by looking at a fund's prospectus, or the fund's investment statement or an asset manager's statement of ESG and impact investing that is publicly available on their website. But when you look at those documents, they are replete with words like proprietary ESG Dashboard or proprietary ESG Scorecard, or integrated ESG Lens. There's no way to get a deep deep look into those funds, unless you are a large asset owner who employs an institutional investment advisory consultant, who issues what's called a request for proposal or RFP to asset managers, offering them multimillion-dollar investment opportunities that they just fill them out.

And in that RFP, you can ask things like, what specifically is your process for integrating ESG into your investment strategy? What data do you use? What happens when there's a conflict between what the portfolio manager wants to invest in and what the ESG specialist that's on that investment team says is investible. And then the consultant reads that RFP, and then they meet with the fund managers and drill them on the processes and ask to see governing documents that support that process. And then they meet with the analysts that help run the funds. And then they take all this information back to their institutional clients to let them know what's going on. Retail investors cannot do that. So regulators are trying to step into the process and enact some sort of balance. And aside from bringing ESG clarity, that's part of all this, another reason why this matters is because of the fees that investment managers charge for actually running a fund, also called expense ratios.

Expense ratios are often why funds have different share classes. A different share class for the same fund will have different expense ratios. And it's just because of the minimum investment you need to put in that fund to lock in a lower expense ratio. Because what an expense ratio says is, if you get a return of 1% per year from investing in this fund, but it has an expense ratio of 0.85% then at the end of the year, what you're actually getting is a return of 0.15% after the fee has been netted out and given to the investment manager. And the thing with actively managed ESG funds is that on average, they charge higher expense ratios than their non-ESG counterparts.

Rumi Mahmood: So the average active ESG fund domiciled in the US has an expense ratio of around 85 basis points. And that's higher than the average non-ESG active fund, which is at around 70 basis points. So on an asset-weighted basis, ESG funds are more expensive than their non-ESG counterparts.

Mike Disabato: There is a reason for that. For an ESG fund, you need more layers to your investment process if you're doing it right. You need that ESG quality overlay. So you have more people you have to pay, you have more systems you have to buy, more oversights needed. Maybe you're buying ESG data from someone like MSCI ESG Research, I don't know. This made me think about a regulation that came out in 2012 by the Department of Labor, called the 404(a)(5)Disclosure. Look it up. What it did was provide participants in retirement plans with more transparency on the fees they're paying. It was called the Rule to Improve Transparency of Fees and Expenses to Workers in 401(k)-Type Retirement Plans. A catchy name, I know. And I asked Rumi if he thought this might be something similar that the fees will be the first to be impacted by all these different regulators, looking at all these different jurisdictions and all these different types of ESG funds.

Rumi Mahmood: I think the impact of regulatory scrutiny won't be on fees. It will be more on how ESG fund providers and fund managers conduct themselves, how they report. I think down the line, they will probably come to some standardized reporting framework so that everyone reports the same metrics, same units in a apples to apples comparable way. And then that in turn should help for the average retail investor to make more informed decisions.

Mike Disabato: That's the optimistic scenario. If the regulators are sufficiently smart and flexible and their implementation of these regulations matches their good intentions. There are also the unintended consequences of this regulatory push, that the regulations won't reflect the reality and nuance that fund managers are attempting to bring to the market with ESG funds. And instead of bringing more clarity, they create more confusion by asking for say, irrelevant disclosures and thus to press innovation in a burgeoning field. There could also be a fragmentation in regions, where in one jurisdiction funds would have one set of rules that could conflict with another jurisdiction. The EU in US, for example, are already seemingly going down different regulatory paths. But ultimately we're going to have to wait and see how this all turns out. The tracks of regulations cannot be known to a certainty.

Ah, wind energy. In the chaos of these past two years, I almost forgot about it, but the sector is growing. Technological advancement, financial incentives, and policy pushes have changed the wind energy landscape over the past decade and will likely continue to do so in the coming decade. Or so say my two colleagues, Matthew Lee and Nelson Lee, no relation, who recently wrote a report on identifying the wind companies best positioned to benefit from the growing demand for more clean energy. So to find out more about this, I called them up to ask them about the industry as a whole and what they found in their research. So Nelson, let's start with you. What is going on in the wind industry as a whole?

Nelson Lee: So there's been a couple of major things that's happened in the wind industry in the last decade. One, the installed capacity, like how many wind turbines there are out there have quadrupled. There's four times as many wind turbines today as there were back in 2010. So there's much more wind energy on the grid. And then the other dramatic change that's happened is the cost decline in wind prices have dramatically fallen for the price to install a turbine and to get it up and operated. So those two things together have made wind energy one of the most compelling new energy products to put onto the grid.

Mike Disabato: What about the turbine size? I remember that there was this great article in 2018 where it compared the size of what US turbines used to look like back in the day and what they look like now and how some of them are about half the size of the Empire State Building, for example. Are turbine sizes with wind energy also continuing to grow?

Nelson Lee: Yeah, absolutely. So back in 2010 average blade sizes were about 90 feet long. They're pushing a 120, 150 feet right now. And you can stand inside a wind turbine blade and have ample room to move your arms around. So as the blades get longer, the amount of sweep area that the blade sweep increases in size, and the area that the blade sweep basically determine the power output of each individual wind turbine.

Mike Disabato: Okay. Matthew, I want to move to you now. So that's the industry as a whole, it's continuing to grow, it's continuing to advance and that's all being seen by you in this paper. But what about the actual companies that are in this industry and best positioned to benefit from this continued advancement?

Mathew Lee: Yeah. Mike, we thought of it as two groups. So one group are these equipment manufacturers, turbine manufacturers. And so these are the GEs, the Vestas, the Goldwinds of the world. And then the second group, being the utility, or sometimes private energy developers that actually develop and own and operate these wind turbine projects. Because of the complex regulatory environment, as well as the capital intensiveness of the wind industry, especially in light of supply and chain pressures and inflationary environments, think first-mover advantage is what comes to mind. It's going to be a lot harder now to enter and emerge as a leader. So that's why, in this report, we looked to, already has established themselves as a leader in the space. So for the equipment manufacturers, their R&D capabilities through things like their patent data was what we looked at. For developers, we compared their existing wind capacity. See if they've already developed 5 to 10 gigawatts, as well as their planned capacity. Have they already won the rights to develop many contracts in the future, in the short term?

Mike Disabato: Do you have any examples of some of these already established companies that are in play that you looked at?

Mathew Lee: Sure. Yeah. So a couple of utility companies that already have over 10 gigawatts of installed capacity include a couple of Chinese utilities where they tend to be, over 80% of their power generation portfolio is in wind. So these are China Datang Corporation, China Three Gorges Corporation, Longyuan Power. The European utilities also have pretty significant existing wind portfolios, like Iberdrola, EDP, Energias de Portugal, and RWE. They actually are a bit more diversified in their power generation portfolio though. And in all three of these utilities, wind is no greater than 50% of their installed capacity.

Mike Disabato: Okay. This is the last question for either of you. I think a lot of times we talk about renewable energy. We talk about whether or not there's enough installed capacity to help us meet the either 1.5 degree Celsius or 2 degree Celsius cap of warming that the IPCC, the Intergovernmental Panel on Climate Change, or other climate scientists say we need to do in order to stave off catastrophic climate change. Do you see wind energy now as being able to meet those energy demands in the coming years?

Mathew Lee: Well, I think the tricky part is sustaining the rate of growth. So in a net-zero by 2050 scenario, wind energy is meant to provide 16% of total global energy supply. This is using the Network for Greening the Financial Systems scenarios. It's currently 1%, so that's the scale of growth we're talking about here. I think that if you were to linearly project this out, there's about 150 gigawatts of capacity additions you need through 2030 to align with this type of a scenario. And that's one-fifth of our entire global capacity right now every year.

And so in an absolute sense, wind industry growth, definitely I think the prospects are good. So I would look to what I would call complimentary items that need to come along with this for it to be successful. So it is the grid transmission, especially in the US that's really fallen behind compared to Denmark, where on a given day, 90 plus percent of the country is powered by wind, even though they have many islands. Just because they have an interconnected grid. And then batteries are the other big thing to look out for, that can really help with the intermittency of wind and make sure that your supply generated by wind energy to meet the demands of your grid.

Nelson Lee: Yeah. Another strategy is to just overbid the wind. And when you do that, you're going to have too much energy at certain times a day, but that's going to unlock all these opportunities for new businesses to come in and take advantage of that. And one thing that's happening right now is they're doing a lot of pilot projects trying to co-locate wind with hydrogen electrolysis. And so when you have too much wind and the grid can't handle it, then you just convert that wind using electrolysis into hydrogen. And hydrogen has all these potential uses across the economy.

Mathew Lee: And also, I think that's the green hydrogen, one way people are building out green hydrogen opportunities. Where the primary energy input used to create this hydrogen is also renewable so that you're not having as ambitious intensive of a process compared to gray or blue hydrogen.

Mike Disabato: Okay, great. Thank you both so much.

And that's it for the week. I want to thank Rumi and Matthew and Nelson for talking to me about the news with an ESG twist. And I want to thank you so much for listening. I really appreciate it. If you like what you heard, don't forget to rate and review us. That can push us higher up on some podcast lists and more people can find us. And if you like what you heard, don't forget to subscribe, because then you can hear myself or Bentley every week. Have a good rest of the week and talk to you soon.

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