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Green transition on track despite disappointing COP27

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The United Nations climate summit has ended without a major breakthrough on phasing out fossil fuels. While the COP27 conference did produce a commitment to create a new fund to help pay for climate-related damage in more exposed nations, there was little progress in reducing carbon emissions beyond last year's COP26 gathering.

Frans Timmermans, who leads the European Commission's climate initiatives, said that the world was in a "make-or-break decade," adding that the COP27 agreement was "not enough of a step forward."

Despite the lack of significant progress, we continue to expect governments and companies to invest more in the transition to a zero-carbon economy. Governments have made strong capital commitments toward sustainable goals, including the EUR 300bn REPowerEU and the USD 370bn US Inflation Reduction Act. Such initiatives should also be boosted by a heightened focus on the reliability of energy and food supplies due to the war in Ukraine. This too favors increased investment in domestically-generated green energy over globally-traded fossil fuels, as well as on techniques to step up local food production.

Meanwhile, we maintain a positive view on the long-term prospects of companies that provide products and services to address environmental and social challenges.

But going forward, investors need to pay attention to diversification by sector, style, and asset class.

Investors shouldn't neglect value-oriented companies in the sustainability space. Some sustainability-linked themes with exposure to high-growth technologies did poorly in 2022 as investors exited growth oriented sectors in favor of value. We expect volatility among growth companies to continue into 2023. This highlights why investors should ensure portfolio diversification and not neglect more value oriented long-term ideas in the sustainability space. For example, we see numerous value-oriented opportunities in food supply chains, waste management, and recycling.

Focus on sustainability improvers as well as leaders. Having previously outperformed conventional indexes over a number of years, environmental, social, and governance (ESG) leaders underperformed in 2022, mostly due to their relative under-allocation to traditional energy companies. We believe this demonstrates the importance of considering not only ESG leaders, but also ESG improvers—companies that demonstrate consistent improvement on ESG issues that affect their financial performance. At the index level, ESG improver equities have outperformed broad equity markets by nearly 2 percentage points a year over the past five years.

Asset class diversification is also important for a balanced sustainability strategy. Diversification was not only a challenge for sustainability-focused investors in 2022; the high correlations between bonds and equities affected traditionally managed portfolios, too. Nonetheless, we believe diversification across sustainable investing asset classes should help improve risk-adjusted returns. In addition to the opportunities to diversify across equities, we therefore highlight the need to proactively address sustainable fixed income allocations. We see particular opportunity in sustainable bonds—including green, social, sustainability, and sustainability-linked bonds—with shorter tenors and somewhat higher credit risk than benchmark indexes. We think such positioning should result in lower volatility and higher total returns during periods of slower economic growth.

So, while 2022 has been a challenging year, investors should explore strategies to ensure the resilience of sustainable assets within their portfolios.

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