2023 Sustainable & Impact Investing Outlook: Recalibrating the Industry Paradigm

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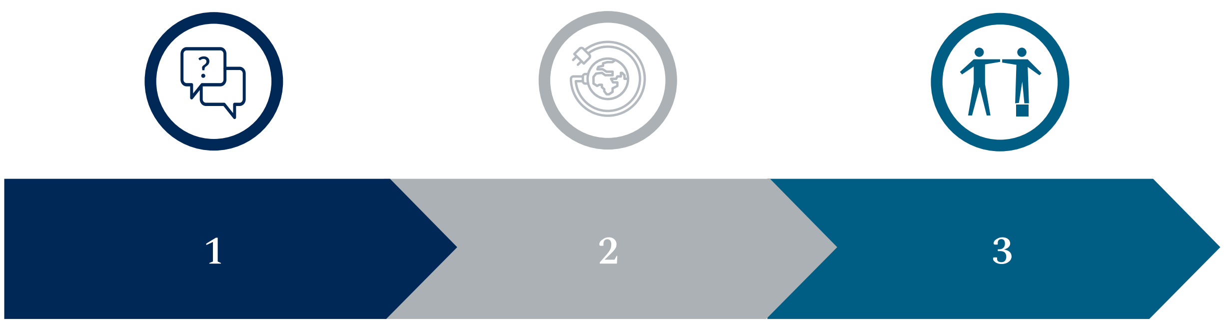
Introduction

Following several years of asset inflows and investor interest in sustainable and impact investing strategies, 2022 represented an industry recalibration. This past year witnessed a slowdown in inflows,[1] driven by a convergence of factors including increased scrutiny by asset owners, media and regulators alongside performance headwinds for some strategies.

In our view, 2023 heralds in a new phase for sustainable and impact investing, characterized by three themes (Figure 1):

- Improved standardization and regulation to further combat greenwashing
- Increased emphasis on building climate-focused portfolios positioned to "invest" over divest to achieve energy security
- A push from mission-aligned organizations to achieve systems-level change through capital.

FIGURE 1: Sustainable and Impact Investor Themes for 2023



Investor Takeaways

ESG: Sham or Savior?

Intensifying scrutiny on ESG may push investors, managers, and regulators **to better define and standardize the industry and intension** with the goal of combatting greenwashing

Climate Change & Energy Resilience

Increasing focus from investors for **corporate commitments to turn into action**, while recognizing the realities of **managing the transition in an era of energy security**

Capital as a Catalyst for Systemic Change

Expanding set of tools and strategies across investment, engagement, and philanthropy **for mission-aligned organizations to address systemic issues**

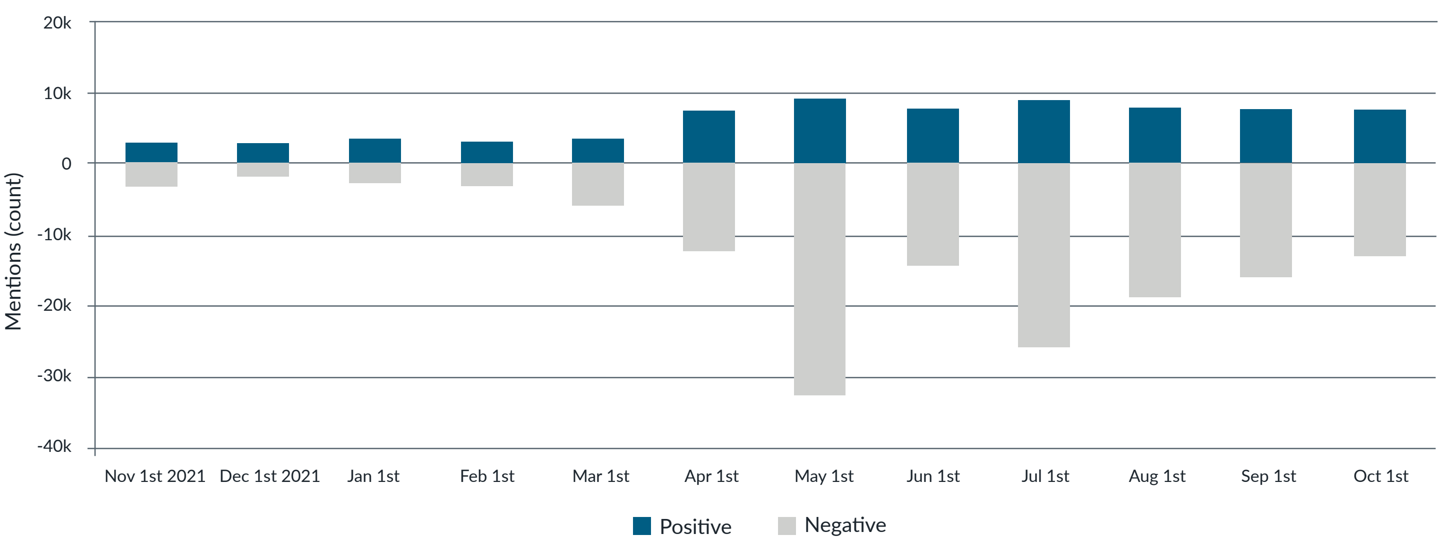
Source: Glenmede

[1] *Morningstar as of December 2022; "Strategies" defined as U.S. "Sustainable" labeled Mutual Funds and ETFs.*

Theme 1: ESG Savior or Sham?

Skepticism around environmental, social and governance (ESG) investing was pervasive in 2022, as we wrote in our September 2022 paper "Has the Sustainable & Impact Investing Industry Reached an Inflection Point?" We raised questions around the discipline's performance merits, ability to produce measurable societal impact, greenwashing and even its political motivations. Over the last year, at least 18 states have proposed or enacted some form of anti-ESG legislation.[2] More broadly, a Pitchbook survey of over 500 financial professionals in October found 50 "highly negative" responses to ESG in 2022 compared with just one highly negative response in the prior survey held in 2020.[3] Further, Manifest Social, tracking publicly available social media data across Twitter, Facebook, TikTok and Snapchat, found that the term "ESG" was associated with negative sentiment 70% of the time in 2022 versus 42% in 2021 (Figure 2).[4]

FIGURE 2: Sentiment across Social Media related to "ESG": November 2021-October 2022



Source: Manifest Social as of November 2022

Skepticism around ESG may be deserved in some cases. For example, there may be a level of mismarketing broadly around what ESG is designed to do: It is not always to "save the world" as some skeptics point out, nor does it have to sacrifice returns to achieve political or personal motivations. ESG data can simply be *information* which can be used to help identify financially material issues when making investment decisions (an "integrated" approach) or to help achieve a societal and environmental impact alongside investment returns (a "mandated" or "thematic" approach). While the media has increasingly positioned ESG data in a binary light, either as a savior able to singlehandedly cure the world of its intractable problems, or a sham serving as a marketing tool without real material consequence, ESG data is merely an input into complex investment frameworks, like any quantitative tool.

[2] *"Impact Funds Hit $1 Trillion, Defying Anti-ESG Fallout." Bloomberg. October 7, 2022.*

[3] *"Sustainable Investment Survey shows clear politicization of ESG." Pitchbook. October 8, 2022.*

[4] *Manifest Social, as of October 2022.*

What this means for investors

In 2023, investment managers likely will seek to address how their strategies stand up against greenwashing, driven by asset owner and regulator calls for proof of systemized ESG integration. In 2022, the Securities and Exchange Commission (SEC) issued a proposal seeking increased governance of ESG-related fund labeling, with enhanced disclosures and documentation required for those with "ESG," "Sustainable" or "Impact" in the name of the fund. Should the proposal be approved, investors may see a transition in 2023 into more standardized categorizations of sustainable and impact investing strategies, as defined by forthcoming rules from the SEC that may borrow language from the European Union's (EU's) regulations. Perhaps signaling what may come in the U.S., almost a quarter of ESG or Sustainable labeled funds were stripped of their label in 2022 by the newly issued EU Sustainable Finance Disclosure Regulation.[5]

Wealth managers and consultants will increasingly need to assert their proprietary view of what constitutes a sustainable fund and what standards they're applying in evaluating a fund across a range of criteria. This includes how ESG data is used to identify material risks and opportunities, how ESG analysis is documented and reflected in investment decision-making and how ESG is systemized through a repeatable process.

Finally, the industry may see more reporting on both the financial costs and opportunities related to anti-ESG rhetoric and actions. Following the passage of anti-ESG rules in a number of states, certain municipalities were no longer allowed to invest with certain financial institutions that had publicly signed onto ESG policies as underwriters for municipal bonds. A study by the Wharton School of Business concluded that Texas cities would pay $303-$532 million in interest on bonds,[6] representing an unintended cost on taxpayers and illustrating how such legislation could reduce competition. At the same time, should traditional energy continue to materially outperform other sectors in 2023 as it did in 2022, state regulators may continue to point to fiduciary concerns associated with elevating ESG-related issues, given that some ESG strategies offer a structural underweight to traditional energy. Regardless of the legislative outcome, in a maturing industry of sustainable and impact investing, scrutiny is a healthy check to reduce greenwashing and to better define processes, definitions and potential outcomes.

> "MORE SEASONED INVESTMENT APPROACHES CONTINUE TO FOCUS ON THE ABILITY TO HARNESS ESG DATA TO IDENTIFY SOURCES OF RISK AND ALPHA, WHICH REMAINS AN AREA WHERE INVESTORS CAN CONTINUE TO MINE OPPORTUNITY."

[5] *"'ESG' Stripped From 23% of EU Sustainable Funds in Review." August 18, 2022. Bloomberg.*

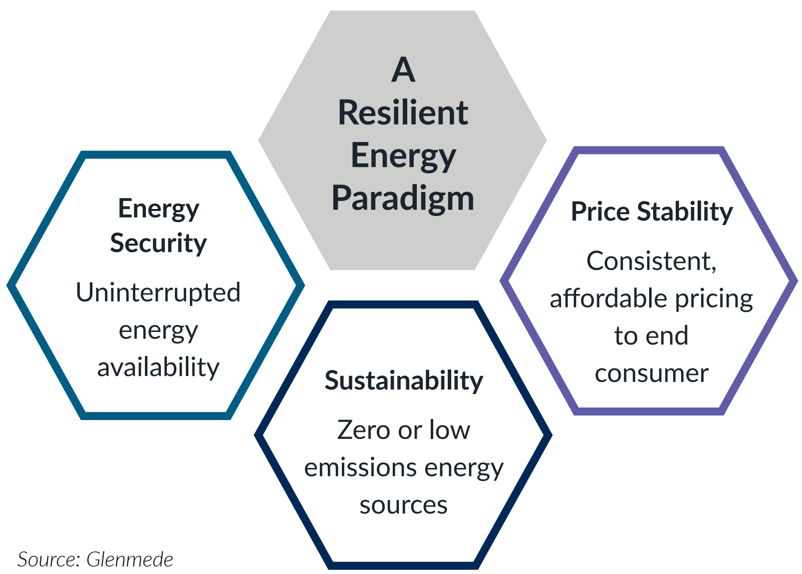
[6] *"Texas Fought Against ESG. Here's What It Cost." July 12, 2022. Knowledge at Wharton. https://knowledge.wharton.upenn.edu/article/texas-fought-against-esg-heres-what-it-cost/.*

Theme 2: Climate Change and Energy Resilience

Russia's invasion of Ukraine and the resulting energy crisis has fueled significant volatility in global energy markets. Drawing some parallels to oil markets in the 1970s,[7] today's energy crisis encompasses a broad range of fossil fuel assets, not just oil, and reverberates globally through households, businesses, and macroeconomic growth in today's interconnected markets. This begs the question: What is the limit to fossil fuel dependence given increasing global emissions, price volatility and geopolitical conflicts? The energy crisis painfully reminds us of the need for a resilient energy paradigm, one delivered by a nexus of energy security, price stability and sustainability (Figure 3). 2023 will likely be an inflection point toward exploring how these synergies will develop in energy markets as well as investment implications for the growing climate investment landscape, moving beyond divestment and into investing in a wide range of solutions.

Moving towards a resilient energy paradigm works in tandem with shifting away from fossil fuel-based energy toward greater renewable energy share. This shift, known broadly as the clean energy transition, is essential in addressing climate change since the burning of fossil fuels for energy use is the largest contributor to global warming.[8] However, the transition itself will not be a smooth one; shifting current global energy generation towards renewables and other technologies requires phased infrastructural changes amidst supply shocks and pricing volatility. Transition fuels — less carbon-intensive energy sources such as natural gas that may substitute for more high-intensive fossil fuels like coal — will likely contribute to bridging clean energy adoption in the short to medium term. Recognizing this tradeoff within the context of today's energy crisis, the EU decided in October 2022 to reclassify gas-fired plants built through 2030 as "green," so long as they replace coal and commits to switch to low-carbon gases such as green hydrogen by 2035.

FIGURE 3



Source: Glenmede

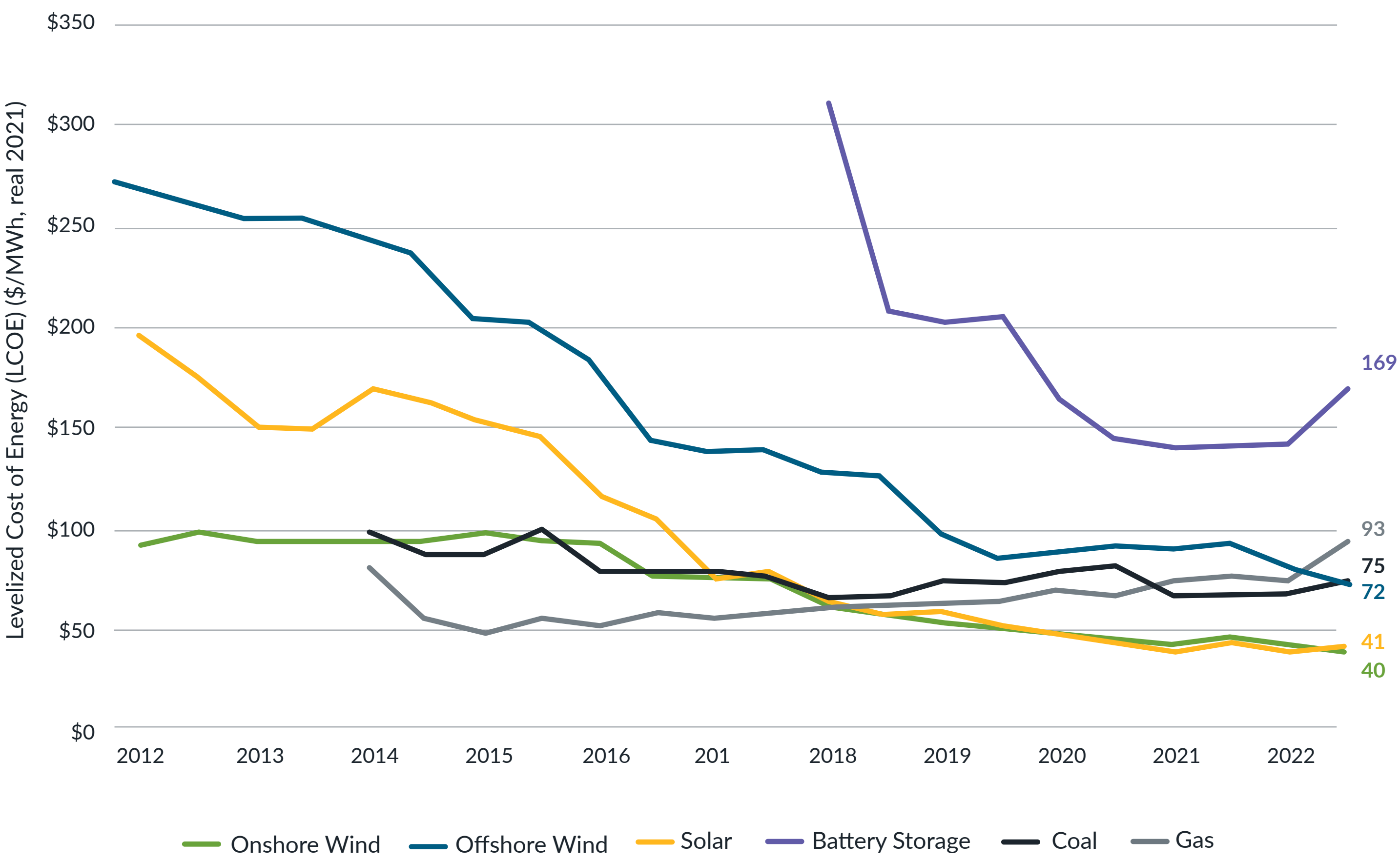
[7] *"Jason Bordoff and Meghan O'Sullivan on Maintaining Energy Supply While Still Hitting Climate-Change Goals." March 26, 2022. The Economist.* https://www.economist.com/by-invitation/jason-bordoff-and-meghan-o-sullivan-on-maintaining-energy-supply/21808312.

[8] *"Energy and the Environment Explained. Where Greenhouse Gases Come From."* https://www.eia.gov/energyexplained/energy-and-the-environment/where-greenhouse-gases-come-from.php.

The future energy sector will thus likely be a mosaic of energy sources, dominated by renewable energies and supplemented by transition fuels and emission-reducing technologies. In the near term, renewable energy share is expected to continue to grow, led by solar and wind which have levelized costs cheaper than fossil fuels in most regions on an unsubsidized basis (Figure 4). Medium- to long-term shifts in energy generation will likely require new technologies in the sector and further clean energy infrastructure buildout. For example, regulation such as the Inflation Reduction Act signed in late 2022 supports the development of new technologies to marginally curb emissions intensity of nonrenewable sources, such as monitoring to prevent methane leakage in natural gas productions. Policy incentives are also targeting longer-term infrastructure needs, such as battery storage, carbon capture and low-carbon fuel alternatives like green hydrogen.

The clean energy transition is also expected to require extensive capital investments. Just considering current government commitments, an estimated $2.7 trillion is expected to be invested in clean energy by 2030. Taken further, an additional $2 trillion would be needed by that same year to reach ambitious net zero emissions goals globally.[9] With this increase in demand, the cost of clean energy has also rapidly decreased in recent years relative to fossil fuel assets (Figure 4). Even among today's inflationary pressures, new-built onshore wind and solar projects are estimated to cost roughly 40% lower than global benchmarks for new coal- and gas-fired power projects.[10] With both increasing demand and decreasing levelized costs of renewable energy, we expect a clear path toward more resilient energy, and accordingly, a robust pipeline of new investment opportunities within the climate investment landscape.

FIGURE 4: Global Levelized Costs of Energy by Source, 2012 - 2022



[9] *International Energy Agency. Annual global energy investment benchmarked against the needs in 2030 in IEA scenarios, 2015-2030, IEA, Paris https://www.iea.org/data-and-statistics/charts/annual-global-energy-investment-benchmarked-against-the-needs-in-2030-in-iea-scenarios-2015-2030, IEA. License: CC BY 4.0.*

[10] *"Cost of New Renewables Temporarily Rises as Inflation Starts to Bite." BloombergNEF. https://about.bnef.com/blog/cost-of-new-renewables-temporarily-rises-as-inflation-starts-to-bite/.*

What this means for investors

Investing in climate solutions is a rapidly changing field; new opportunities are becoming available across the mosaic of energy sources for investors that align with the resilient energy paradigm.

Beyond the energy sector, we believe many investors will also increasingly seek to better understand how companies across their entire portfolio are preparing for the clean energy transition. Public companies continue to face pressure from investors and regulators to enhance corporate climate transition plans, which involves providing a clear roadmap to navigating the transition and disclosing material issues such as greenhouse gas (GHG) reduction targets and planned capital expenditure on decarbonization. Additionally, the SEC's recent proposal to mandate more consistent disclosure of GHG emissions and corporate commitments, if finalized, would further enhance investors' ability to evaluate companies more consistently across sectors. Finally, we expect active ownership on transition planning and other climate-related issues to increase and be an additional lever to help further drive corporate behavior.

Theme 3: Capital as a Catalyst for Systemic Change

Last year gave us a series of unprecedented events, including the aftermath of the COVID-19 pandemic, challenges to democracy and increasingly extreme weather events from climate change. These events have caused undue strain to systems already riddled with widening income disparities and environmental degradation. Looking to 2023, a growing movement in sustainable and impact investing likely will be to invest in systemic change, which focuses on addressing the causes rather than symptoms of these growing inequities by transforming policies, practices, and power dynamics.[11]

Until recently, investing frameworks, advocacy, and philanthropic practices were seen as disparate levers for social and environmental impact, with investors, policymakers and philanthropists largely siloed. However, the rise of active ownership through shareholder advocacy[12] and the advent of innovative financial instruments that draw upon catalytic capital[13] from private and philanthropic sources — often called "blended finance" — have enabled investors to unlock new avenues and pursue greater impact with their investments.

[11] *"About Systems Change." Catalyst 2030. https://catalyst2030.net/what-is-systems-change/.*

[12] *As of mid-July 2022, 813 shareholder proposals were filed in the Russell 3000 and 642 in the S&P 500 – the highest volume in each index in the last five years. A growing number of these proposals are related to environmental and social policies. Source: "Shareholder Voting Trends (2018-2022)." Harvard Law School Forum on Corporate Governance. https://corpgov.law.harvard.edu/2022/11/05/shareholder-voting-trends-2018-2022/.*

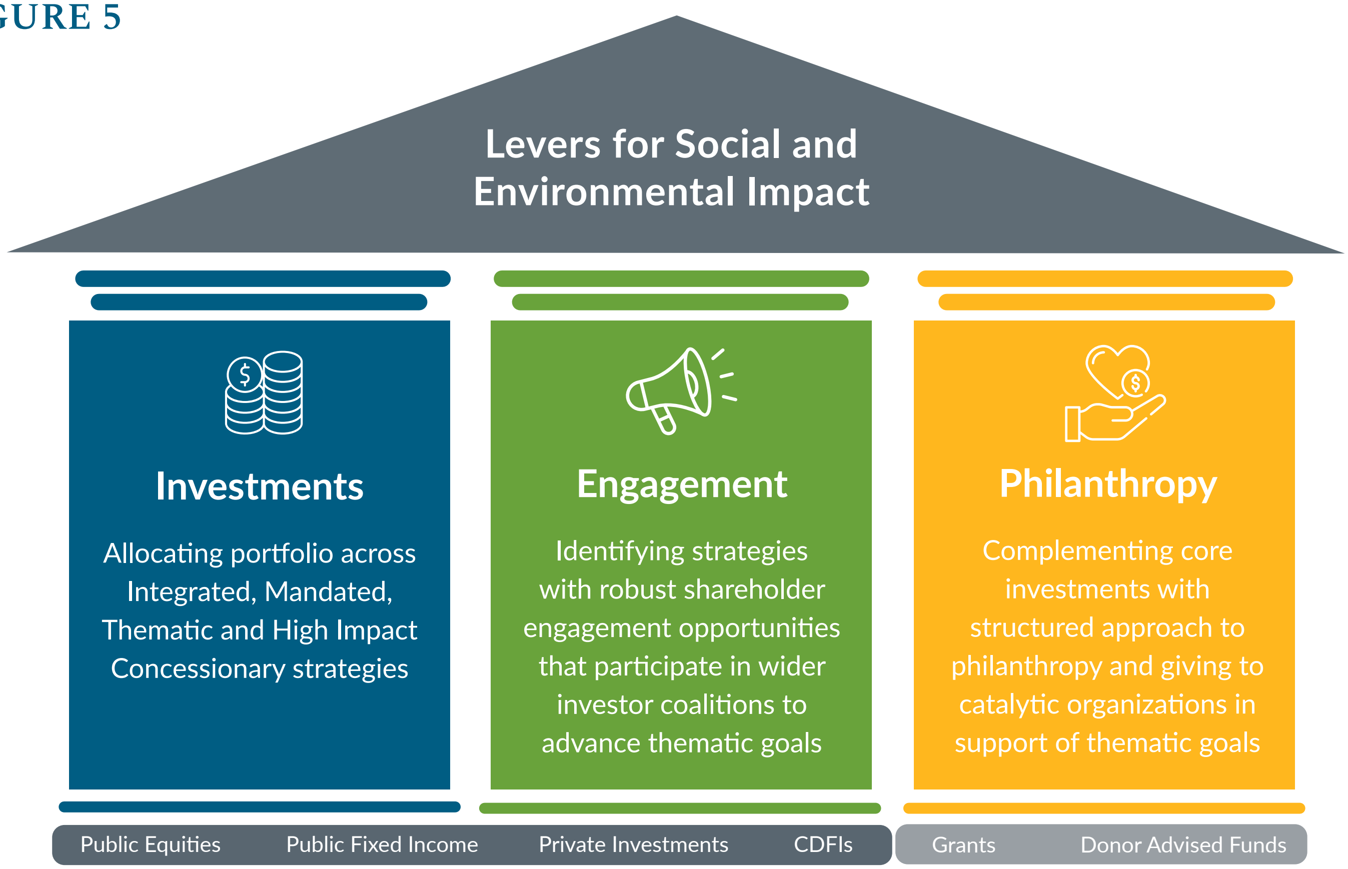
[13] *Catalytic capital refers to mixing the pursuit of financial return-first returns alongside concessionary capital to target greater social and environmental impact. For example, a Community Development Finance Institution can mix private investment and philanthropic funding to offer a loan with a 2-3% coupon for the development of affordable housing or the expansion of a healthcare facility serving predominantly low-income patients. Access and affordability to this capital are critical for high-need communities and thus can have a much greater impact, compared to a loan with a similar level of risk commanding a 6-7% coupon in the traditional marketplace.*

What this means for investors

Investors are increasingly turning to an expanding set of tools and strategies across investments, engagement and philanthropy to address systemic issues (Figure 5). Organizations that holistically leverage all three may be more successful in affecting broader change since they seek to move from one-off investments to affecting transformational impact across social and environmental goals. Investors can factor for systemic impact by considering both positive and negative externalities generated by holdings in their portfolio and thinking about whether those externalities reinforce existing systems that may be detrimental to social or environmental causes.

For example, investors who are conscious of closing racial disparities may consider not only screening out exposure to private prisons and predatory lending — two areas that disproportionately affect communities of color — but also may consider identifying investment strategies that seek to advocate for greater financial inclusion across the banking sector. Using shareholder advocacy, investors may seek strategies that engage multiple tech companies on their use of facial recognition — evidenced to have a significant racial bias against Black Americans[14] — to achieve change in industry-wide practices. Or, an investor may complement strategies targeting risk-adjusted market-rate returns with grants to a business incubator supporting first-time Black founders or make an investment in a Community Development Finance Institution (CDFI) note for an affordable housing development that would otherwise fall short of necessary funding.

FIGURE 5



Source: Glenmede

[14] Najibi, A. "Racial Discrimination in Face Recognition Technology." https://sitn.hms.harvard.edu/flash/2020/racial-discrimination-in-face-recognition-technology/.

Ultimately, the next phase of sustainable and impact investing will likely seek to leverage a varied set of tools to enable transformational change across an entire portfolio. If, as investors, the goal is to contribute to society through improvements to societal wealth and well-being,[15] recognizing the systems-level effect of investment decisions will be critical. Shareholder advocacy and philanthropy can be additive to scaling the impact of our investments and allow for mission-aligned investors to support shaping a more resilient economy. Please reach out to your Glenmede relationship manager to learn more.

Conclusion

Intensifying scrutiny is prompting more enduring standards to encourage enhanced disclosure for those seeking competitive risk-adjusted returns alongside societal and environmental impact. Meanwhile, the current energy crisis reminds sustainable and impact investors of traditional energy's pivotal role in the long-term sustainable energy transition and the importance of taking a diversified approach to building climate-aware portfolios. Investors will have the opportunity to leverage capital through their investments, advocacy and philanthropy to shape a more resilient economy.

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[15] *Future of Sustainability in Investment Management: From Ideas to Reality." CFA Institute®. https://www.cfainstitute.org/-/media/documents/survey/future-of-sustainability.pdf.*