# The Role of Private Markets in ESG


Philip Ng

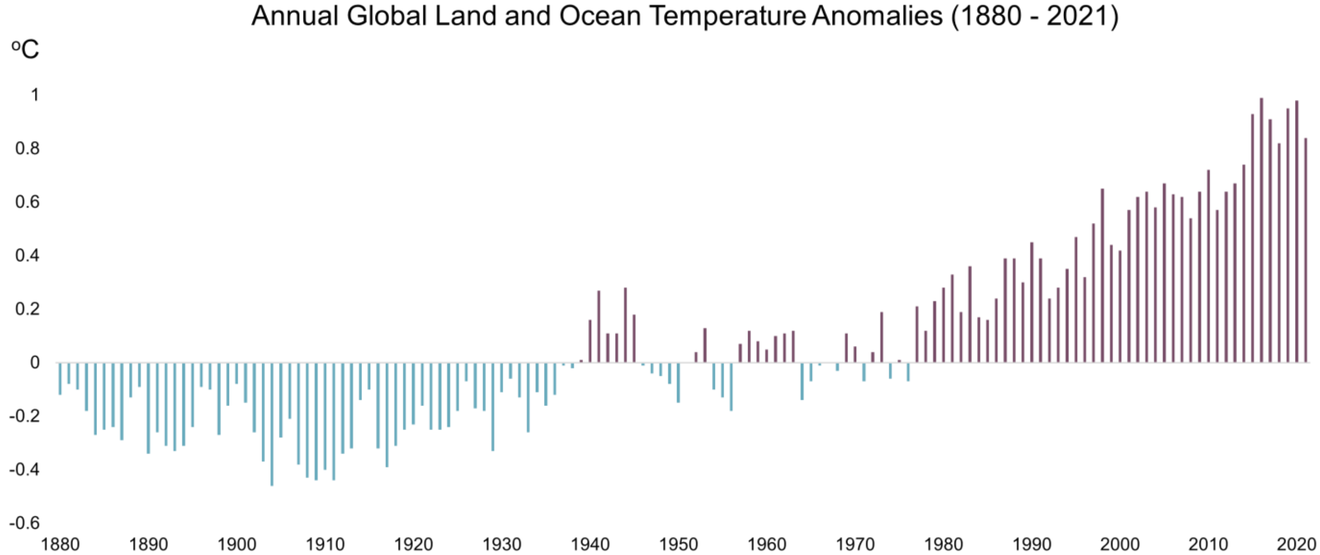
Managing Director
Petiole Management
(Hong Kong) Limited


In a recent survey of over 450 professionals, including asset managers, institutional investors, consultants, and wealth advisors, 40% said Environmental, Social and Governance (ESG) efforts had a high impact on their asset flows.[1] And for a good reason.

The latest UN Climate Change Conference, known as COP26, held in Glasgow last November, resulted in a new global agreement The Glasgow Climate Pact, which aims to reduce the worst impacts of climate change.[2]

More recently, the Intergovernmental Panel on Climate Change (IPCC) - the UN body for assessing the science related to climate change - warned in March that many of the impacts of global warming are now simply "irreversible".[3] This, among other factors, will drive the investment trend as investor and consumer concerns about ESG factors gather pace.

Annual Global Land and Ocean Temperature Anomalies (1880 - 2021)




Sources: Climate at a Glance | National Centers for Environmental Information (NCEI) (noaa.gov)

# No Need to Sacrifice Returns

There is credible data suggesting portfolios that incorporate ESG concerns perform better over the long term than those that do not. Although past performance is no guide to future returns, studies by Morningstar, for example, paint a consistent picture of outperformance.

Morningstar established a Sustainability Index Family in 2016 and regularly publishes reports on its performance. In 2020, the data provider found that nearly six out of ten sustainable funds had delivered higher returns than equivalent conventional funds over the previous decade. Indeed, a sample of 745 Europe-based sustainable funds showed that the majority of strategies had done better than non-ESG funds over one, three, five and ten years.[4]

Morningstar's latest report covering the US market, published in January 2022, stated that "it paid for investors to be sustainable in 2021, even as energy companies were among the stock market's best performers... Companies that scored the strongest on environmental, social, and governance metrics saw some of the highest returns in 2021." ESG strategies' outperformance in 2021 is notable "given that the best-performing stocks across the market last year by far were oil and gas-focused energy companies — names that don't make it past ESG screens".[5]

# Private Markets and ESG

Investing with ESG goals has made huge inroads into private markets. Last December, Preqin estimated that as much as $3.1 trillion of private capital assets under management could have an ESG focus. That is equivalent to around 36% of the total $8.52 trillion of private capital and alternatives-focused AuM that the data manager tracks around the globe. The figure for private debt is close to 50%. (6)

An increasing number of private asset firms are signing up to the Principles for Responsible Investment (PRI), a United Nations-supported network of investors that works as an avenue to guide partners in implementing ESG principles, as well as serving as a commitment to include ESG in investment decisions and reporting.

Why are private markets well placed to promote the development of ESG concerns? That's because private market investors focus on the long term and seek to create value when they exit. To generate the best possible return, they must build a better business than they bought, which means developing a sustainable business.

Moreover, private market investment managers have a particularly close relationship with business management, so they are effectively positioned to encourage businesses to align themselves with core ESG principles. These managers are increasingly focused on establishing whether a business meets key criteria or whether executives are willing to commit to change before they provide funds. Once invested, they can have a dramatic impact on firms' behavior towards ESG-related targets.

At the same time, regulators are implementing sustainability-related disclosure requirements in the financial services sector. These encourage private equity firms to adopt new methods of monitoring the behavior of the companies in which they invest, and engage with them when improvements are required.

# Challenges

Issues such as "greenwashing", i.e. when a company claims to pursue environment-friendly policies when it is not or exaggerating the impact of those policies, are important in both private and public markets. Given their close engagement with the business, private market investors have the advantage to address this challenge and can exert significant influence over the company's activities and policies.

The lack of quality ESG data also remains a major challenge. However, unlike managers of public assets, many private market managers will already be familiar with obtaining financial data from portfolio companies.

More can always be done, but there is little doubt that private markets are willing to overcome these challenges as ESG factors become an increasingly important driving force in shaping the future of investing.

Petiole is a signatory of PRI, and uses exclusionary screening and positive screening at its core Responsible Investing approaches when making investment decisions while maintaining financial returns.

# Key Takeaways

- Investors across all asset classes are increasingly concerned about ESG factors.
- ESG factors do not necessarily mean sacrificing returns.
- Private markets are in a better position to address these issues than their public counterparts, due to the close ties that limited partners have with businesses.
- We expect ESG issues to play a greater role in private markets in the coming years.

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