WALTER SCOTT

QUARTERLY COMMENTARY

STEWARDSHIP

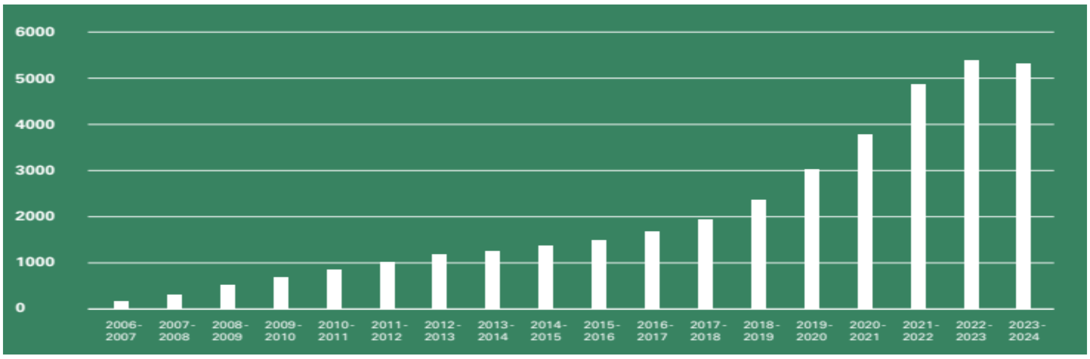
Ending 31 December 2024

COMMENTARY

It's been 20 years now since the then UN Secretary-General Kofi Annan convened a group of institutional investors to establish the Principles for Responsible Investment. Not the humblest of origin stories admittedly, but the growth in the intervening years of this once small network of financial institutions is still remarkable.

The PRI is not guilty of hyperbole when styling itself "the world's leading proponent of responsible investment". Starting out with just over 60 signatories representing US$2 trillion in assets under management, it now boasts over 5,300 representing $128 trillion respectively. If this was a potential investment, those double-digit compound annual growth rates in the years following the Paris Climate Agreement and the launch of the UN Sustainable Development Goals in 2015 might even have piqued the interest of Walter Scott's Research team.

Nice Growth Profile!
PRI has added signatories at an impressive rate



Source: PRI Annual Report 2024, total signatories by financial year.

But despite this impressive backstory, the PRI today finds itself at a juncture. The 'ESG backlash' is challenging the seemingly inexorable rise of 'responsible investing'. In its most recent annual report, the organisation flagged this shift in sentiment as a significant risk, noting the potential for "reduced appetite for investor collaboration and convening, as well as litigation risk arising from anti-ESG actions". Signatory numbers have dropped for the first time. It appears the PRI's mission of facilitating greater understanding of the investment implications of ESG factors and how to integrate them into decision-making is facing serious headwinds.

Talking ESG in Toronto
If there is a cloud hanging over the ESG industry at present, it wasn't immediately obvious when we attended the PRI's flagship 'In Person' event in October. The organisation's convening power remains formidable, with over 1,700 delegates in attendance at the Metro Convention Centre in Toronto. Closer inspection revealed a shift in tone and emphasis from past iterations, however.

With some justification, PRI events have often been likened to echo chambers. Gatherings of like-minded individuals vigorously agreeing with each other. That was less evident in October. While it would be a stretch to claim that any attendees were genuine ESG sceptics, there was a greater plurality of views on key topics than at prior forums. For an industry that rightly champions the merits of cognitive diversity, this should be embraced.

In keeping with the less-uniform tone, some of the more thought-provoking contributions came from speakers challenging conventional industry thinking (and, importantly, backing up their arguments with hard data). Notably compelling was one speaker who argued that committed sustainability-focused investors should remain open-minded about owning mining companies and investing in so-called 'transition mines.'

If the global economy is to decarbonise, vast quantities of minerals will be required to power clean energy technologies, from wind turbines and solar panels to batteries and electric vehicles. Inevitably, this will come with localised social and environmental impacts. Concerned investors, it was argued, should be actively involved in the challenges of how to responsibly develop the more than 300 mines it is estimated will be required to support the energy transition. By refusing to invest in mining companies, they simply exclude their voice from an important debate.

Charting a New Path

Encouragingly, the PRI's proposed 'Progression Pathways' strategy suggests it recognises the need to accommodate a wider spectrum of member views, positions and clients. Soon to go is the old 'one size fits all' approach to tracking and evidencing progress on responsible investment goals. The proposed new, voluntary framework would allow signatories to choose between three differentiated 'pathways' most relevant to their investment approach.

- **Pathway A** – maximising returns by incorporating ESG factors.
- **Pathway B** – maximising returns by incorporating ESG factors and addressing the drivers of sustainability-related financial risks.
- **Pathway C** – meet financial objectives while pursuing positive impact.

We think segmentation along these lines would be a timely and necessary evolution. It would reflect the focus on financial materiality and fiduciary duty at one end of the investment spectrum, and the growth of impact investing at the other. Importantly, the PRI has said there would be no hierarchy between the Pathways and no requirement or inherent expectation for signatories to track towards impact investing over time.

Such a strategy would also, in our view, be a positive development for Walter Scott and our clients. A more bespoke approach would allow us to confidently remain signatories to an initiative which is understandably important to a number of our clients.

Pending further detail, Pathway A in its proposed guise would appear to potentially provide a more streamlined and relevant framework that is well aligned to our core approach, which considers all risk factors, ESG or otherwise, through the lens of financial materiality. We are also likely to be interested in learning from collective efforts to understand and address systemic ESG risks, such as climate, nature and human rights, under Pathway B, wherever such work ties in with long-term financial considerations.

For now, we await further updates on the PRI's plans and continue to study the proposed new methodology and its potential implications for disclosure.

Shelter from the Storm

We left Toronto with the impression that the PRI has been somewhat surprised by the extent of the US ESG backlash of recent years. That said, it has shown a welcome willingness to adapt and appears to be looking to the future with renewed confidence. There is a belief that the Pathways approach will resonate in both a US and international context, while making the group less of a target for anti-ESG attacks. Whether this optimism survives interaction with the new US administration remains to be seen.

Moving into 2025, can the PRI maintain its position as "the world's leading proponent of responsible investment"? We think so. It has the incumbent's advantage, with a global membership and impressive convening power reinforced by its UN-backed origins. The world's list of sustainability challenges is also steadily growing rather than diminishing, ultimately driving engagement from signatories and their underlying clients, such as pension funds.

The heady growth of the past may be over, but with a pragmatic strategy that accommodates and indeed welcomes a diversity of approaches to ESG and responsible investment, the PRI is well-placed to meet the challenges that lie ahead. We believe it can continue to fulfil its original purpose of convening and supporting capital markets to address the world's sustainable development challenges.

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