Opinion **Markets Insight**

Lack of investment rigour risks creating an ESG bubble

A trend of 'demonstration investments' can be counter-productive over the long term

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Ultimately, a successful clean energy transition is one that is cost effective and affordable to all © REUTERS

Dambisa Moyo 9 HOURS AGO

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A wall of money is driving equity valuations to record highs across broad markets, spurred by pandemic stimulus programmes and low interest rates.

Stocks targeted by investors for environmental, social and governance reasons have been particular beneficiaries from the deluge. The pool of assets under management with an ESG mandate is expected to rise to $50tn by 2025, from $35tn last year, according to a survey by Bloomberg Intelligence.

High volumes of capital pursuing environmental initiatives in itself is not a risk — but big fund flows without traditional investment rigour and discipline can damage financial markets by creating price bubbles, and undermine efforts to achieve net zero emissions and a low-carbon future.

In particular, with pressure to invest into the "clean energy" asset class comes the risk that capital is misallocated, as investors prioritise urgent societal imperatives and optics over pure business nous and discipline.

This approach of "demonstration investments" to back environmental causes may be justified in the short term but can be counterproductive in the long term, for several reasons.

First, large, undisciplined financial flows into renewables can lead to mispricing, by inflating the price of assets so the market loses sight of what fair value is.

This distortion in company valuations in turn affects how companies in the sector issue debt and equity, pay dividends, reinvest and pay employees. It can also harm mergers and acquisitions as it increases the risk that companies overpay in transactions.

Already, anecdotal evidence indicates that start-ups at the early fundraising stages are being valued with multiples as high as 15 times revenues. The listed companies that the Renewable Energy Producers Exchange Trades Fund has invested in are valued, including debt, at a steep average multiple of 17 times their reported earnings before interest, tax, depreciation and amortisation, according to advisory firm Finerva.

And just as the market is placing a substantial premium on "renewable" assets, it is also aggressively discounting traditional energy sources. Of the 11 sectors in the S&P 500, only energy and utilities have not yet recovered to pre-pandemic levels.

The US energy sector is trading on a price equivalent to about 13 times the consensus forecast earnings for it over the next 12 months, compared with about 20 times for the broader S&P 500 index members. This perhaps explains why the energy sector represents just 2.3 per cent of the S&P 500 today, down from 11.3 per cent in 2007.

The trend in part reflects how larger investors — such as university endowments and pension funds — are exiting these investments in part to demonstrate their green credentials to their stakeholders.

In essence, new patterns of investment flows are buttressed by a new market doctrine that "everything renewable is great and everything fossil-fuel-related is awful".

As a consequence, disinvestment in conventional energy companies and assets could lower investment in the global energy supply, create shortages and drive inflation up. Essentially, this would worsen living standards and add to the estimated 1bn people who already live in energy poverty.

The surfeit of money can also (inadvertently) hold back innovation, as many investors are neither willing nor incentivised to allocate capital to more innovative areas that would enhance existing energy sources — such as carbon capture.

Innovation is vital if the world is to achieve net zero emissions by 2050, and part of it should be to enhance the sustainability of existing fossil fuels.

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After all, fossil fuels will remain a key component of the global energy equation over the next three decades. According to the IEA, for example, even under its most aggressive energy transition scenario to reach net zero by 2050, fossil fuels will still contribute 20 per cent of global energy in 2050, compared with about 80 per cent today.

In financial terms, if demonstration capital flows continue at pace there is the real prospect of the ESG bubble bursting in much the same way that we have seen similar episodes end in technology and property markets.

Ultimately, a successful clean energy transition is one that is cost effective and affordable to all. It is vital that the trillions of dollars we collectively invest in the transition are subject to the same discipline we apply to any business initiative we hope will survive.

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