# The reckoning of ESG: turning the backlash into opportunity

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4 June 2025

## From niche to overused acronym

The concept of ESG (Environmental, Social, and Governance) has grown phenomenally over the past decade, from a niche idea to a mainstream investment approach. As it gained in popularity, it also quickly became a perceived silver bullet in the financial services industry, oversimplifying complex and multi-layered concepts. The acronym, in bundling broadly unrelated topics, became a catch-all label with no clear definition. Paradoxically, the more the industry and regulators tried to define it, the more fragmented the concept became.

Some in the industry saw it as a golden opportunity, leading to sudden and remarkable growth of ESG-labelled funds. What began as a useful acronym though, quickly turned into an overused and overpromising marketing gimmick, becoming loosely defined and threatening the credibility of the industry.

## The politicisation of ESG

Beyond the greenwashing scandals and regulatory pressure, the lack of clear meaning brought to light obvious contradictions making the concept easy to undermine. Politicians, in the US in particular, saw an opportunity to exploit these trends, quickly turning the acronym into a synonym for woke capitalism, accusing it of prioritising political agendas over shareholder profits and client interests. ESG became a proxy for broader and deeper political and cultural divides within the US.

The political baggage associated with the ESG label has become too heavy, suggesting it might be time to move on. US President Donald Trump's election victory is another blow in a series of setbacks for ESG, and could signal the end of ESG as we know it. Over the past few years, the term has become increasingly contentious. As the backlash intensified, references to ESG have either been scrapped across the industry or swapped for less contentious variants using the "sustainability" term instead. Notably, in June 2023, BlackRock CEO Larry Fink declared he would no longer use the ESG label[1] for being "entirely weaponised". In March this year, the CFA Institute renamed its "Certificate in ESG Investing" to "Sustainable Investing Certificate," dropping the ESG terminology[2].

[1] https://www.reuters.com/business/environment/blackrocks-fink-says-hes-stopped-using-weaponised-term-esg-2023-06-26/

[2] https://www.esgtoday.com/cfa-institute-drops-esg-label-from-esg-investing-certificate/

## The end of ESG?

While the ESG label might slowly disappear, it does not signify the demise of the concept. It is crucial that we do not discard valuable principles along with the terminology. The contradictions of ESG have been exposed and this should be a welcomed evolution. This is a natural course correction rather than a death knell. The backlash is an opportunity to rethink, recalibrate and redefine our approach to integrating sustainability considerations in the investment process. It exposed confusion in the role of asset managers and their responsibilities in meeting their fiduciary duty particularly amid regional differences in its interpretation.

Alex Edmans, a professor of finance at London Business School and leading voice in the investment community, argues in his paper titled "The End of ESG"[3] that we should stop putting ESG on a pedestal and instead integrate it seamlessly into investment analysis as an integral part of long-term value creation. As he succinctly put it: "ESG is both extremely important and nothing special". In a follow-up piece,[4] he proposes renaming the concept to "Rational Sustainability", to strip the name of its political baggage and avoid being caught up in irrational sustainability belief. His proposal tries to address the weaknesses of ESG by providing a well-defined framework recognising, among other things, the importance of financial materiality and adopting an evidence-based approach while also accepting trade-offs when pursuing specific sustainable objectives.

Beyond the label, these debates emphasise the importance of two key considerations for investors: materiality and fiduciary duty.

## Materiality and fiduciary duty

The concept of ESG has often been misunderstood or misrepresented (sometimes deliberately), with critics reducing it to "virtue signalling" rather than recognising its fundamental purpose. At its core, ESG has always been about identifying and managing material long-term risks, whether environmental, social, or governance-related, within a broader investment strategy. It is a tool for assessing long-term risks and opportunities, ensuring they are accounted for when they are relevant. It should not be put on a pedestal, neither on the periphery, but should be systematically considered as part of any long-term investment process.

And one of the key criticisms of ESG—that it conflicts with fiduciary duty—is, in our view, fundamentally flawed. The premise of ESG aligns with fiduciary responsibility, ensuring investors consider all potential risks, including those that are less immediately tangible, such as climate risks.

## Meeting investors' expectations

In the end, the direction of ESG and sustainable investing will be shaped by investor demand. If clients value sustainability and expect their money to be managed with a broader view of risk and impact, asset managers should respond, as their role is the stewardship of their clients' capital. That does not mean taking an overly cautious view that reduces ESG to nothing more than financial risk management. It also does not mean pushing an agenda that goes beyond what investors want. The balance lies in understanding client priorities and ensuring investment strategies reflect those expectations.

The backlash goes beyond the ESG label and extends to the role of asset managers. The recent withdrawals by many asset managers from climate commitments evidences these changing times. Investors are starting to reconsider their public commitments towards sustainability.

With this changing landscape, asset owners might become more vocal about their expectations, and asset managers should respond with clarity about their offerings. For instance, asset managers have started to lose mandates due to their withdrawal from net-zero commitments.[5] This highlights a critical shift: asset managers will need to make strategic choices about their ESG commitments. While this may pose a risk of not appealing to every client, it also presents an opportunity to provide more tailored services and meet specific client expectations. This clarity and alignment can lead to stronger client relationships and better investment outcomes.

[3] https://onlinelibrary.wiley.com/doi/10.1111/fima.12413

[4] https://onlinelibrary.wiley.com/doi/full/10.1111/jacf.12609

[5] https://www.ft.com/content/541c715b-d518-49c3-9838-1cf8d3fb73e5

## An opportunity for improvement

The current backlash against ESG is an opportunity to refine and improve its integration into investment decision-making. By focusing on financial materiality and long-term value creation, we can strip ESG of its political baggage and reframe it as a crucial component of fiduciary duty. This approach not only meets client expectations but also drives better investment outcomes, ensuring that ESG is both extremely important and nothing special.

In conclusion, the backlash against ESG should be seen not as a setback but as a catalyst for progress. By embracing Rational Sustainability and focusing on financial materiality, asset managers can enhance their investment strategies, fulfil their fiduciary duties, and meet the evolving expectations of their clients. This approach ensures that important underlying principles of the ESG label endure, safeguarding and guiding long-term capital through the myriad risks inherent in a complex world.

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