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Environmental, Social, and Corporate Governance (ESG)

Environmental, social, and corporate governance (ESG) is an indexing technique used in business and investing to measure a company's performance across multiple areas of social responsibility. Some sources simplify the term as environmental, social, and governance, eliminating the word "corporate."

ESG criteria track corporate behavior across three broad categories: environmental responsibility, social and community relationship management, and governance standards. These criteria combine to generate an ESG score, which investors can research to source companies whose values align with their own. As of 2021, ESG metrics are voluntary and publicly traded companies are not required to include or report them in their mandatory financial reports or disclosures. However, ESG scores are of increasing interest to institutional and retail investors seeking ethical and socially responsible opportunities.

According to finance industry analysts and experts, investor demand for companies with relatively high ESG scores is growing. They also note that ESG metrics tend to be especially important to younger investors, particularly those from the millennial generation.

Brief History

ESG represents a modern iteration of impact investing, a strategy that seeks to commit capital to opportunities capable of generating significant, quantifiable social and environmental benefits in addition to profits. Impact investing has a history in the United States dating back to the eighteenth century, when Methodists launched organized campaigns to inhibit the flow of money to slave trading, smuggling, liquor, tobacco, and gambling. A recent and more modern example of US impact investing took place in the 1960s, when protesters against US involvement in the Vietnam War (1954–1975) began demanding that universities cease to invest their endowment funds in companies that produce weapons and military equipment.

In 1984, the United States Social Investment Forum (US SIF) was established in Washington, DC as a nonprofit organization. US SIF catalogues information on socially responsible investment opportunities and provides educational resources and programs to individuals and institutions seeking to choose more ethical investments. The organization changed its name to US SIF: The Forum for Sustainable and Responsible Investment in 2011. US SIF holds membership in the Global Sustainable Investment Alliance, an international organization with a similar mandate that operates across multiple regions including the United States, Canada, the United Kingdom, Australia, and the European Union.

The term “ESG” was coined in a 2005 research paper titled “Who Cares Wins,” which was jointly published by the United Nations and the Swiss Federal Department of Foreign Affairs. The paper outlines and describes the framework that now defines the ESG system, placing the ESG methodology at the theoretical epicenter of an evolved global financial system designed to promote sustainability and social responsibility.

Following the paper’s publication, ESG developed into a codified indexing system that generates scores across its three defining categories. Interest in EGS investing soared during the global COVID-19 pandemic as a growing number of investors, especially from younger demographics, turned to the financial markets during the widespread business closures and economic shutdowns prompted by the global health crisis. A 2021 report published by NASDAQ noted that ESG investing surged in 2020; it compared that year to 2019, NASDAQ found that 51 percent more institutional investors and 45 percent more investment fund selectors actively sought ethical and socially responsible investment opportunities.

Overview

As described in the original 2005 “Who Cares Wins” report, ESG indexes evaluate a company’s commitment to sustainable, responsible, and inclusive environmental, social, and governance policies. Analysts evaluate a company’s performance across each of these three main factors, with their aggregates combining to yield an overall score. Investors can then search for exchange traded funds (ETFs), companies, and other investment opportunities in businesses with particularly strong commitments to one, two, or all three ESG principles.

Each ESG category contains a specified set of subfactors, which combine to generate the category score. The environmental category considers five such subfactors: (1) the company’s action to mitigate climate change and its related risks, (2) the amount of toxic byproducts and waste generated by a company’s economic activities, (3) the company’s level of commitment to emerging environmental protection regulations, (4) transparency and accountability with regard to environmental issues, and (5) the company’s activity in emerging markets for sustainability and environmental friendliness.

The social index considers how a business governs its relationships with customers, employees, supply chain partners, and the communities in which they operate. Again, the category considers five particular subfactors: (1) workplace health and safety standards, (2) community relations, (3) management of human rights issues, both within the company and with suppliers and contractors, (4) how it operates in developing countries, and (5) transparency and accountability.

Corporate governance indexing also analyzes five subfactors: (1) leadership and board structure, especially with regard to diversity and inclusion, (2) executive compensation standards, (3) honesty and transparency in accounting and financial disclosure practices, (4) the structure and integrity of internal auditors and auditing committees, and (5) how the company manages bribery and corruption issues.

Notably, ESG investing differs from socially responsible investing (SRI), its conceptual predecessor. Finance and investing experts characterize ESG as a less demanding and more flexible approach than SRI, which actively excluded and eliminated any company with any ties whatsoever to the social or environmental problems an SRI investor sought to solve. For example, an SRI fund might fully exclude any company directly involved with the manufacture or distribution of firearms while an ESG fund might instead analyze all companies involved with firearms manufacturing or distribution, then allocate investment capital only to those with the highest sustainability scores.

Some models consider SRI and ESG to be completely separate concepts. Others include ESG along with impact investing and ethical investing as a subcategory within the SRI framework.

Impact

Despite some efforts by ESG supporters, ESG index scores have not become a standard part of the financial reporting and disclosure standards to which publicly traded companies must abide as of 2021. In 2020, the US Department of Labor issued a ruling on the issue, finding that the only fiduciary duty of those managing company-based retirement plans covered sourcing investments meeting the highest possible financial performance standards. Pro-ESG advocates had been seeking to compel retirement fund managers to consider environmental, social, and corporate governance issues when allocating money to specific investments.

Nevertheless, ESG investing has grown sharply in popularity to become an increasingly high-profile part of the conversation surrounding global financial markets. Beyond the sharp year-over-year growth from 2019 to 2020 reported by NASDAQ, other financial analysts have documented major inflows of capital to ESG-friendly ETFs and companies. According to a 2021 article published by Bloomberg, global private investment in sustainable assets has eclipsed the $35 trillion barrier. Of that money, $25 trillion is committed to ESG-integrated assets. ESG integration, which is sometimes called ESG consideration, requires investors to factor ESG indexing performance into their modeling and decision-making processes.

The vague definition of ESG integration marks a significant point of criticism related to ESG investing. According to critics of ESG systems and standards, fund managers are beholden only to indistinct requirements to “be aware of” ESG principles or “take into account” ESG performance when choosing investments. Notably, the standards do not actively mandate fund managers to prioritize these criteria or select investments based on hard ESG performance data.

The ESG system has also drawn criticism from some economists, including Nobel Prize laureate Milton Friedman. Friedman, considered one of the world’s preeminent neoclassical economic theorists during his long career, voiced strong opposition to ESG standards. According to Friedman’s view, investors and analysts should focus solely on a company’s profits, profit potential, and other financial performance metrics. He argued that corporate social responsibility spending is nonessential and generally achieves little apart from reducing shareholder value.

Financial market observers note that Friedman’s line of thinking does not generally resonate with the values of younger investors. These investors became increasingly active in financial markets during the late 2010s and early 2020s, pushing for higher levels of social responsibility and corporate accountability. In response, a growing number of brokerages, wealth management firms, mutual funds, and robo-advisors have developed

investment products that account for ESG indexing to varying degrees. Supporters of the paradigm continue to work toward making ESG scoring a mandatory aspect of the financial reporting process. In the future, they hope revised, globalized investing standards will make ESG a primary determining factor in capital flow and investment decision-making processes.

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