



What Is ESG Investing?

ESG & Sustainability Transformation

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Environmental, social, and governance (ESG) investing refers to a set of standards for a company's behaviour used by socially conscious investors to screen potential investments. Environmental criteria consider how a company safeguards the environment, including corporate policies addressing climate change. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.

The principles of ESG investing are nothing new. Hundreds of years ago, religious and ethical beliefs influenced investment decisions. Muslims established investments that complied with Sharia law, which included prohibitions on weapons. The first ethical unit trusts in the US and UK were developed by Quakers and Methodists. Today, the growing prominence of corporate social responsibility (CSR) and social sustainability has led to increased investor awareness about ethical participation in the market. ESG investing may have officially entered mainstream investing discourse following the release of the Principles for Responsible Investments (PRI). PRI is a group of contracting investors started in 2006, and supported by the United Nations. The aim is to help investors integrate ESG factors into the investment process. Thus, PRI has established a specific, voluntary, and aspirational set of principles for investors to follow.

As investor interests in ESG grow, so does the number of signatories in PRIs. That is, in 2006, the PRI had 63 signatories commanding \$6.5 trillion in assets under management. In 2021, this number increased to 3826 signatures, controlling \$121.3 trillion.

In addition, the Deloitte Center for Financial Services expects ESG-authorized assets in the United States to account for 50% of all professionally managed investments by 2025. ESG investing can also be known as 'social impact' or 'social responsibility' investing, as it aims to make ethical and impactful investment choices.

So, is it possible to make money from the markets while maintaining a principled stance? ESG proponents certainly believe so.

Once dismissed as a virtuous concept that potentially compromised portfolio returns, ESG investing has moved centre-stage within the global investment arena in recent years. ESG is one of several approaches to investing which is as concerned with its impact on people and the environment as it is with potential financial returns.

At its core, ESG investing is about influencing positive changes in society by being a better investor. - Hank Smith, Head of Investment Strategy of The Haverford Trust Company. Socially responsible investing (SRI) is an investment strategy that highlights this one facet of ESG. SRI investors seek companies that promote ethical and socially conscious themes including diversity, inclusion, community-focus, social justice, and corporate ethics, in addition to fighting against racial, gender, and sexual discrimination.

How Is ESG Investing Different From Sustainable Investing or Impact Investing?

ESG and sustainability are closely related. ESG investing screens companies based on criteria related to being pro-social, environmentally friendly, and with good corporate governance. Together, these features can lead to sustainability. ESG, therefore, looks at



how a company's management and stakeholders make decisions; sustainability considers the impact of those decisions on the world.

Impact investing is the practice of making investments that generate not only financial returns but also positive social and environmental impact—has its origins in religious groups who placed ethical parameters on their portfolios. ESG in investing establishes criteria and indicators to mitigate the risk and ensure sustainability. The screening process ensures to identify potential negative impacts in society and the environment, and provides opportunities to mitigate those risks through a proper management plan.

KEY TAKEAWAYS

- Environmental, social, and governance (ESG) investing is used to screen investments based on corporate policies and to encourage companies to act responsibly.
- Many mutual funds, brokerage firms, and robo-advisors now offer investment products that employ ESG principles.
- ESG investing can also help portfolios avoid holding companies engaged in risky or unethical practices.
- The rapid growth of ESG investment funds in recent years has led to claims that companies have been insincere or misleading in touting their ESG accomplishments.

The ESG Investing Boom

Recent years have seen a significant expansion of ESG investing around the globe as organizations and individuals increasingly recognize the interdependencies between social, environmental, and economic issues. The COVID-19 pandemic encouraged this trend notably. Market disruption and uncertainty caused by the pandemic in 2020 led many investors to turn to ESG funds for increased resiliency. In fact, the first three months of 2020 saw \$45.6 billion USD flow into these funds globally. \$30.7 trillion currently sits in sustainable investment funds worldwide, and it is predicted this could rise to around \$50 trillion in the next two decades.

More investors are looking to fund organisations and products that support and promote sustainability and comply with emerging regulations such as climate change regulations. This demand has been met with increased action on ESG issues in the business world, as well as progressively higher returns on investment for ESG funds due to their resilience against conventional market disruptions. Portfolios incorporating ESG and sustainability also frequently perform better in the long-term than those that don't. For example, US financial services firm Morningstar found that over a period of 10 years, 80% of blend equity funds investing sustainably outperform traditional funds. They also found that 77% of ESG funds that existed 10 years ago have survived, compared with 46% of traditional funds.

This boom in ESG investing can be attributed to a range of factors. As supply chains become more complex, there is a wider awareness of social, labour, and human rights issues and risks for the business world. Growing concern for environmental issues such as climate change also influences investor decisions. The heightened engagement of groups previously less involved in traditional investing—particularly young people and women—is also thought to have contributed to the ESG investing boom. To reflect these evolving societal values and norms, it is important that organizations adopt forward looking ESG practices if they want to remain competitors in their industry and contribute to the common good.

Industries that are slow to uptake these changes receive increasing criticism and pressure from stakeholders, investors, and concerned citizens alike. Legal obligations are also



expected to progressively tighten for these industries. In May 2021, a Dutch court ruled that Royal Dutch Shell cut greenhouse gas emissions by 45% by 2030. In the same week, ExxonMobil and Chevron faced pressure from their shareholders to reduce the companies' contributions to climate change. It is likely these events will spark further transformations within these industries.

What Does ESG Mean for a Business?

Adopting ESG principles means that corporate strategy focuses on the three pillars of the environment, social, and governance. This means taking measures to lower pollution, CO2 output, and reduce waste. It also means having a diverse and inclusive workforce, at the entry-level and all the way up to the board of directors. ESG may be costly and time-consuming to undertake but can also be rewarding into the future for those who carry it through.

How ESG Investing Works

Investors have, in recent years, shown interest in putting their money where their values are. An ESG strategy can help companies look better to their clients and investors. This is a key factor in staying competitive and relevant within their industries. Research by Charles Stanley found that up to half (48%) of investors are looking to increase their ESG investments within the next three years.

As a result, brokerage firms and mutual fund companies have started offering exchange traded funds (ETFs) and other financial products that follow ESG investing strategies. Robo-advisors including Betterment and Wealth front have promoted these ESG-themed offerings to younger investors.

ESG investors are also increasingly informing the investment choices of large institutional investors such as public pension funds. According to an industry report from US SIF Foundation, investors held \$17.1 trillion in assets chosen according to ESG principles in 2020, up from \$12 trillion just two years earlier. ESG-specific mutual funds and ETFs also reached a record \$400 billion in AUM in 2021, up 33% from the year before - and are expected to continue to grow rapidly in the coming years.

Many ESG investors are willing to make that trade-off, though; according to a recent survey of Investopedia and Treehugger readers, nearly half of ESG investors said they'd be willing to take a 10% loss over a five-year period to invest in a company that "aligns exceptionally against ESG standards." But 74% of respondents said that valuation/price was "very or extremely important to them." This indicates that the average ESG-friendly investment trades at a premium, making it a relatively more expensive investment style.

According to the CBI, two-thirds of investors take ESG factors into account when investing in a company meaning ESG has the potential to grow your business while benefiting the environment and community.

Investors are now more commonly seeing ESG strategies as a "need to have" rather than a "nice to have" in order to protect and future-proof their investments. Even for SMEs who are considering reporting on ESG for the very first time, seeking advice from an audit professional is recommended, preferably one that has already a good understanding of the business and its market, and in particular, appropriate technology is required in data processing in the report.



SMEs that prioritise ESG today are putting themselves in a better position to penetrate new markets, expand existing ones, and ensure their stable, long-term success. So they shine to stand out from the crowd.

ESG Criteria

Investment firms following ESG investing often set their own priorities. For example, Boston-based Trillium Asset Management, with \$5.6 billion under management as of December 2021, uses a variety of ESG factors to help identify companies positioned for strong long-term performance.

The criteria are set by analysts who identify the relevant issues facing specific sectors, industries, and companies. Trillium's ESG criteria preclude investments in the following:

- Companies that operate in higher-risk areas or have exposure to coal or hard rock mining, nuclear or coal power, private prisons, agricultural biotechnology, tobacco, tar sands, or weapons and firearms.
- Companies involved in major or recent controversies over human rights, animal welfare, environmental concerns, governance issues, or product safety.

In contrast, Trillium looks for investments meeting the following ESG criteria:

Environment

- Publishes a carbon or ESG/ sustainability report.
- Limits harmful pollutants and chemicals.
- Seeks to lower greenhouse gas emissions and CO2 footprint.
- Uses renewable energy sources.
- Reduces waste.

Social

- Operates an ethical supply chain.
- Avoids overseas labour that may have questionable workplace safety or employ child labour.
- Supports LGBTQ+ rights and encourages all forms of diversity.
- Has policies to protect against sexual misconduct.
- Pays fair (living) wages.

Governance

- Embraces diversity on the board of directors.
- Embraces corporate transparency.
- Someone other than the CEO is the chair of the board.
- Staggers board elections.

Pros of ESG Investing

Some have argued that, in addition to their social value, ESG criteria can help investors avoid the blowups that occur when companies operating in a risky or unethical manner are ultimately held accountable for its consequences. Examples include BP's (BP) 2010 Gulf of Mexico oil spill and Volkswagen's emissions scandal, which rocked the companies' stock prices and cost them billions of dollars.

As ESG-minded business practices gain more traction, investment firms are increasingly tracking their performance. Financial services companies such as JPMorgan Chase (JPM),



Wells Fargo (WFC), and Goldman Sachs (GS) have published annual reports that extensively review their ESG approaches and the bottom-line results.

The rising profile of ESG has also been plainly evident in investments, even while the rate of new investments has recently been falling. Inflows into sustainable funds, for example, rose from \$5 billion in 2018 to more than \$50 billion in 2020—and then to nearly \$70 billion in 2021; these funds gained \$87 billion of net new money in the first quarter of 2022, followed by \$33 billion in the second quarter. Midway through 2022, global sustainable assets are about \$2.5 trillion. This represents a 13.3% fall from the end of Q1 2022 but is less than the 14.6 % decline over the same period for the broader market.

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An ESG strategy can demonstrate that the company is reducing risks such as adapting manufacturing processes to meet future environmental legislation which could make the business a good bet for longer-term growth.

With ESG as an important component for business growth, it can pay to understand what ESG is, where your business can adopt its principles and approaches, and how it can benefit your organisation.

The ultimate value of ESG investing will depend on whether they encourage companies to drive real change for the common good, or merely check boxes and publish reports. That, in turn, will depend on whether the investment flows follow ESG tenets that are realistic, measurable, and actionable.

Cons of ESG Investing

The downside of ESG investing is that you will not be able to hold the full universe of stocks available in the market. After all, tobacco, and defense, two industries avoided by many ESG investors, have historically produced well-above-average market returns and can buck recessionary trends. In other words, U.S. investors may be sacrificing a small amount of returns in exchange for making investments that fit their values.

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How Do I Know Which Investments Are ESG?

Several financial firms have come out with ESG ratings and scoring systems in recent years. For instance, MSCI has come out with a ratings scheme covering more than 8,500 companies around the world, giving them scores and letter grades based on their compliance with ESG standards and initiatives. Several other companies like Morningstar have also released ESG scores for publicly-traded companies.

The Bottom Line



ESG investing focuses on companies that follow positive environmental, social, and governance principles. Today, investors are increasingly eager to align their portfolios with ESG-related companies and fund providers, making it an exciting area of growth that also has positive effects on society and the environment. Whether or not ESG investing is right for you depends on whether you want to combine your values with your investments. From there, you can look to one or more of several ESG rating systems that have appeared in the past few years to build the right portfolio or consider an ESG tailored ETF or mutual fund.

To learn more about ESG and sustainability-related models, don't hesitate to contact [**YTT Consulting!**](mailto:info@ytt-consulting.com)

