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What's Your ESP on ESG?

By James P. Freeman

"Behind every stock is a company. Find out what it's doing." -- Peter Lynch (legendary investor)

As President Biden's administration takes shape, it is likely that -- as global climate disruption and other environmental issues take center stage -- you will hear more and more about Environmental, Social, and Governance investing or "ESG." ESG is a form of so-called responsible investing that integrates largely non-financial factors into investment decision-making, with the hope that it will lead to better investment outcomes as well as "saving the planet." While ESG is emerging from the fringes of the investment ecosystem, there is widespread debate about it being financially sound. Still, ESG is the hottest trend in investing today.

Fidelity Investments defines ESG investing as the "evaluation and analysis of factors that impact a company's sustainability and long-term value."

The phrase ESG was reportedly first coined in 2004. In June of that year, a group of 20 international financial institutions (including Goldman Sachs and Morgan Stanley) published and publicly endorsed a report facilitated by the UN Global Compact entitled "Who Cares Wins: Connecting Financial Markets to a Changing World." It was part of the *Who Cares Wins* initiative led by the United Nations. The recommendations by the financial industry sought to "better integrate environmental, social and governance issues in analysis, asset management and securities brokerage."

Since then, growth in ESG investing has been extraordinary.

According to the publication Pensions & Investments (P&I), the value of global assets "applying environmental, social and governance data to drive investment decisions has almost doubled over four years, and more than tripled over eight years, to $40.5 trillion in 2020." Furthermore, P&I reported

in July 2020, there were almost 400 ESG strategies launched in the Morningstar investment universe in 2019, way up from around 160 launches in 2016. Estimates place total ESG investing at a quarter of all financial assets under management around the world. And in December 2020, The Wall Street Journal reported that investors had added a record $27.4 billion to U.S. ESG ETFs alone for the year.

In the institutional-investment arena, the top three holdings of ESG assets by investor type in 2018 were insurance companies, public funds (think government pensions), and the education sector.

ESG-type investing is not new.

In fact, ESG, as an investment philosophy, builds on the Socially Responsible Investment (SRI) strategy that has been around for a much longer time. For instance, one of the earliest iterations of SRI might include Methodists more than 200 years ago protesting investments in companies that made weapons or grew tobacco. Similarly, certain groups protested companies that made Agent Orange and other chemicals being used in the Vietnam War in the 1960s and 1970s. More recently, some consider South Africa's apartheid period to be an inflection point, when activists encouraged divestiture from companies doing business there.

There is a key difference between SRI and ESG. In the past, traditional SRI investing was really focused on *excluding* certain industries or companies because they failed to live up to certain ideals. With ESG, on the other hand, investors focus on *including* companies precisely because of their impressive environmental, social, and governance attributes. Over time, however, greater emphasis is being placed on trying to make ESG investing financially sound -- not just staking out moralistic positions against perceived unethical behaviors.

Notably, ESG is used in different ways and there are no official standards in the financial industry. Nor are ESG metrics commonly part of mandatory financial reporting. But perhaps more challenging, while ESG factors can often be measured (i.e., carbon emissions), assigning them a monetary value can prove difficult (i.e., carbon tax credits).

Exactly what factors go into ESG investing?

Consider some of the following examples, which are by no means exhaustive:

<u>ENVIRONMENTAL</u>:

-Climate Change
-Energy Efficiency
-Deforestation
-Waste Management
-Air & Water Pollution

<u>SOCIAL</u>:

-Data Protection & Privacy
-Community Relations

-Human Capital
-Product Liability
-Customer Satisfaction

GOVERNANCE:

-Board Composition
-Executive Compensation
-Political Contributions
-Lobbying & Business Ethics
-Bribery & Corruption

The governance side of ESG investing is particularly compelling, especially for its growing transparency. For instance, many public companies now address some type of ESG reporting in their annual reports to shareholders. An estimated 85 percent of Standard & Poor's 500 companies publish detailed sustainability reports outlining such efforts. And more and more corporate Websites contain sustainability pages and links.

That corporate America is rationalizing ESG is remarkable, reflecting an evolution in corporate philosophy.

More than 50 years ago, the economist Milton Friedman helped propel "Shareholder Value Theory." The theory held that the primary responsibility of a corporation was to maximize shareholder value. Shareholders were essentially deemed the principal stakeholder (known as "shareholder primacy") in the corporate model. Today, though, it is understood that a corporation has many stakeholders -- employees, community members, vendors -- with each one vying for equal weighting with shareholders. This is a sea-change in thinking.

The Business Roundtable (BRT) -- a trade group of nearly 200 of America's most prominent chief executives -- has led the charge. Recently, BRT has reimagined the role of the corporation; it now professes to embrace a much more expansive role of the corporation: the duty to address the concerns of multiple stakeholders. Friedman in 1970 couldn't have imagined this headline in the September 2019 Fortune magazine cover story: "Profits and Purpose: Can Big Business Have It Both Ways?" In 2021 that means many ways.

Taking it one step further, some argue that ESG is in itself a stakeholder centric theory. How companies treat all their stakeholders, the reasoning goes, will ultimately affect their long-term success or failure.

As might be expected, therefore, ESG analysis -- from an investor standpoint -- has become an increasingly important part of the investment process. Investors are starting to incorporate ESG data to gain a better understanding of the companies they invest in. This is made particularly challenging as there are no formal financial-reporting standards regarding ESG yet. But institutions are working to formalize standards of ESG investing and reporting. Investors are likely to be reading more about the Global Reporting Initiative (GRI), Sustainability Accounting

Standards Board (SASB), and Principles for Responsible Investments (PRI), among other things. One can expect more clarity and consensus to emerge from these concepts.

Last October, The Motley Fool published a guide to ESG investing, perhaps reflecting its increased popularity with individual investors. Accordingly, there are now a number of investment strategies tied to ESG investing. Among them: "Socially Responsible Investing" (SRI), which emphasizes screening out certain companies and industries (such as weapons makers and fossil-fuel companies); "Shareholder activism," which uses such tactics as filing shareholder proposals and speaking directly with corporate executives; "Impact investing," such as boosting sustainable agriculture; and what is known as "Conscious Capitalism," described by The Motley Fool as a "business management strategy that emphasizes aligning the business with stakeholders for shared success."

Just a passing fad?

"Cynics," wrote Georg Kell for forbes.com in 2018, "may argue that responsible investing is just a fad. But a closer look at the forces that have driven the movement over the last 15 years suggest otherwise." He surmised that the intersection of technology with the demand for more transparency, as well as environmental changes, and the sense of empowerment fueled by technology, have created powerful forces driving ESG. Finally, Kell makes this intriguing point: "The rise of ESG investing can also be understood as a proxy for how markets and societies are changing and how concepts of valuation are adapting to these changes."

Others also see ESG becoming much more prominent. Fidelity Investments, for example, believes that the U.S. is still in the "early innings" of ESG investing. Tellingly, Fidelity projects that ESG will become the "new normal" in the next 20 years. Lottie McGurk, writing for esgclarityus.com in January 2021, notes the changing attitudes in the U.S. She reports on the increase of ESG in fund selection and portfolio construction by fund managers and clients alike. Clients are putting more money into ESG strategies, they are spending more time reading about ESG, and are seeking more in-depth ESG reporting.

Women investors are increasingly playing a greater role in personal finance, especially in retirement planning. A 2018 U.S. Trust "Insights on Wealth and Worth" study indicated that women are showing greater interest in ESG investing (49 percent of women review their portfolios for ESG impact, the study found).

Increasingly, investors will want investments that not only align with their values but also perform well, too. After all, for most people, performance is at the crux of any investment decision. And, so, unsurprisingly, there has been much debate about the relationship between ESG and investment performance. ESG investments have shown mixed returns.

Take Morningstar. On March 12, 2019, Dan Lefkovitz, on morningstar.com, concluded that, "An updated and expanded study of Morningstar's 56 unique ESG-screened indexes finds that performance across the range tends to be strong." Back then, 41 of the 56 of Morningstar's ESG indexes outperformed their non-ESG equivalents. But flash forward to 2020 (admittedly a year of market anomalies) and the results were not as consistent. On January 5, 2021, Jeffrey Ptak,

also writing on morningstar.com, showed that, "Funds courting less [ESG] risk beat their benchmark indexes more often, and by larger average margins, than funds courting more ESG risk in 2020." In other words, ESG investing performed worse. Evidently, it remains to be seen whether incorporating ESG helps or hurts returns.

Institutional investors play a big role in ESG investing. Consider the fact public pension funds are the second largest institutional investor in ESG assets, exceeded only by insurance companies. Last October, the Center for Retirement Research at Boston College published a brief on ESG investing and public pensions. Its findings are quite illuminating.

The authors of the brief remind readers that public pension funds have engaged in social investing since the 1970s in response to mandates by some state governments. But only recently, they say, have the plans been arranged to embrace "a new form of investing that incorporates [ESG] factors." Still, they are decidedly negative in their assessment of ESG investing. Their research drew this conclusion: "The evidence suggests, however, that social investing: 1) yields lower returns; and 2) is not effective at achieving social goals."

No matter where you lie on the ESG spectrum right now, you will be hearing more about ESG.

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