INVESTMENTS
& WEALTH MONITOR

*A reprinted article from May/June 2021*

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*By Dambisa Moyo, PhD*

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Much has been written on the investment merits and growth in assets earmarked for environmental, social, and governance (ESG) considerations.

According to Morningstar, demand for ESG investments reached US$1.7 trillion in 2020.[1] Meanwhile, J.P. Morgan estimated that in 2020 the "broadly defined" ESG market was expected to reach $45 trillion in assets under management.[2]

Corporate boards are well aware of the surging appetite for these investments—and are responding across each of the E, S, and G pillars or components. Although discussions about ESG trends often are dominated by the environmental component, corporations are making progress in the equally complex areas of social and governance issues as well.

The following is a boardroom perspective on how corporate boards are navigating the new ESG cultural frontier in concert with the broad shifts of corporate responsibility from financial shareholder primacy to stakeholder capitalism—taking into consideration regulators, employees, and society writ large.

## ENVIRONMENTAL CONSIDERATIONS

There is no doubt that environmental concerns have attracted enormous focus and attention from civil society, regulators, and wider communities.

This has translated to important strides in identifying the key risks around environmental change and, crucially, the development of tools and metrics for corporations and investors to track progress in the space. For example, public policy targets to stabilize the heating of the earth by setting a maximum increase of 2°C from pre-industrial levels. Such explicit policy goals have led boards to consider specific targets for their own companies toward net-zero greenhouse gas emissions.

Additionally, companies are creating tangible and measurable targets for reducing water usage in their operations and also increasing the use of graywater.

From banks and financial institutions, to airlines, technology companies, mining firms, food producers, and consumer goods—environmental concerns are top-of-mind in every sector. In fact, to encourage other businesses to get involved, major global corporations including Microsoft, Nike, Unilever, Starbucks, and Mercedes-Benz have now banded together to launch Transform to Net Zero, a group committed to reaching net-zero carbon emissions.[3]

Microsoft has committed to being carbon negative by 2030, and consumer-goods giant Unilever has committed to achieving net zero across its value chain by 2039; both showing that boards and their companies are making aggressive pledges—going beyond those set by governments.

Across all industries, boards generally think about mitigating climate-change risk by addressing three areas: physical risk (the impact of changing weather patterns on a company's assets, financials, earnings, and reputation); transition risk (including how the transition to a low-carbon economy could disrupt business); and liability risk (the need to assess and mitigate the costs of stakeholder litigation or regulator enforcement). Nevertheless, environmental concerns remain fraught with complex considerations that corporate boards must navigate.

From a boardroom perspective, environmental considerations present at least two challenging issues: timing and striking a balance between risk mitigation and pursuing upside opportunities.

Take, for example, energy-company boards. On timing, these boards need to navigate the expectations of environmental campaigners who demand aggressive action to immediately stop fossil-fuel energy production and energy companies that, at best, see a multi-decade transition from fossil fuels, even with innovation. According to the International Energy Association (IEA), total global energy usage will increase 50 percent by 2050.[4] Although fossil-fuel use is forecast to fall percentage-wise, fossil fuels still will represent two-thirds of all energy sources, falling from 80 percent of global energy consumption in 2018 to 68 percent in 2050. More generally, nonrenewable energy sources such as petroleum, natural gas, coal, and nuclear still will represent 73 percent of the energy supply because absolute use of fossil fuels will rise significantly.

Energy-company boards will have to weigh the trade-off between tackling climate change versus meeting the needs of the 1.5 billion people who currently do not have access to reliable and affordable energy. In practice, boards face the complex task of balancing the transition from their existing fossil-fuel energy portfolios to renewable energy sources while satiating the demand for clean energy for billions of people around the world.

A hyper-accelerated transition toward renewables would risk leaving many without energy because the alternatives do not yet offer the capacity to supply the world on a scalable, cost-effective, and reliable basis. In fact, according to the IEA, as of 2020 renewable energy satisfied only 28 percent of global electricity generation.[5]

There is, to be sure, a belief across the energy sector that addressing climate change is both urgent and important. Although energy companies are making considerable investments in the transition to renewable fuels, calls to defund energy companies also are intensifying, thereby threatening to both destroy economic value and expose billions of people to entrenched energy poverty.

With regard to risk mitigation versus pursuing upside opportunity, boards must encourage companies to manage downside concerns, such as emissions controls and carbon footprints, and drive the search for growth and investment opportunities, particularly as the world economy transitions to an era of greener energy. This means committing real capital and human resources toward innovations in biofuel, battery, geothermal, solar, wind, and cleaner fourth-generation nuclear power.

More must be done, however, because although new investment in clean energy worldwide rose six-fold from 2004 to 2019, the level of U.S. investment ($360 billion) has changed little since 2015.[6]

## SOCIAL CONSIDERATIONS

On the backs of the #MeToo and Black Lives Matter movements, there is no doubt that social considerations—including pay parity, gender equity, racial diversity and inclusion, and worker advocacy—have leaped up board agendas.

Across corporations, boards understand that these issues must be addressed because of changes in public policy and because of the proliferation of public rankings that name and shame company performance (for example, Glassdoor's "Best Places to Work" and *Fortune's* "100 Best Companies to Work For"). Boards also are under immense pressure from investors to respond to social issues. In 2018, for example, the investment firm JANA Partners and the California State Teachers' Retirement System, both major shareholders of Apple, urged the smartphone maker to create ways for parents to restrict children's access to their mobile phones.[7] The groups also pushed for Apple to study the effects of heavy smartphone usage on mental health.

However, boards make their decisions understanding that the reasons to act are to manage their companies' reputations and to enhance their companies' ability to retain and attract employees.

As a result, boards work to address social concerns through well-defined and transparent metrics that incentivize progress. This can include tying increases in senior-manager pay and promotions to meeting social targets and goals.

Over the past five years, I have seen first-hand as a board member that, through their own initiatives or in response to government policy, boards have taken notable action on pay and gender equity by specifically tracking and responding to metrics. These metrics can include minimum living-wage levels for employees, equal pay for the same work across gender and race, and managing compensation as a ratio of the highest paid to the lowest paid in the company.

It is also not uncommon for companies to act ahead of legislation. In 2018, online retailer Amazon set the minimum wage of its employees and temporary workers at $15 per hour, which was more than double the federal minimum wage of $7.25 per hour. Furthermore, Amazon's move came three years ahead of President Joe Biden's proposed 2021 legislation to raise the federal minimum wage to $15 per hour.

In addition to how a company operates, boards also are addressing social concerns through their engagement with professional service providers such as search firms. This includes insisting on diverse candidate slates of women and minorities for open positions.

With the amount of financial capital and human resources at their disposal, boards and the companies they serve also have the scale to be more ambitious in demanding diversity and equity from subcontractors, pension managers, and legal and accounting firms. Increasingly, in my board experience, boards also are requiring host cities where they gather for events and house their headquarters to show that they are making equitable progress in health, education, criminal justice, and employment in their municipalities.

However, social concerns—like environmental concerns—are complex. Boards must constantly push beyond pledges and proclamations on social concerns—which can be seen as being in reaction to a particular event—toward embedding social considerations into the day-to-day operations of their companies.

The death of George Floyd in 2020 was met by monetary pledges toward racial equity and justice initiatives including US$12 million by Google, US$10 million by Goldman Sachs, and US$100 million by Apple. Crucially, boards are going beyond these efforts by instituting more granular efforts that hold specific senior managers such as the chief executive officer (CEO) or chief diversity officer accountable and explicitly tying embedded social targets to compensation.

Boards are pursuing meaningful social change within organizations and not merely throwing money at social problems.

Even so, in their quest to address social concerns, boards must not introduce a culture that alienates certain groups (such as white male employees) or gives the impression that certain groups don't have an opportunity for career progress.

This requires boards to drive a narrative that goes beyond quotas by underscoring the need for meritocracy and encouraging greater transparency, especially in decisions around employee pay and promotion. To do so, boards must insist that positions be advertised and include more panel-based interviewing, which can be less susceptible to individual bias compared with one-on-one interviews.

Finally, although many social issues are cast as articles of faith, corporations that operate in very different cultural and legal jurisdictions also must consider the challenges of establishing a global social agenda. Consider the globe's varying work-ethic standards, including China's 9-9-6 schedule (9 a.m. to 9 p.m., six days a week) or the European Union's directive on a maximum 48-hour work week, which stand in stark contrast to work-life balance standards in many countries.[8] Boards need to be mindful of the work-ethic standards established in the nations where their companies operate.

## GOVERNANCE CONSIDERATIONS

Governance is about addressing how management and boards are refreshed. The importance of diversity in boardrooms and corporations generally is well established. For example, in a 2015 report, "Diversity Matters," McKinsey concluded that companies in the top quartile for gender diversity are 15 percent more likely to have financial returns above their respective national industry averages.[9]

The report also found that companies in the top quartile for racial and ethnic diversity were 35 percent more likely to have financial returns above their respective national industry medians.

Yet in 2019, 15 percent of the 3,000 largest companies in the United States still had no female board members.[10] A *Harvard Business Review* article also revealed that 37 percent of S&P 500 firms did not have any Black board members in 2019 and that Black directors comprised just 4.1 percent of Russell 3000 board members that same year.[11] In the United Kingdom, the 2017 Parker Review into the ethnic diversity on U.K. boards found that only 85 of the 1,050 director positions in the FTSE 100 were held by ethnic minorities.[12] Additionally, the review found that 51 companies of the FTSE 100 also did not have any ethnic minorities on their boards.

In some jurisdictions, public policy has stepped up to mandate change.

In August 2018, California announced a requirement that all companies headquartered in the state must have at least three female board members. This policy follows a long line of similar quota-based approaches in Belgium, France, Germany, Iceland, India, Israel, Italy, Norway, Pakistan, and Spain, all of which have legislated quotas for women on corporate boards of publicly listed companies.

The 2017 Parker Review into ethnic diversity on U.K. boards also proposed that every FTSE 100 board should have at least one director from an ethnic minority background by 2021 and that every FTSE 250 board should do the same by 2024.

Boards already recognize that the key to corporate success in the future will be a more diverse workforce. To achieve this, transparency of recruitment and promotion, in terms of race and gender, as well as experience and expertise, will be critical.

As society pivots from shareholder to stakeholder capitalism, this more diverse approach ensures that senior management will be better equipped to tackle societal changes and navigate the macroeconomic and geopolitical trends that are likely to dominate the business landscape.

For example, boards need to hire business leaders who can ensure governance processes are capable of navigating a more deglobalized world. The risk of a more balkanized world makes it harder to trade goods and services, and to move capital and hire talent across borders. Added to that is the risk of more fractured regulation and the separation of China and U.S.-led internet platforms and reduced power of global institutions such as the United Nations.

Already some of the best-known U.S. companies generate more than half their profits internationally. These include Ford (51 percent), IBM (64 percent), Intel (85 percent), McDonald's (66 percent), and Nike (50 percent). For each of these U.S. companies, and many others, having board members with international backgrounds and an understanding of the specific opportunities, risks, and complexities of operating in a global marketplace is crucial for a company's future success.

One way that boards are improving corporate governance is by including ethical considerations more consistently and explicitly in their decision-making.

The #MeToo movement, estimated to have led to the ouster of more than 400 high-profile executives over 18 months, highlights how ethical considerations have required a more active focus from a board and its company.[13]

Specifically, the scrutiny of personal behavior is resonating in the process of recruiting chief executives—a key mandate of the board. Increasingly, boards are placing greater emphasis on strong ethics when assessing the credentials of CEO candidates, going as far as forcing candidates to attest to reasonable ethical standards that could stand the test of public critique.

The question of ethics also pervades a company's investment decisions. Increasingly boards are requiring that company investment decisions—establishing a mine, drilling a well, or opening a branch—be legal, profitable, and pass a high ethical bar. This matters when investments are in poorer countries and regions where there are many more opportunities for ethical infringements. It is for these reasons that some boards are now adding ethics committees to their board structures. These committees are mandated to evaluate ethical questions and to act as a referee on issues that emerge within the company.

Ultimately, ethical considerations vary according to specific circumstances and must be viewed on a case-by-case basis. Boards therefore benefit from board-based engagement with all manner of stakeholders—regulators, communities, shareholders, customers, and even their own employees—as ethical questions become ever more prominent in society.

The 2021 Edelman Trust Barometer found that 86 percent of respondents agreed that CEOs must speak out on societal challenges such as the coronavirus pandemic, job automation, and local community issues.[14] Sixty-eight percent surveyed also said that CEOs should step in when government fails to fix societal problems.

In short, society expects corporations to act in the wider, public interest.

## SUMMARY

The corporate board's mandate has evolved beyond merely setting company strategy and hiring (and firing) the CEO. ESG is now front and center on board agendas.

Corporate involvement in ESG has increased tremendously over the past decade. Not long ago, companies often engaged in fragmented and piecemeal community donations and employee initiatives. Under the banner of corporate social responsibility, many of these activities were brought together—but remained on the periphery of board agendas.

These issues are now more central in the age of ESG. Environmental, social, and governance considerations are becoming integrated within strategic and operational decision-making. Progress has been rapid, but there is still a long way to go around the development and standardization of metrics to capture ESG considerations across companies and sectors.

In addition to corporate boards, rating agencies, institutional investors, accounting and legal firms, policymakers, and index providers are also now striving to set new standards that monitor corporate ESG activity.

In the years to come, this period of messy experimentation no doubt will yield high-quality metrics that can serve as accepted industry-wide benchmarks. For now, boards remain vigilant in tracking and measuring ESG concerns in these all-important areas, both across time and across industries.

Successful corporations in the future will use ESG as a framework to evaluate downside risk as well as to identify opportunities to grow.

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