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Why ESG Matters

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INVESTMENTS & WEALTH INSTITUTE®

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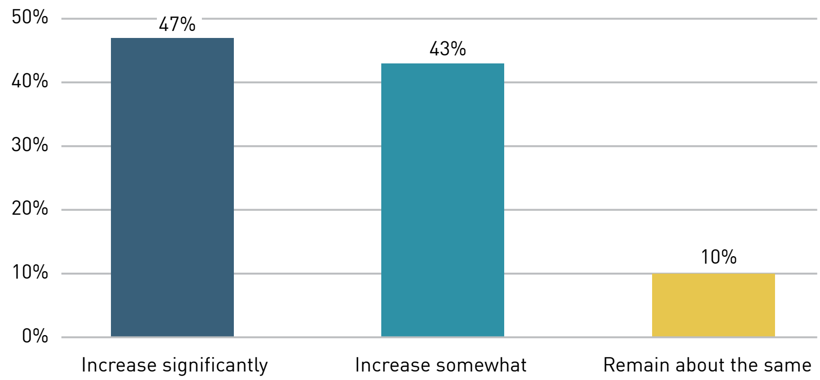
Environmental, social, and governance (ESG) characteristics have become a fundamental concern of investors today. For that reason alone, ESG considerations should be a top-of-mind topic for advisors these days. But will ESG become an impactful motivator of manager behavior? That will depend on regulation and client demand.

In the meantime, advisors need to familiarize themselves with the origins and complexities of ESG investing. When clients ask about ESG—and if yours haven't asked you already, they will very soon—advisors need to be ready to discuss. This is a current affairs topic in the advisory industry, and you need to be current (see figure 1).

Figure 1

ESG PRESSURE

Asset managers say the pressure on ESG issues will ...



Source: IHS Markit survey, Q2 2021

ESG'S ORIGIN STORY

Modern ESG investing is like a river with many historical tributaries. Mosaic law of the Old Testament, Islamic teachings from the Quran, prohibitions on usury, Henry VIII's legalization of commercial lending, 18th-century English and Methodist social movements, and the 20th century's socially responsible investing (SRI) all have embodied "doing good."

ESG investing's early practice merely screened out business activities perceived to harm the environment or society. In the past 50 years, responsible investing has taken on a greater urgency and focus. This period coincided with the rise of mutual funds that owned increasingly large shares of public companies. Beginning with the U.S. civil rights movement and the drive to end apartheid in South Africa, fund managers used their growing clout to enact change in social equality and faith-based investing.

Environmental awareness also came to the fore in the 1960s and 1970s, with regulatory agencies such as the newly founded Environmental Protection Agency working with Congress to pass the Clean Air Act and other key legislation. Chernobyl, Bhopal, and the Exxon Valdez disasters cemented concerns about lasting damage created by corporate and governmental environmental mismanagement.

The Global Financial Crisis (GFC) was a brutal reminder that financial markets run for profit alone, without regard to sound governance principles, can cause havoc in the economy and society. Finally, the coronavirus pandemic and the racial justice movement underlined "S" issues such as racial equity, human capital management, frontline labor, and supply chains.

These historic milestones have contributed to a sense that companies don't exist in a vacuum, but (as one study put it) "there are links between the companies in which we invest and how they (and stakeholders) interact with the environment and society in which they operate."[1]

For a variety of reasons, including a progressive political climate combined with broader debates around fiduciary responsibility, Europe has been a leader in ESG alignment—a decade ahead of the rest of the world. Regardless, fundamental investment analysis generally now includes attention paid to ESG factors.

It's hard to know whether this development is a natural outgrowth of a half-century's experience or a reaction to investor pressure and regulatory scrutiny. This uncertainty has led to skepticism about the value of ESG inputs and outputs. Using terms like ESG, SRI, and impact investing (II) interchangeably adds to the confusion.

SRI tends to identify investments based on ethical standards, II identifies investments that generate direct and measurable positive social or environmental outcomes, and ESG embodies an intersection of risk-adjusted returns and societal values. With technological advances allowing data from such esoteric approaches as geospatial analysis, climate value-at-risk modeling, and natural language processing, ESG signals have become both more exacting and diffuse.

If a quick survey of ESG's history shows anything, it's that assessing financial dealings against environmental impacts and human interest is neither new nor unreasonable. As ESG data and tools develop, our appreciation of that relationship is bound to become more sophisticated.

ESG COMPLEXITIES AND CONTRADICTONS

Any thoughtful discussion of ESG investing, however, requires an acknowledgment of its inherent complexities and contradictions.

For example, consider the Russian invasion of Ukraine through the ESG investing lens. Beyond its humanitarian and geopolitical aspects, this war gives rise to serious ESG conflicts. Europe's reliance on Russian energy, for example, could be lessened by natural gas imports from elsewhere, yet that would mean more drilling elsewhere. Ukraine has begged for—and received—more military weapons, but arms manufacturers are on many ESG-sensitive investors' do-not-buy lists. Can the United States and Europe put aside their negative screens to support Ukrainian defense? Who decides the "good" fights from the "bad" ones?

Just like most current-affairs topics, ESG topics have political and economic consequences. There are disagreements about definitions, methodologies, and metrics, and there is certainly no consensus about financial or philosophical implications.

Yet the breadth and depth of the ESG movement is beyond dispute. Bloomberg estimates that ESG assets will exceed $53 trillion globally by the year 2025 (see figure 2). That's almost 40 percent of a projected $140.5 trillion in assets under management (AUM).

On Main Street, 95 percent of companies on the S&P 500 have detailed public ESG data (per the Center for Audit Quality). On Wall Street (according to Morningstar), ESG labeled mutual funds and exchange-traded funds raised $51 billion in 2020, more than the total previous 11 years.

ESG INVESTING, CLIMATE CHANGE, AND FOSSIL FUELS

In spite of the politics of climate change, the burden of scientific evidence, biodiversity's accelerated decline, and an increase in extreme weather (such as droughts and floods) have compelled global policy makers to largely unite their efforts around decarbonization.

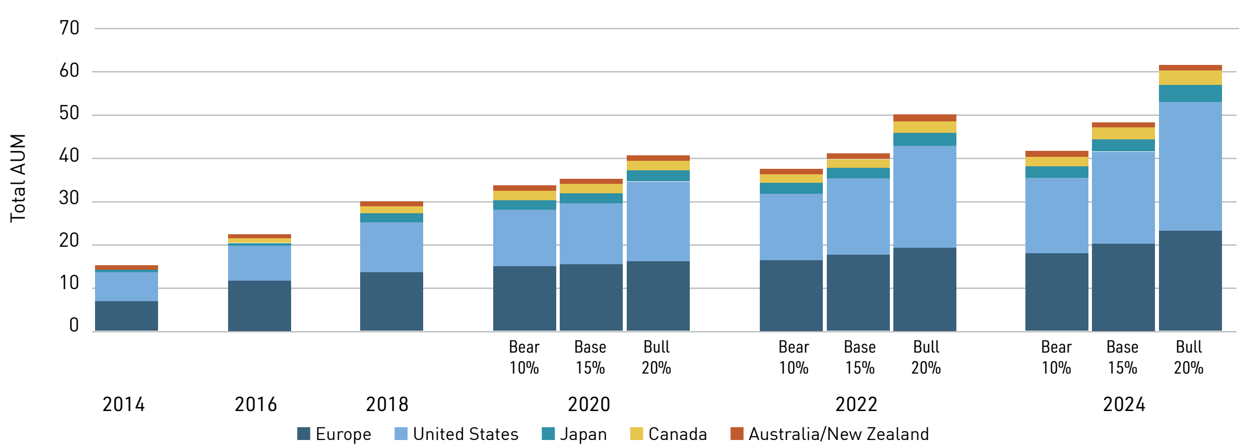
One of the most significant is the Net Zero Asset Managers initiative. It comprises 236 signatories representing $57.5 trillion in AUM who also are aligned with the 2015 Paris Climate Accords. Across countries, municipal, state, and regional governments, and major companies, net-zero targets now represent at least 68 percent of global gross domestic product purchasing power parity and 61 percent of global greenhouse gas emissions.

Achieving these goals will require a galactic shift in how nations employ energy resources. It will require changing from a world where more than 50 percent of energy consumption is based on either coal or oil (see figure 3) to one powered by nuclear, wind, water, solar, and other renewable energy sources.

This transition is complicated by increased capital costs weighing on less-favored fuels. By one estimate, more than half the fossil fuel reserves

Figure 2

ESG GLOBAL PROJECTED AUM BY COUNTRY

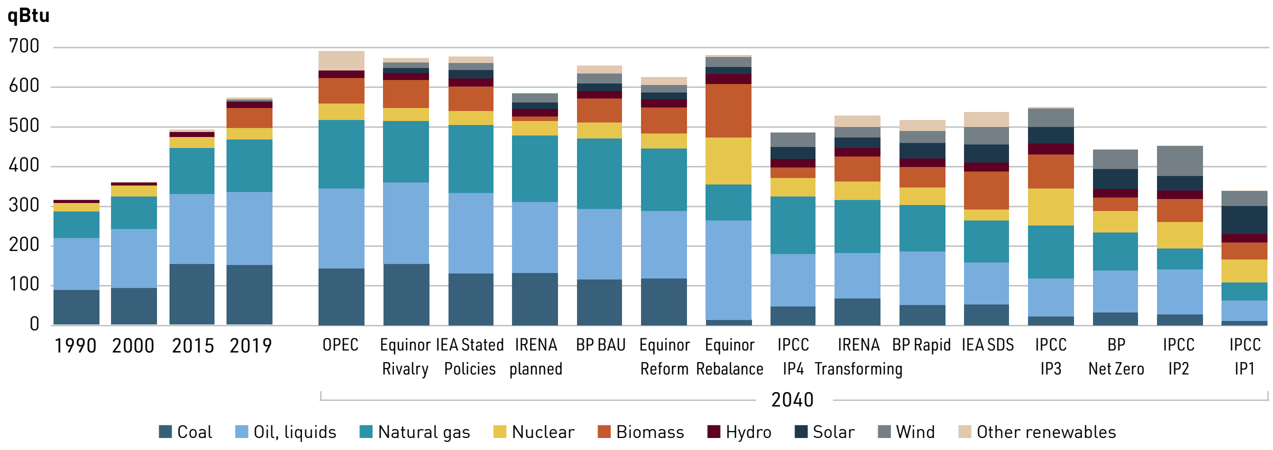


Source: Global Sustainable Investment Alliance, Bloomberg Intelligence

Figure 3

GLOBAL PRIMARY ENERGY FUEL SHARES IN 2040

Projections for alternative (and traditional) energy sources vary greatly.



Source: Resources for the Future

would be "stranded," with values and returns impeded by their drag in a net-zero world.[2]

Risks for fossil fuels and other industries also stem from technological innovation. If electric vehicles follow typical adoption rates, which companies and industries will become obsolete? Won't greater demand for batteries mean a dramatic step-up in mining lithium, cobalt, and nickel?

Arguments against abrupt and wholesale abandonment of coal, oil, and gas include unintended consequences resulting from distressed sales to bad environmental actors. Some national oil companies are controlled by countries less aligned with interests of their international counterparts. Global energy supply and price dislocations remain major concerns, thrown into stark relief by the Russian invasion of Ukraine.

Fundamental differences exist between developed and developing worlds. Despite their reputation today, fossil fuels were responsible for huge advances in health and longevity in our history. Developing countries seek the same benefits from energy scale and access, yet they rely on coal.

The potential for social, economic, and environmental trade-offs apply to U.S. constituents as well. Similarly, decades of U.S. reliance on big oil won't end without significant disruption to livelihoods and communities. How that is managed politically and economically with current stakeholders is critical to gaining broad acceptance for a move to alternatives.

Still, awareness is growing that climate change isn't just a theory—it's happening. Insurance companies are feeling the impact of weather extremes including storms and flooding, and agriculture is feeling the impact of severe heat and drought.

The huge investments needed to combat climate change are daunting. But behavior modifications may be the greater challenge.

ESG INVESTING AND DIVERSITY ISSUES

Contemporary demands for diversity, equity, and inclusion—known as "DEI"—and goals of broad representation, fair pay, and equal opportunity have become the lens through which investors are judging managers' investment selections. DEI attention has driven global policy-making and regulation toward disrupting the status quo. Numerous markets in Europe now employ gender quotas for company boards. In the United States, the Securities and Exchange Commission recently approved Nasdaq's proposal for listed companies to disclose board demographics and meet minimum diversity tests.

These efforts are not without controversy and unintended consequences. With intense pressure on corporations to demonstrate commitment to diverse workforces and equal opportunity, talent pipelines become critical. This is challenging at senior management and board levels, where women and candidates of color historically have comprised a minority. Companies often are vying for concentrated pools of eligible and qualified professionals.

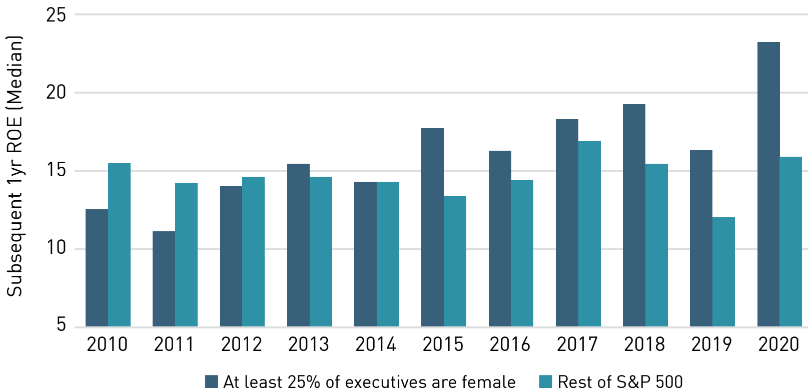
Seeking diversity and requiring prior board or executive leadership experience becomes a Catch-22. Many argue that the solution is to reinvent hiring practices and expand the scope of searches; others raise concerns about losing perspectives gained through tenure.

In the process, "equity" and "inclusion" have become charged words. But their intents are reasonable. As figure 4 shows, research supports DEI as a performance enhancer. Awareness is growing that different perspectives and backgrounds foster innovative thinking and problem-solving. Demonstrating commitment to a level playing field and a nurturing culture has become a hiring magnet

Figure 4

HOW DIVERSITY MATTERS

Companies whose executives are more than 25-percent women show better return on equity than the rest of the S&P 500

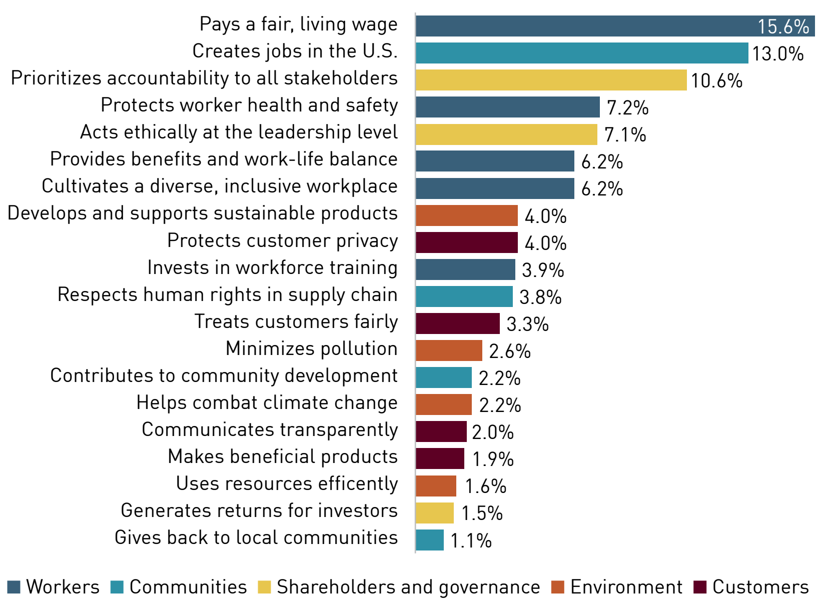


Source: Bloomberg, BofA US Equity & Quant Strategy

Figure 5

AMERICANS' TOP PRIORITIES FOR COMPANIES TODAY?

Job creation, fair pay, and stakeholder accountability are top demands of companies today.



Source: 2022 JUST Capital Foundation

amid the fierce competition for human capital.

This competition for workers accelerated with COVID's onset. Over one weekend, the world's employees abruptly left their offices for home, upending established employment norms. Employees discovered they had leverage just as awareness of systemic racial and gender inequality became heightened. The timing of Amazon's recent loss in the battle to unionize one of its New York City warehouses may be emblematic of that evolving sensitivity.

DEI is often seen as a corporate box-checking exercise. But as more evidence mounts of the tangible growth benefits of a more diverse and inclusive workforce and management team, we suspect the best employers will take more proactive steps in their employment practices.

ESG INVESTING AND CORPORATE GOVERNANCE

Corporate governance is the G in ESG. Governance's importance was cemented by the sub-prime debacle and the resulting GFC. Corporate malfeasance and lack of transparency propelled the need for good corporate governance and regulatory enforcement.

As a partner in a venture fund dedicated to ESG investments put it: "Governance is the foundational element of the ESG triumvirate, though seemingly the least sexy of the three. Good corporate governance generally comes down to the need to be accountable and transparent, both at a board and executive level."[3]

The good news is that the disciplines found under the governance umbrella—for example, accounting, enterprise risk management, or legal and compliance—are hardly controversial. Corporate accountability is also driven through standard mechanisms such as board independence, shareholder rights, board oversight of management, and executive compensation.

Today's complexity of corporate matters such as cyber security and reputational risks via social media are challenging the most competent of boards and management teams. Establishing best practice in governance is often a starting point to meaningfully managing any E or S issue.

As E and S issues are increasingly attached to corporate vision and mission statements, boards and managers are being held responsible for them. DEI, as a "foundational element," sets the tone at the top for board diversity. It also drives key performance indicators tying them to executive compensation and outlining more explicit board oversight for climate risk and sustainability.

As ESG demands from investors and stakeholders grow (see figure 5), a burgeoning industry has developed to help companies with governance practices. Accountants, law firms, and consultants all pump out thought leadership pieces across a plethora of esoteric topics. But, as one study reported, not necessarily with agreement on "a common baseline for disclosure standards consistent across jurisdictions and industries."[4]

Along with corporate advice comes investor-centric tools. Rating agencies offer grading systems on how well companies perform against benchmarks. But it is also certain that lack of agreed-upon standards and making ESG numbers look better than they are ("greenwashing") will be continuing headwinds to identify which ESG issues should in fact be governed and assessing what good governance looks like.

ESG DISCLOSURE AND REGULATION

It's clear that compelling dynamics are behind ESG in all its aspects. It's also evident that defining, let alone organizing or regulating, such a multidimensional entity goes beyond borders and jurisdictions. Yet the attempt to do so was there from the start.

The impetus for environmental disclosure has perhaps the longest history. The result has been the development of many standard-setters: the Carbon Disclosure Project, the Global Reporting Initiative, the International Integrated Reporting Council, the Sustainability Accounting Standards Board, and the Task Force on Climate Related Financial Disclosures, which is the widely recognized standard on climate risk reporting.

To simplify this regulatory maze and help create common frameworks, several agencies have merged and others have formed partnerships.

The urgency to create manageable disclosure and reporting systems has grown with concerns around greenwashing. Deceptive ESG representation is drawing scrutiny from government and regulatory agencies. That plus investor demand for transparency is leading to higher standards of disclosure for portfolio companies and managers.

Sketchy reporting also is fueling general skepticism about ESG. There's precedent for hope around data legitimacy. Nutrition labels are a given today, but in the 1960s the idea of listing calories and serving sizes was far-fetched. With better technology, food could be precisely analyzed, and in 1973 a Food and Drug Administration regulation finally forced manufacturers to allow consumers to make informed decisions about fat and sodium content.

In the same way claims of food being called "organic" also attracted regulatory attention, the Securities and Exchange Commission is today focusing on funds calling themselves "green." In a rule proposed in March 2022, the agency recommended "certain climate-related disclosures ... including information about climate-related risks ... [and] disclosure of a registrant's greenhouse gas emissions."[5]

Disclosure and reporting go hand-in-hand, but what about the challenge of collecting and measuring ESG-related data itself? The head of sustainability for a major private equity firm reported in a recent *Wall Street Journal* article, "In the absence of clarity on what information to collect and how, we get a ... mishmash of information that's ... not decision-useful."[6]

How does one measure social factors? Some items that can be assessed include turnover, recruitment, productivity, and workplace safety. As one study suggested, whatever metrics are eventually developed, it's not just inputs but the impact of that data that matters.[7]

ESG EVOLUTION BY ASSET CLASS

Now that we've established the broad sweep of ESG's domain as well as the challenges of reporting and disclosure, let's look at how it gets implemented across various asset classes.

Traditionally ESG existed within public equities given shareholders' theoretical ability to change corporate behavior. Leverage could be applied as an incentive to adopt sustainability programs or diversity measures. But soon it became apparent that more-sophisticated tools would be needed to track ESG compliance and opportunities.

So-called ESG integration describes the process whereby investors incorporate all aspects of environmental, social, and governance elements in their risk analysis of a business or manager. Individual investors have developed their own individual frameworks to measure quality against a spectrum of elements. Critical to this evaluation is whether data can be validated by third-party research.

Underlying this approach is the assumption that companies managing ESG frameworks effectively over time and against reasonable benchmarks likely are managing other aspects of their businesses competently. The industry has thus moved beyond a negative-screening, box-checking approach to seeking companies strategically targeting ESG risks and opportunities.

For credit investors, it's less about the upside. The public fixed income market has now adopted and refined ESG datasets and frameworks to mitigate downside risk. Assisted by rating agencies, these questionnaires mirror checklists in financial categories, albeit with a blizzard of details across items such as carbon emissions, supply chains, and shareholder rights.

Sustainability bonds and related types of investments (see figure 6) have multiplied as managers, issuers, and investors have responded to the enormous global demand for ESG product. "Use of proceeds" bonds fund specific projects such as water-filtration plants; other "linked" bonds finance businesses with sustainability targets.

Applying an ESG lens in private markets is the next frontier. At least in the middle market, one would be hard pressed to find more potential for beneficial impact than with private equity capital and attention. The clear challenge with smaller companies is being able to extract the data to apply the right metrics, or in some cases, to find data at all.

But as asset classes converge around ESG standards, it's likely that bars being set for one won't be lowered for others. Financing partners know, too, that ESG focus can add value for private equity investors and protect lenders from default risks. As one asset sales head put it, "… lenders working together and influencing the decisions of companies is key for improving on ESG."[8]

ESG OUTLOOK FOR PRIVATE CREDIT

Finally, let's examine how private credit integrates ESG into its various strategies.

Credit managers typically are not involved in the direct management of businesses they finance. An exception is impact investing. According to a recent *Private Debt Investor* article, private debt represents 34 percent of all impact investing assets under management, with real assets and private equity at 22 percent and 19 percent, respectively. Noteworthy areas include health care, renewables, and housing.[9]

Similarly, sustainability-linked loans (SLLs) compel borrowers to reach given ESG goals. SLLs are a small but growing category within the overall $732-billion (per BloombergNEF) sustainable debt market. That suggests momentum for investors to seek green private debt alternatives as well.

Nevertheless, negative screening is a powerful tool for lenders. The European Leveraged Finance Association reported 90 percent of managers surveyed had "passed on, reduced or sold out of a credit investment entirely due to ESG reasons at least once."[10]

As lender checklists become more sophisticated, demands on borrowers will grow. Larger companies, particularly broadly syndicated loan issuers, can be incentivized with spread discounts for meeting certain ESG targets. Middle market businesses don't always have the capability to track their carbon footprints, for example. But doing so will carry cost benefits the same way that better credit ratings do.

Using ESG criteria at the beginning of borrower due diligence is critical to establishing baselines against which to measure future performance. These classifications generally fall into three categories: macro, micro, and values-based. Direct lenders tend to focus on the latter two, with specific frameworks established to find red flags, then monitor closely after the deal closes.

Key to successful ESG integration in private debt is the close relationship lenders have with both the private equity owner and the borrower. The tighter the circle of credit providers, the more likely key issues will be communicated. As one global investment manager noted, "You are working almost in partnership on those transactions."[11]

A sector-specific approach is also critical to getting the most transparent, ESG-credible results. Defensive service industries, particularly those with low capital expenditures, fewer plants, and minimal production waste, are likely to yield smaller carbon footprints and less pollution risk.

CONCLUSION

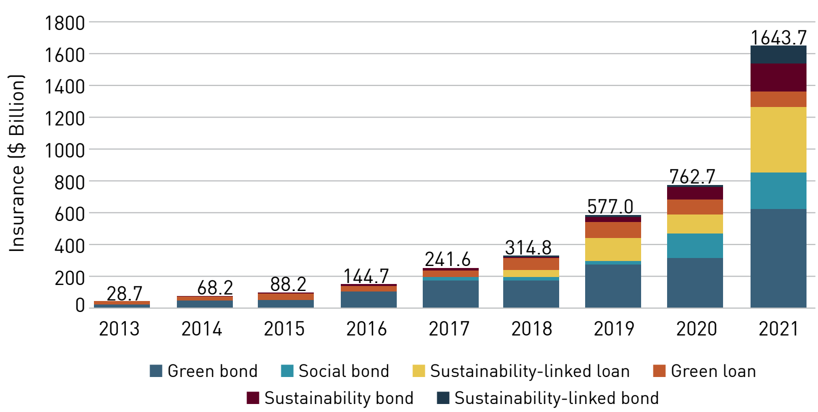
ESG should not be viewed as principles outside the asset universe being imposed on investors. Rather, ESG is a natural evolution of historic developments combined with the reality of a shrinking, interconnected planet.

What matters, after all, is not the definition or categorization of these principles, but the effort itself to create alignment, modified as necessary over time, with your firm's moral and ethical standards and the investment choices you make.

Figure 6

GREEN FIELDS

The types and scale of sustainability bond and loan investing has grown dramatically.



Source: BloombergNEF

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ENDNOTES

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