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What Is ESG, and Why Is ESG Investing Good for the Planet and for Business?

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BUSINESSES MUST TAKE THE LEAD IN MITIGATING CLIMATE CHANGE'S EFFECTS. LEARN WHY ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) INVESTING IS A KEY STEP.

When it comes to the increasingly severe effects of climate change, planet earth will do just fine if humanity does nothing to limit carbon emissions. The earth will continue to turn. The rabbits and moles in the park next to my San Francisco house will continue to hop and tunnel around, unfazed by decreasing biodiversity and increasing civil unrest and inequality. But the planet's 7.96 billion (and counting) humans will not fare so well, as the scientific literature agrees.

People are feeling the impacts of climate change, mourning the loss of species, and protesting in the face of injustice. Yet most people have played a part in creating these scenarios - and can also have a large role in mitigating them. Environmental, social, and governance (ESG) investing is one way to ensure a sustainable future for people and the planet.

What Is ESG?

ESG (environmental, social, and corporate governance) investing is a tool that investors use to measure the nonfinancial issues of a company and understand how it manages externalities associated with doing business. ESG initiatives are actions a company takes to lead in more

sustainable and ethical ways to influence and challenge its environmental impacts (E), social impacts (S), and governance (G).

The 3 Pillars of ESG

In 2005, the world's most powerful financial institutions came together to explore how companies can link profits with purpose. They introduced the concept of ESG in the report "Who Cares Wins: Connecting Financial Markets to a Changing World," which defined the three pillars of this movement.

ENVIRONMENTAL

"Environmental" represents how companies can lessen their impact on the natural world. The global economy has been structured on an energy system dependent on fossil fuels to power the means of production. This system has yielded great benefits - specifically, incredible economic growth - that have unfortunately come with great costs. One of those costs has manifested in climate change. Environmental initiatives encourage companies to adopt sustainable operating models, like using renewable energy, sourcing sustainable materials, reducing waste, and greening supply chains. These efforts can reduce the amount of carbon emissions associated with economic growth.

SOCIAL

Corporate practices have led to imbalances and inequities within companies and in the world at large, creating huge gaps in income and opportunity. "Social" investments focus on human rights: empowering workers, communities, and people up and down supply chains. They include diversity initiatives, fair labor practices, workplace health and safety, pay equity, workforce training, consumer protection, and data privacy.

GOVERNANCE

"Governance" focuses on corporate behavior. Poor governance can result in mismanagement and even fraud, like Volkswagen's 2015 emissions scandal that increased the risk of investing in this legacy brand. Investors measure governance by things like a company's financial accountability and transparency, employee and executive compensation, board structure and diversity, and risk management.

How to Use ESG Investing for Your Company

The purpose of ESG is to create business value while making societal and environmental impacts. And it's more than just a fad: ESG investments are expected to reach $53 trillion by 2025.

WHAT'S DRIVING ESG INVESTING?

ESG investing is a spectrum. Companies typically begin their ESG journey for compliance reasons, which is simply to "do less bad." They're offsetting carbon and starting diversity initiatives to check certain boxes. But compliance is the gateway drug for authentic ESG and "doing more good," paired with the realization that business doesn't do well when society isn't doing well.

Recently proposed Securities and Exchange Commission (SEC) rules will expand emissions reporting to include Scope 3, a classification that comprises upstream vendor emissions and downstream emissions from customers - which have traditionally been the toughest emissions metrics to quantify. This rule makes it more critical for companies to align themselves with ESG-friendly associates. Increasingly, companies are required to disclose their environmental practices, through reporting agencies such as the CDP and the Dow Jones Sustainability Index (DJSI), such that their customers can demonstrate that their suppliers are environmentally friendly. It's no longer about what a company is doing as a sole entity - but also what it's doing within the ecosystem in which it operates. Every business is a part of each other's Scope 3 emissions now.

HOW IS ESG RATED?

ESG ratings are a measurement of risk associated with a company based on its policies and practices. Ratings help determine a company's long-term financial outlook and are key metrics for investors.

There are different ratings agencies that compile ESG scorecards with varying degrees of transparency. These organizations - such as Sustainalytics, MSCI, or DJSI - use industry-specific criteria to determine how a company ranks against its peers. For example, MSCI created a letter grade system. Companies are leaders (AAA, AA), average (A, BBB, BB), or laggards (B, CCC). Others use numeric scores.

But just because a company is strong in one area doesn't guarantee a great rating. Tesla scores high on E, but its S and G issues bring its overall rating down. And it is scored against other automotive companies, not the private sector writ large. That is why Tesla might not make the ESG leaderboard, and unsustainable but high-scoring companies like Royal Dutch Shell (which is rated against its peers) may score higher. Some greenwashing does skew the scores, but with the SEC's new disclosure requirements regarding climate risks, it will be harder to game the system.

How Companies Can Implement ESG Initiatives

Right now, companies are missing the boat if they're not onboard with ESG initiatives, especially in the architecture, engineering, and construction (AEC) and manufacturing industries.

» AEC and manufacturing are associated with 60% of global carbon emissions.

» Labor shortages and complicated supply chains increase risk.

» AEC and manufacturing are lagging behind other industries in diversity.

Here's how companies can implement ESG strategies:

1. Talk to investors, shareholders, and board members about creating an ESG roadmap.

2. Regularly report to ESG raters and be transparent about what you're doing.

3. ESG investments should support your goals, be core to your company and mission, and help your customers and your industry.

4. AEC and manufacturing companies need to think critically about how to incorporate ESG into business models and apply lifecycle thinking to include entire supply chains.

5. Leverage technology to support ESG initiatives. Technology empowers employees. For example, building information modeling (BIM) delivers data for easier tracking and reporting, and digital inventory management can reduce waste by 30%.

What About the Backlash to ESG?

There has been some resistance in the United States to the rise of ESG investing, with journalists and politicians noting that ESG investing alone will not solve for climate change and social inequity. This is certainly true. However, the long-term prospects for ESG lie on solid ground. Investors continually seek to manage risk, and climate change and inequality are big risks to manage. The pressure for companies to disclose their carbon emissions, diversity metrics, and governance standards will not abate in a world where volatility and uncertainty are only increasing. ESG is evolving and changing, but it is assuredly here to stay.

5 Benefits of ESG Investing

Although ESG initiatives require a financial investment, the benefits will far outweigh the costs in the long run.

1. ESG Investing is Good for the Planet

As more companies embrace ESG, equality will increase and emissions will decrease, which is ultimately good for society and the planet. The new SEC rules will speed up the process. Companies are joining movements such as the UN's Race to Zero Campaign and The Climate Pledge and committing to become carbon neutral by doing things like buying renewable energy and carbon offsets. With every company doing its part, the world will be better off.

2. ESG Helps Manage Risk

As BlackRock CEO Larry Fink said in a 2020 letter: "You can't separate climate risks from business risks anymore." The new SEC rules are pushing companies to better manage climate risks that will be priced into a company's valuation. Companies need to manage their externalities and have the proper governance in place to mitigate risk or face the consequences from the market.

The future of ESG will be how companies are reducing inequality and contributing to decarbonization in their industries. For example, Autodesk has been proactive about its commitment to sustainability, creating an ESG steering committee and a three-part impact strategy: what we do as a company; what we do for customers; and how we make industries low-carbon, resilient, and more equitable.

3. ESG Is Good for Business

A New York University Stern School of Business study showed that companies participating in ESG reporting have greater valuation over time. Managing ESG risks that support equity, reduce emissions, ensure customer privacy, and foster diversity to enable innovation can maximize revenues. The Stern study also showed that companies that prioritize ESG are more resilient during a societal or economic crisis, which is attractive

to investors, especially considering the lessons from the COVID-19 pandemic.

When you’re focused on “doing more good” instead of just checking boxes, ESG investments bring superior returns because they show you’re conscientious, which brings more business. They also attract and retain talent, an advantage in today’s labor market. That type of smart governance is what leads to greater investor interest and higher returns.

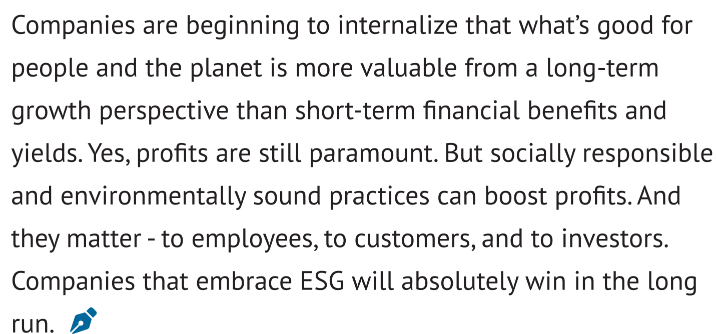
4. Next-Gen Investors

Today’s generations of investors are moving the needle with a new set of criteria. They care deeply about the greater good and consider the risks of climate change and inequality as high stakes, making it costlier not to deal with them. And the corporate world is responding. In 2019, the Business Roundtable, an influential trade association, redefined what a corporation is - from being exclusively focused on shareholders to including customers, employees, and communities.

5. ESG Standards Are Here

ESG ratings reveal what tens of thousands of companies are doing to mitigate risks. Even though ratings continue to evolve and expand - some even include cybersecurity and geopolitical risks - they set the standard for companies to see how they rate compared to the competition and how to do better. And the public sector, specifically in the European Union and United States, is starting to standardize the reporting requirements for carbon emissions and social issues. There is still work to do, but there is greater clarity around what companies are expected to report to meet specific ESG requirements.

Companies are beginning to internalize that what’s good for people and the planet is more valuable from a long-term growth perspective than short-term financial benefits and yields. Yes, profits are still paramount. But socially responsible and environmentally sound practices can boost profits. And they matter - to employees, to customers, and to investors. Companies that embrace ESG will absolutely win in the long run.



About the Author

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About the Article

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