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ESG investment: a fad or reality?

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ESG Investing

ESG is a system for measuring the sustainability of a company or investment in three specific categories: environmental, social, and governance. To understand the concept of ESG better, we need to understand and compare it with a few other types of investing. Traditional investing as we know has always been functioning on monetary benefits where corporations were primarily paying attention only to the profitability, growth of their business, and investors on their returns. Although we have regulations in financial markets, such as minimum wages, and pollution control which have played an important role in curbing malpractices, economists believe there are still grey areas and issues that are not addressed with these regulations. Two other forms of strategy are Impact Investing and Community Investing, where impact investing is a general strategy that seeks to generate financial returns while also creating a positive social or environmental impact whilst community investing is a form of investing that channels public and private investment to low income and other underserved communities to provide capital, credit, and training that these communities would otherwise lack. But since these forms of investments look only into a specific set of value addition it also bears a higher risk. It is thus interesting to note that ESG has emerged as a competitive alternative, with companies and investors prioritizing decision-making that benefits stakeholders in addition to stockholders. Since ESG is a combined ideology of all three types of investment strategies discussed, it has the lowest risk involved as it conceptually diversifies.

What is ESG?

Environmental: What kind of environmental impact does a company have? This can include a company's carbon footprint, the sustainability efforts that comprise its supply chain organization by assessing the attributes such as pollution control, animal welfare, and water consumption.

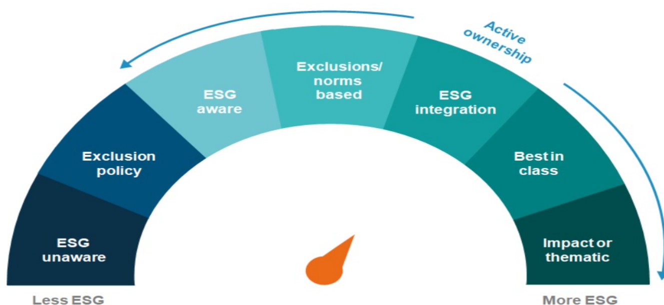
Social: How does the company improve its social impact, both within the company and in the community at large? Social factors include LGBTQ+ equality, the well-being of its employees, compensation benefits, and community involvement.

Governance: How does the company's board of directors and management promote positive change? Governance issues range from the diversity of the organization and the management, gender equity and share-class structure as well as how well that leadership responds to and interacts with shareholders.

Calculating ESG scores

ESG scores represent ratings that research firms assign to individual companies, using multiple criteria to evaluate individual E, S, and G components. Bloomberg, S&P Dow, MSCI, and Refinitiv are among the most reputable ESG research firms. Scores are typically assigned on a 100-point scale: the higher the score, the better a company performs in meeting various ESG criteria. ESG rating firms commonly review annual reports, CSR activities, resource management, board structure, employee benefits, and even controversial weapons screenings to assign scores.

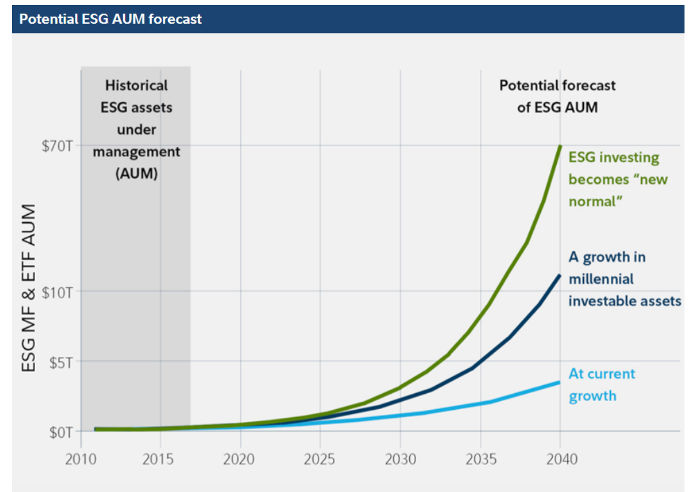
With the advent of technology, global accessibility has now become an important attribute for investors to make informed decisions and take it upon themselves to invest in areas that align with their values using the strategies of positive and negative screening. Positive screening is the process of identifying companies that outperform their peers in terms of ESG factors. These companies can then be chosen for long-term investment portfolios. It is the inverse of negative screening, which seeks to weed out low-scoring firms so that they can be avoided. Many investors consider negative and positive screening to be two sides of the same coin and run both screens at the same time. Peer comparison is frequently used to construct portfolios with enhanced sustainability profiles based on criteria such as superior environmental records, strong reputations for labor practices and gender equality, and good governance of issues such as non-involvement in controversies. A poor environmental or waste management record, including unacceptably high carbon footprints; poor labor relations, particularly related to the non-payment of living wages; and poor governance issues, such as a lack of diversity on boards or overly controlling private shareholders, are typical factors that the screening process looks out for. A rough guide for screening is presented below.



Source: Bloomberg Intelligence

Radical change in numbers for ESG

Climate change and social justice investors had a banner year in 2021, successfully urging companies and regulators to make changes amid record inflows to funds focused on ESG issues. Extreme weather becoming more common, as well as events highlighting social justice issues, have contributed to ESG rising to the top of the agendas for investors, companies, and policymakers. Assets under management (AUM) at global exchange-traded "sustainable" funds with publicly stated ESG investment objectives totaled more than $2.7 trillion as of December 2021, with 81% in European-based funds and 13% in US-based funds. The MSCI World ESG Leaders Index has risen 22% this year, compared to a 15% gain for the MSCI World Index. According to the Sustainable Investments Institute, support for social and environmental proposals at US companies' shareholder meetings increased to 32% in 2021, up from 27% in 2020 and 21% in 2017. According to a study conducted by Morningstar, potential ESG AUM could be as high as $70 trillion by 2040, if ESG investing becomes a "new normal" implying that ESG investing becomes synonymous with retail investing, and the 2040 retail ESG market is the 2040 retail (MF/ETF) market, with a 27% CAGR.



Source: Morningstar Direct Sustainable Universe

Companies in sectors such as renewable energy have ridden the secular wave of the structural shift to sustainability and have distinguished themselves through the value they have created. This expansion is also supported by innovation, which continues to deliver technological advancement at lower costs.

Around the world, there is growing policy and regulatory momentum in favor of ESG. The Biden administration has prioritized clean energy and sustainability in its agenda and ambitious infrastructure plan. Similarly, the EU Green Deal is at the heart of the EU's economic recovery efforts following the pandemic. Japan and South Korea have also joined the US and the EU in announcing plans to achieve carbon neutrality by 2050, with China aiming for the same goal a decade later. Most recently, India's capital markets regulator- The Securities and Exchange Board of India (SEBI), released a consultation paper stating that it planned to regulate what it described as "ESG risk ratings" and "ESG impact ratings", alongside similar products such as carbon risk ratings, corporate transaction risk scores, and others. According to a report from Bloomberg Intelligence, the $2.2 trillion ESG debt market could grow to $11 trillion by 2025 even if it grows at half the rate of the previous five years. Green, social, and sustainability bonds are on track to surpass $2 trillion in cumulative volume by the end of the year, following the meteoric rise of social bonds this year.

Is ESG metric a fad or reality?

Many proponents and detractors of ESG have argued for a long time if ESG is for real, or just a fad? That is dependent on the goal. In terms of the environment, if one is truly committed to saving the planet, ESG is a powerful tool in the hands of such a rescuer. Prof Aswath Damodaran, a valuation expert, in his recent blog argued, among other things, that ESG adopters were doing it for their benefit (i.e., to sell more products), that there is limited data and correlation between ESG and returns, and value systems differ across people. Of course, these are valid points, but the solution may not be to completely disregard ESG. Also, how do investors incorporate ESG into their investment strategies is an important question. While 'G' has always been important to some investors, 'E' and 'S' factors are also beginning to gain traction. These layers should be applied to all investments rather than just specific ESG-labelled funds. Some experts also avoid certain industries entirely, for example defense. An explosives manufacturer aimed at civilians is unquestionably a no-go. What about one that develops defense systems to protect its country's borders? You can now see how many grey areas exist. However, this is also a place with a lot of opportunities. Rather than simply 'excluding' sectors and companies based on low scores, it is critical that we engage with and guide them towards better disclosures and best practices. There is much to learn, but moving forward is imperative, especially in a space that is evolving at a breakneck pace. There is already a convergence of driving factors that point to this being more of a genuine long-term shift than a fad. According to industry leaders, ESG investing will become a fundamental precept of investing in the future. It will become as important as EPS in investors' decisions on public equities and fixed income securities.

The bottom line

ESG investing was once viewed as a hedge against the potential consequences of a policy shift or a willingness to forego some returns for the sake of the greater good, however, it has evolved into an economic imperative. This can be attributed to the growing understanding that inaction on 'E' is simply not an option and would have disastrous economic consequences. Moody's Analytics, in one of its research reports, predicted that climate change alone could wipe out $69 trillion in global wealth by 2100. While no single person or entity can work against this to bring about an enormous change, if we all do our part, we can succeed as a group.

Sustainability-driven industries and ESG-driven investing are still in their infancy, there is still much wood to be cut. Despite efforts to develop universally recognized definitions and standards, there is currently nothing preventing a company or fund from using the term ESG or issuing a grandiose mission statement proclaiming their sustainable credentials while taking little or no quantifiable action to make that a reality.

As an investor, you can identify potential investments that might align with your goals to build a diversified portfolio with an asset allocation strategy that best fits your horizon. For this purpose, ESG can be utilized as a forward-looking analysis for assessing smaller companies that lack the resources to reach the disclosure transparency of larger peers. Of course, even when utilizing ESG scores, you should dig deeper into the investments that you are considering. Simply because an ETF or mutual fund scores well on a provider's rating scale for adhering to ESG principles doesn't necessarily mean it meets your preferred ESG characteristics or that it makes sense for your investment mix.

About the Authors

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Nivedhitha is a full-time MSF graduate who enjoys reading, painting, trekking and hosting board game nights. She has 5 years of professional experience in the securities trading division at Goldman Sachs. She decided to pursue a master's in finance to explore the different avenues in the field of finance and currently enjoys learning about financial modelling and valuation.

Rishi completed his Bachelors in EC Engineering and discovered his passion for finance during his experience at IIM Ahmedabad as an equity research intern. He aspires to build his career in the financial services and capital markets sector. He is also a sports enthusiast, particularly tennis and cricket, and is up for playing a match anytime.

The Deal Desk provides a platform to JSOM students to share their views on important events affecting the finance industry

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Alumni Spotlight

Sebi Tennyson
MS Finance 2021

I completed my master's in finance at UTD after receiving my bachelor's in Finance and Marketing from Baylor University. Graduate school during a pandemic added an extra layer of challenge to an already strenuous program. Because of the pandemic, face-to-face interaction was limited, so I quickly learned the value of human resources from collaborating with classmates and one-on-ones with professors.

As a graduate student, it is important to understand the wealth of knowledge, that surrounds you. People come from all different backgrounds and stages of life, and we are privileged to have access to them.

Connecting with my classmates helped me develop new study strategies as well as useful tips when seeking employment. At UTD, my passion for financial literacy prompted me to have multiple conversations with colleagues and professors which inspired my podcast "Make It Make Cent$" with the goal of making investing and other personal finance topics easy to understand.

During my second semester, I worked as a teaching assistant where I helped juniors navigate the intro to finance course. By the spring of 2021, I started hunting for a job. The tips I had gained from classmates, professors, and the resource center, helped me successfully land a full-time job.

My takeaway from my time at UTD is, "Do it Scared." Coming to America as a teenager was scary, going through graduate school was scary, searching for a job as an international student during a pandemic was scary; however, if you don't face your fears, you will never get to the other side of success.