Guest blog

The ESG Brouhaha: Tempest in a Teacup

What is ESG and why the commotion?

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You've likely seen recent articles and tweets about corporate investors taking Environmental, Social, and Governance (ESG) metrics into consideration for their investment decisions, and how several politicians, business owners, and public figures are reacting.

From Elon Musk's recent "ESG is a scam" tweet to former Vice President Mike Pence's comments that ESG is politically driven, to the state of Texas barring local governments from doing business with banks that don't support oil, gas and guns, the ESG space has become quite difficult to navigate.

But why all this brouhaha?

ESG Investing a misnomer

The biggest problem facing ESG is the lack of understanding and agreement about what it is and how we should use it. To me, ESG is nothing more than a set of metrics, i.e., quantifiable measures, that businesses and other stakeholders can track to better assess how Environmental (e.g., climate change), Social (e.g., human rights abuses) and Governance (e.g., in-house sustainability committees) factors impact a business, and in turn, how the operations of that business impact the environment and society.

But alas, given its sudden popularity and usage in the business lexicon, my understanding isn't broadly shared.

To trace the origins, ESG investing, or more correctly, investing using ESG metrics, emerged in its most recognized form from Socially Responsible Investing (SRI) in 2004 when the then UN Secretary General, Kofi Annan, wrote a letter to over 50 CEOs of financial firms inviting them to participate in a new initiative focused on integrating ESG factors into investment decisions in capital markets.

The logic was straightforward – the way a firm deals with the planet and its people, has a bearing on its profit. This Annan initiative yielded a report in 2005 titled "Who Cares Wins," which coined the term "ESG investing." The first signs of trouble arise –

while you can analyze and use ESG metrics to invest in an "ESG friendly way," you cannot really invest in ESG itself. ESG is not an asset class, it is not a style, and it is definitely not a strategy; it is an investment research discipline.

The term "ESG investing" itself is a misnomer.

The good news is that use of ESG metrics in investing is on the rise: According to Bloomberg Intelligence's (BI) latest ESG 2022 Outlook report, financial assets that have integrated ESG are on track to exceed $41 trillion this year, representing almost 30% of the projected $140.5 trillion in total global assets under management.

Lack of Standardization – What to measure and how?

Even after we clear up what ESG is and isn't, the next big problem facing ESG is the lack of standardization - there are multiple standards and frameworks. For example, there are multiple ways to measure the risk that climate change poses for a company's future and pundits can't agree on one.

Standardization is direly needed to improve reporting efficiency on companies' part and data comparability on investors' part. With standardization, stakeholders will be able to better assess, validate, and evaluate companies across a range of critical issues which will result in increased investor confidence and better investment decisions.

There is bit of a silver lining in that the bigger players such as IFRS has broad buy-in for its pending standards/frameworks; multiple governments have already mandated Taskforce on Climate-related Financial Disclosures (TCFD) and a large number of large companies and investors already collaborate with the Carbon Disclosure Project (CDP). But more needs to be done to coalesce around what to measure and how.

Case in point: Stuart Kirk, Head of Responsible Investment at HSBC Holdings PLC recently said, "Climate change is not a financial risk that we need to worry about. There's always some nut job telling me about the end of the world," at a recent Financial Times Conference, a comment for which he lost his job.

Clearly, there is a discrepancy at hand.

To complicate matters, a recent article by Bloomberg argues, "ratings don't measure a company's impact on the Earth and society. In fact, they gauge the opposite: the potential impact of the world on the company and its shareholder."

In other words, there are *or should be*, two different kinds of ESG metrics: one that measures the impact of people and planet on a firm's operations and subsequently profits, primarily meant for investors, and the other that measures the impact of a firm's operations (and thus quest for profits) on people and planet, typically used by other stakeholders such as NGO's, governments, policy officials and civil society. Note that although there will undoubtedly be overlaps in metrics across these two categories, they are conceptually different, and it is important not to conflate them – one is inward and the other is outward. For jargon lovers, these two complementary roles of ESG metrics is called "double materiality", a set of metrics material to the firm's future and one material to the future of our planet and its people.

Crisis of plenty

A third challenge that also stems in part from a lack of shared understanding of the concept, is the sheer complexity of the ESG ecosystem.

The World Economic Forum identifies ten roles in the ESG ecosystem, spanning from framework developers to standard setters all the way to investor coalitions and initiatives, with multiple players offering services in each area. Compounding this problem is the sheer number of ESG ratings and rankings: there were more than 600 ratings and rankings as of 2018 and the number has continued to grow.

To ease matters a bit, the Sustainability Institute by ERM conducts the 'Rate the Raters' research series to highlight investors' views on current ESG ratings and how they use these ratings to evaluate ESG topics. Their reports also include specific recommendations for companies on how to approach the ESG ratings landscape to meet investor needs.

The 'Rate the Raters' report answers some of ESG Investing's biggest questions, like: How exactly are investors using ESG data? How does that drive where companies should spend their limited time? Which ratings do investors use most, and how can that knowledge inform where companies focus?

The latest report has several interesting insights including that all investors are not alike in the way they use ESG information; some prefer to use the raw data rather than the ratings; etc. I encourage managers and investors alike to make use of this excellent resource on an ongoing basis.

Additionally, Christensen, Serafeim and Sikochi did an interesting study to establish that greater disclosures by companies is related to greater ESG rating disagreement. The authors note that over time, as analysts develop a consensus both on the metrics to use to assess a firm's performance on a specific ESG issue and how to interpret the information reflected in each metric, the relation between disclosure and disagreement might diminish or even become negative. In other words, we are in the early stages of innovation around ESG disclosures.

ESG vs. Sustainability

The various terms applied to this part of the business agenda can also present challenges in understanding how to talk about ESG and ESG ratings.

With its increasing popularity and usage, ESG is often used interchangeably with sustainability. But should it?

If sustainability is THE societal goal, then ESG analysis and subsequently investing using ESG metrics, is a necessary step to achieve that goal. In that sense, ESG comes closest to the notion of "sustainability metrics" or key performance indicators (KPI's) that are discussed in detail in my book, Small Actions Big Difference. Of course, some of the language that investors use to describe ESG metrics in terms of risks and probabilities, is inaccessible to the layperson. Overall, sustainability is a much bigger concept than ESG per se and the two must not be conflated.

Reminding us to be mindful of the difference, Andrew Winston says very aptly in his blog for MIT Sloan Management Review: "Just as fossil fuel companies should not lead the planning of our energy future, it seems unwise to let finance lead the journey to a humane, more just, less greed-filled form of capitalism."

The best we can do to address the confusion is to create greater ESG literacy. Getting clear on science-based ways to talk about cutting carbon emissions and other environmental harms, improving human and labor rights, paying living wages, and having a positive impact on the surrounding community is vital in establishing ESG as a topic across industries to help create systemic change.

ESG Investing vs. Sustainable Investing

ESG metrics and analysis is intended to be "a means to an end, and that end is a planet that is liveable - and lives worth living... a strategy that explicitly acknowledges that investors have a role to play in providing these outcomes to the world," says Amy Domini, the founder and chair of Domini Impact Investments and a pioneer in the ESG field. ESG ratings, to some degree, have lost sight of this mission; recent initiatives such as promoting the understanding of "double materiality" that provide different ratings to different stakeholders (e.g., investors, the public) can provide valuable course correction.

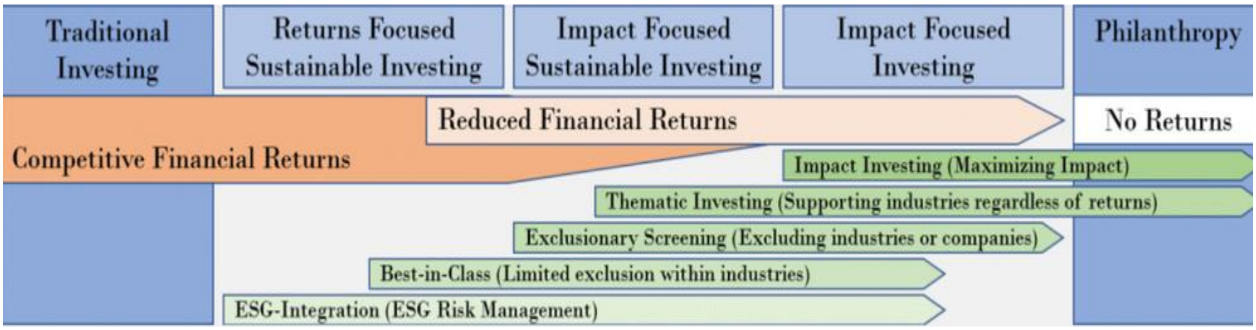
While many assume ESG investing and sustainable investing, sometimes known as SRI (Socially or more recently, Sustainable Responsible Investing), are interchangeable terms, this is not the case.

A major difference between "ESG" and "Sustainable" investing in practical settings can be traced to who is doing the investing and for what purpose. ESG metrics and ratings used by traditional investors usually focus on making a portfolio less harmful, whereas those who want to go for positive change right away will use ESG metrics to invest in companies that are actively making a positive difference in the world (e.g., renewable energy companies).

For example, a portfolio that reduces exposure to fossil fuel companies is less harmful, whereas a portfolio that invests only in renewable energy is more in line with future sustainability goals.

Exhibit 1 below reproduced from MAAL Associates, depicts the six ways in which the CFA Institute classifies ESG investing – from ESG-integration at one end all the way to impact investing on the other. Again, we observe that "ESG investing" means different things to different people, and education and heightened awareness of these nuances would greatly help lower the temperature around this topic.

Exhibit 1: **CFA Institutes Classification of ESG Investing**



Source: CFA Institute

Stuart Kirk, the ousted HSBC officer I quoted above, wrote in a recent Financial Times article that while the former type of investing is "input focused", in that ESG is an input along with firm financials and operations to the investment decision, the latter is "output focused", in that achieving ESG and sustainability goals is the top priority.

In light of this distinction, he argues that ESG should be split into two. While we don't need to go that far, we must realize that "ESG-investing" occurs along a spectrum, and the answer to what it is can well depend on who you ask.

Politics has no place in the ESG debate

Going back to the opening paragraph, ESG has faced a wide range of criticisms as it has become mainstream. Former Vice President Mike Pence criticized investor-activist campaigns that encourage companies to follow socially conscious investing principles, claiming this elevates left-wing ideals while casting the goals and interests of businesses to the side.

Elon Musk recently tweeted that ESG is a "scam" and wrote it off as an idea of "woke capitalism." Musk's words came in response to S&P Global removing Tesla from an ESG index due to accusations of racial discrimination and other forms of worker mistreatment.

Recent articles by media giants like Bloomberg, New York Times, and The Washington Post reveal concerted political efforts to influence ESG investment on an institutional level.

Politicians cite states where fossil fuels are a major contributor to the local economy, framing ESG as a means to take away jobs and disrupt economic development. (Interestingly, recent research shows that banning ESG criteria will cost the state of Texas an additional $300 million+ in additional interest).

ESG criticisms coming from such high-profile sources have shaped the public view of ESG and continue to wreak havoc and erode trust in systems that, at their core, aim to help drive positive human and environmental outcomes through business.

For investing using ESG to achieve its promise, politicians must not weaponize a topic to win a race or to cater to their own self-interests. The role of politicians is to implement legislation and laws that support sustainable development. While ESG can never be completely divorced from politics, politicians need to stay in their lane and ESG must remain true to its purpose. ESG faces the dangers of misinformation and political blacklisting if these ratings lose scope of their core goal – and humanity will suffer.

A silver lining from these public discussions is that ESG has been exposed to a wide audience and can continue to push responsible corporate behavior through greater education. Parallel to the adoption of Generally Accepted Accounting Principles (GAAP) way back in 1936 amid all the uproar at the time, perhaps this continued broad exposure to ESG will, in a couple of decades, converge on providing decision-useful information that investors and others need to fund the world that leaves no one behind as we journey to 2030 and 2050.

Lead with Purpose and ESG Ratings will follow

ESG has its issues, but it ought not to be the lynchpin of the sustainability discourse.

It is understandable that given its relative infancy, ESG indices and ratings aren't perfect, as they account for many factors and involve many stakeholders with often-opposing interests. While the financial sector is poised to have a role in shaping corporate sustainability and responsibility, we must boost ESG literacy so that it can help us overhaul business models. For example, Patagonia is one company that upholds a business model predicated on doing the right thing; more companies need to follow this lead.

ESG ratings aren't the main driver of sustainable business; they are just part of the puzzle.

But to leverage its potential, ESG must not be treated as a "box-checking exercise" which happens often; indeed, when driven by purpose, bespoke ESG metrics can be transformative and shine a light on the way forward. In other words, businesses themselves need to operate in a purpose-driven way with stakeholder value-creation in mind, rather than tailoring operations to meet a set of ratings or thinking of profit as the primary objective.

When purpose and value-creation for all stakeholders are the driving force of a business, it creates an internal culture equipped to do the right thing and find success as a by-product.

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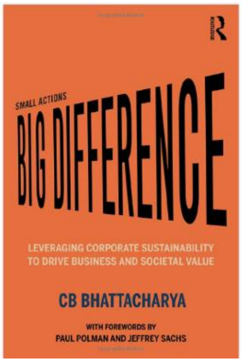

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Prof. Bhattacharya is part of a select group of faculty that has been named twice to *Business Week*’s Outstanding Faculty list. He is one of the top 50 cited marketing scholars per Google Scholar and ranks among the top 1% of marketing scholars in citations per a Stanford University study. He has won several best paper awards, teaching awards and research prizes, including the Steenkamp Award for long term research impact.

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