Introduction to ESG Investing

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Submitted in fulfillment of the Kenan Scholars Program's Research Competency

Spring 2022

Abstract

The term ESG (environmental, social, and governance) investing was coined in 2005, but it has only recently become a priority in the business world. Sustainability no longer exclusively refers to climate impacts, but it also considers the effects companies have on their internal employees and the communities in which they work. In order to create a resilient company, business leaders must take into account environmental, social, and governance challenges.

Now, a focus on ESG challenges is not only encouraged, but it is required by many investors seeking a sustainable company. Due to ESG investing's increasing popularity, many corporations have come forward with bold claims about their efforts towards more sustainable practices. However, many of these claims are made without substantiation or accountability. Words without action have negatively impacted the ESG landscape by allowing companies to "greenwash" or "goodwash" their reputation and actions. ESG investing is the key to building a strong, resilient future, but only if companies are held accountable for their claims. This paper introduces ESG investing, discussing how it began, where it stands today, and important considerations for the future.

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Through this paper, we aim to introduce readers to the components of ESG investing. We will start by defining ESG and discussing the benefits of investing in ESG companies. We will then move into a discussion surrounding the history of ESG followed by a discussion on ESG metrics. Finally, we will wrap up by linking ESG investing to the sustainable development goals and corporate social responsibility.

ESG stands for environment, social, and governance, and many investors want to see a combination of these three factors in the companies in which they invest. For example, investors want to see that a company cares about the environment by decreasing their carbon emissions, social issues by creating safe work environments for employees, and governance by having diversity in the C-suite. But why are these metrics important to investors? As our world continues to change, investors are finally starting to realize that caring about ESG not only pushes the company forward now, but it will also reap long-term rewards. As McKinsey and Co. stated in a report on ESG, “83% of C-suite leaders and investment professionals say they expect that ESG programs will contribute more shareholder value in five years than today” (McKinsey, 2020).

ESG Investing has been around for decades and has drastically evolved over the years. The 1970s spurred the beginning of socially responsible investing. During this time, activism increased in response to chemical weapons (such as napalm and agent orange) used during the Vietnam War. Shortly after, Pax World created the first sustainable mutual fund. Pax World was founded by ministers who wanted to ensure that church funds were invested in companies that aligned with the church’s values. Economic news sources also began discussing sustainability in relation to investment options providing investors with more information and factors to consider.

In the 1980s, the public sentiment from the ‘70s escalated and contributed to more formal public policy and legislation regarding corporate responsibility. In 1984, the U.S. Sustainable

Investing Forum was founded. Shortly after, concern regarding international social issues and the rapid spread of information led the U.S. public to advocate for divestment from South Africa due to the anti-apatheid movement. In 1986, the U.S. Congress banned new investment in South Africa through the Comprehensive Anti-Apartheid Act. In 1988, the Coalition of Environmentally Responsible Economies (CERES) was founded in response to the Exxon Valdez oil spill in Alaska. This group was meant to bring together leaders from the public and private sector to promote sustainability in business and tackle environmental issues (Liu, n.d.).

As the world marched toward the 21st century, sustainable investing continued to grow globally with the help of international organizations like the United Nations. In 2000, Kofi Annan, the U.N. secretary-general launched the Global Reporting Initiative and provided companies with international independent standards on how to communicate their impact on issues such as climate changes, human rights, and corruption. In 2004, the global compact produced "Who Cares Wins", which made recommendations on how to incorporate ESG issues into analysis, asset management, and other business corporations (Liu, n,d).

In the 2010s, more individuals and organizations started to put ESG into action. Public companies were expected to be good stewards of the environment and ESG investments proliferated. In 2015, the Paris Agreement was written during the United Nations Framework Convention on Climate Change, as world leaders came to a consensus in combating climate change and adapting to its impacts. In 2019, flows into U.S sustainable funds topped $20 billion as of December, which is more than quadruple the previous annual record that sustainable funds set in 2018.

In 2020, the Covid-19 pandemic shook investors and markets to their core. In the meantime, the evidence for climate change became clearer with increased frequency and devastation from natural disasters. Investors sought ESG funds in record-breaking fund flows, and fund companies have noticed, leading to record-setting ESG fund launches. In 2020, global sustainable funds had inflows of $45.6 billion during the first quarter, compared to an outflows of $384.7 billion for the overall fund universe amid the coronavirus pandemic market sell-off. In 2021, under the Biden administration, the U.S. Department of Labor said it wouldn't enforce a Trump-era rule that limits the use of ESG funds in retirement plans regulated under ERISA, including 401(k) plans.

While ESG investing has grown exponentially over the past few years, it has come with its challenges. Many companies make claims about improving their environmental, social, and governance involvement, but they often fail to substantiate those claims. ESG metrics were created to hold companies accountable and ensure their words turn into actions. Several organizations have been created as “watchdogs” for ESG investing and regulations. Without tangible impact, ESG investing will have no real impact.

Corporate Social Responsibility is a business model where companies commit to enhancing a society’s welfare as part of their non-financial goals. For many companies, the end goal is often: do well by doing good. While such commitments positively impact multiple stakeholders, firms will commonly invest in CSR because it enhances profitability and firm value. Although corporate social responsibility paves the way for responsible leadership, it often requires incomparable metrics to evaluate the positive influence of different firms’ actions. Examples of CSR include reducing carbon footprints, improving labor policies, charitable giving, volunteering as well as socially and environmentally conscious investments.

One of Ben & Jerry’s goals is to constantly consider positively impacting society. In line with their mission, the Ben & Jerry’s foundation awards approximately $2.5 million in grants to various organizations across the United States. Past grant recipients have worked in environmental health and justice, human rights and fair labor practices amongst others. For businesses, CSR can increase employee engagement and motivation, increase customer retention and loyalty while supporting local and global communities. At its best, corporate social responsibility allows for companies to engage with many of its stakeholders. At its worst, corporate social responsibility has been played as a marketing tool to quickly fix a company's image without following through on the commitments made. All in all, CSR paved the way for ESG investing. ESG actualizes CSR goals but with quantifiable indicators to measure accountability.

While ESG metrics highlight a company's corporate social responsibility, firms may address and adapt the UN's Sustainable Development goals as a tool to improve one's ESG scores. The UN's Sustainable Development goals lay out 169 specific targets to be achieved by 2030 that are combined into 17 overarching goals such as No poverty or Clean water and sanitation (Huber, 2018). When adapted by corporations, these SDG's can help boost a company's ESG status, ultimately attracting institutional investors who favor sustainably driven companies. Internally, these goals can help firms better evaluate material risks that may be brought upon by an absence of action. Failure to address material risks brought upon by SDG's such as Responsible Production (#12) or Decent Work (#8) can disrupt a business's growth prospects, ultimately hurting its bottom line (Huber, 2018).

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October 12, 2021

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