1919 INVESTMENT COUNSEL
Complexity to Clarity

ESG 101: What is Environmental, Social and Governance Investing?

ESG has become a hot topic for investors. With bold public statements from corporate leaders and well-publicized commitments from numerous financial services firms, ESG is what people are reading and talking about. Some investment products are labeled as "ESG," and at times, companies are referred to as "ESG companies." Many companies now reference ESG in their investor presentations. What exactly is ESG?

In this primer, we discuss what ESG is, what it is not, and the basics of ESG investing. At 1919, we have over four decades of experience in employing ESG-informed analysis and responsible investing practices in client portfolio strategies when a client presents us with such a mandate or a portfolio objective. As a rule, and even beyond specific ESG or responsible investing mandates, we integrate ESG factors wherever we believe they will add value for clients.

WHAT IS ESG INVESTING?

ESG is not uniformly defined across the business world, even in financial services, but in short, Environmental, Social, and Governance refers to the use of certain non-financial factors as part of the investment process. However, behind that simple, seemingly straightforward sentence are a number of nuances and assumptions that require deeper consideration.

One of the first challenges when talking about ESG is terminology. Many terms are used in the marketplace, such as ESG, SRI, green investing, impact investing, and sustainable investing. It is not uncommon to find these terms used interchangeably for marketing purposes. However, the terms are not necessarily substitutable, so it is important to recognize the clear differences among the terms and to focus on what ESG means in practice.

ESG Factors

Environmental	Social	Governance
Conservation of the natural world	Consideration of people & relationships	Standards for running a company
- Climate change and carbon emissions	- Customer satisfaction	- Board composition
- Air and water pollution	- Data protection and privacy	- Audit committee structure
- Biodiversity	- Gender and diversity	- Bribery and corruption
- Deforestation	- Employee engagement	- Executive compensation
- Energy efficiency	- Community relations	- Lobbying
- Waste management	- Human rights	- Political contributions
- Water scarcity	- Labor standards	- Whistleblower schemes

[1]

[1] CFA Institute: ESG Investing and Analysis. www.cfainstitute.org. Accessed June 2021.

WHAT ARE ESG FACTORS?

ESG factors are most commonly referenced on a company-level and thought of as external and internal elements that may influence the sustainable long-term growth and profitability of a company. These factors expand the investment decision process beyond traditional quantitative and qualitative analytics, adding to the process the component of longer-term, strategic thinking on the part of management.

While there is no single listing of what an ESG factor may be, there are certain data points frequently collected by research providers and published by companies themselves. The chart on page 1 offers a short list of some ESG factors. Numerous reporting frameworks have been formulated to aid in identifying relevant data. There are also qualitative assessments of issues that may be pertinent. Some factors are more observable and are easier to identify or quantify than others. Certain qualitative assessments of issues can be pertinent as well. For example, energy is an essential input to many types of businesses, and the cost and reliability of that energy could play a role in a company's success. Weak local electrical infrastructure and disruptions from extreme weather events could result in costly breaks in operations. A company can track and report its overall (or by facility) electricity use and the source of that electricity as well as its internal assessment of the risk of power disruption or changes in cost or access – examples of an "E" factor.

Some companies' operations are dependent on key components sourced from areas that are less than democratic or have weak labor laws. Political upheaval or community conflicts, even if caused by exogenous factors, could affect the company's performance. A company can consider the likelihood of such disruptions and perhaps how to pre-empt or diffuse negative impact situations – an "S" factor. Evidence of such preparation could include a reasonable Human Rights Policy and solid community engagement programs, but each situation must be evaluated on its own, qualitatively.

The governance structure and composition of a company's board of directors and executive management team is a "G" factor, which though sometimes overlooked, can provide valuable insight into a company. More and more corporate (and non-profit as well) boards are seeking to diversify their memberships both in social factors such as gender, race/ethnicity, and age, and in professional experience and background. The diversification of thought in the boardroom combined with a board culture that welcomes new perspectives may be expected to provide better outcomes for a company in the long-term as it faces new challenges.
Adding further nuance to the analysis, not all ESG factors are equally relevant to all sectors or industries. For example, employee wellbeing is relevant to all companies, but the majority of the workforce at a mining or railroad company is exposed to greater physical risk while on the job than that of a software developer or a bank. The safety record and the quality and depth of the mining company's health and safety program are germane to the company's long-term performance and should be considered as part of an analysis of the company's social commitment, i.e., an analysis of the quality of its "S." On the other hand, a strong data privacy policy and internal information control system is clearly associated with minimizing risks at a financial institution and might be a more important S factor for that company.

HOW IS ESG USED IN ANALYSIS?

There is growing recognition in the financial industry and in academia that ESG factors may influence long-term corporate outcomes and investor returns. Impact on returns may not exist all the time, nor always in the same way, but explicitly and systematically including ESG considerations in the investment process may aid in identifying and managing risks and improving returns.

Overall, ESG factors provide valuable insight into not only each company's business and operations, but also its culture, its time horizon, and its priorities. By integrating these factors in investment analysis, managers complement traditional fundamental techniques of analyzing financial risk and return to enhance the analytical mosaic of a company.

ESG factors also inform portfolio-level decisions. Some factors, especially those that have a clear and current overlap with global economic trends, such as attention to cybersecurity, may help evaluate how well industries or individual companies are prepared for market disruptions. Other factors can help shine a light on companies ready to take advantage of new opportunities in global trends or to grow marketable segments. Currently, the U.S. economy is turning some attention to infrastructure and a transition to a lower-carbon future. A materials company with a manufacturing process that is demonstrably lower in greenhouse gas emissions may be well-placed to benefit from the situation.

WHAT ARE ESG METRICS?

Multiple organizations or data providers are producing and publicizing “ESG scores,” which appeals to many as a quick way to determine if a company or a portfolio is “ESG-approved.” Used by themselves, these scores are just a shortcut and do not get to the heart of ESG factors. Any ESG score is dependent upon the opinion of the provider, both in the methodology used and on the interpretation of available data. Each provider essentially relies on the same pool of data provided by companies and outside organizations, but then repackages the data in its own way and with its own biases. Not all data sets are created equal, nor equally available from all companies. There are shortfalls in the available data and a good degree of honest human insight is still a key driver into parsing the databases. Compounding the issue of data integrity, much of the data is backward-looking and subject to a considerable time lag in reporting. This is not to say that broad ESG or topic-specific scores are useless; they provide a useful service and starting point. The real value is found when an active manager is willing to dig into the details of ESG factors contextualized for each company and therefore better understands the investment opportunity.

WHAT ESG IS NOT?

It is important to recognize is that ESG is not one specific investable entity or product. When a rating agency, such as Standard & Poor’s or Morningstar, categorizes a product or strategy as ESG, it is easy to assume that everything within the category is comparable. This is not the case. In fact, ESG factors can be considered in any investment strategy, any asset class, any geography, any market cap, and any investment objective. ESG factors can be arbitrarily weighted by an analyst, thereby creating very different conclusions about a company’s ESG qualities. Managers of any strategy or product can use one or more sources of ESG-related information that addresses and highlights different factors and compares companies to different peer groups. ESG is not a catch-all or a uniform investment style. It is subject to wide variability and interpretation.

ESG is also not a surrender of performance in pursuit of lofty goals. There has long been a myth around socially responsible investing that applying investors’ personal preferences inherently involves a drag on returns. This myth persists today, albeit among a minority, that suggests strategies utilizing ESG factors (or analysis or integration) are bound to underperform. There is no reason ESG should necessarily result in underperformance, nor does the use of ESG consideration guarantee outperformance. In active investing, ESG factors are only one part of the investment analysis and portfolio management process.

IS ESG INVESTING THE SAME AS SRI INVESTING?

Although the terms often are used interchangeably, ESG investing is not the same as values-based, faith-based, or the broader approach of socially responsible investing. Those terms describe a process whereby security selection is impacted by the investor’s personal or institutional values. In all fairness, the idea of ESG investing builds on the foundations of decades-old socially responsible investing. Traditionally, investors who believed their monetary associations with companies were an extension of the practice of their faith employed socially responsible investing. Over time, faith-based investors were joined by others pursuing consistency in their economic and personal lives by expressing their values through their investment portfolios. Broadly, socially responsible investing still refers to values-based investors, including individuals and institutions such as churches or foundations, whose preference is for their investments to reflect their ethics, their mission, or their vision.

Values-based investing broadens the scope of criteria for investments beyond purely financial considerations but in a way that is individualized and potentially limiting. In truth, there is quite a bit of overlap between values-based criteria and ESG factors; many of the data points of interest are the same, but those data points are judged from varied viewpoints. For example, a values-based investor may consider environmental performance from the viewpoint that the ecosystem is entrusted to humans and thus protecting that ecosystem from pollution or waste of resources is the right thing to do. On the other hand, an analyst using ESG factors may want to know about environmental performance because there are costs that can be avoided by embracing resource efficiency, limiting waste, and avoiding regulatory punishments, or the potential for gain from changing attitudes and norms around environmental-related behavior.

INTEREST IN ESG IS GROWING

With so much public attention on ESG (and responsible investing for that matter), it is reasonable that investors, institutions and individuals alike, are considering how ESG influences their current investment portfolios. Further, major geo-economic disruptions experienced over the last year or two have highlighted vulnerabilities and a lack of resiliency in our economic system. For some investors, an ESG approach is seen as a way to remediate and avoid the same level of turmoil in the future. The success of some ESG funds has also attracted investors.

In the U.S. alone, the sustainable investing industry has blossomed: $16.6 trillion in U.S. domiciled assets have ESG criteria applied.[i] There are now hundreds of mutual funds and ETFs that consider ESG factors central to the investment process. This does not include the growing number of funds and managers that say ESG factors are considered but not a central feature of the investment strategy.[ii] If recent trends in the growth of ESG-aware investing continue, the trillions in global assets under management using ESG factors stands to expand even more in the future. Whether an investor or manager chooses to adopt new practices or philosophies using ESG analysis, they should remain aware of this growing field.

For more than 45 years, 1919 Investment Counsel has worked with investors interested in values-based and impact investing. Throughout these years, we have learned that an investor that wants to be truly informed wants to be aware of ESG factors that contribute to a comprehensive and thorough understanding of a company. It is a natural extension of fundamental investment analysis. We have seen ESG factors rise in common parlance from externalities of little concern to potentially material considerations. We applaud the broader use of ESG factors as part of the fundamental analysis and portfolio construction process.

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[i] "Report on US Sustainable and Impact Investing Trends 2020." USSIF. 2020. https://www.ussif.org/trends
[ii] "Sustainable Funds U.S. Landscape Report" Morningstar. February 2021. https://www.morningstar.com/products/esg-investing

About 1919 Investment Counsel

1919 Investment Counsel, LLC is a registered investment advisor. Its mission for more than 100 years has been to provide counsel and insight that helps families, individuals, and institutions achieve their financial goals. The firm is headquartered in Baltimore and has regional offices across the country in Birmingham, Cincinnati, Houston, New York, Philadelphia, San Francisco and Vero Beach. 1919 Investment Counsel seeks to consistently deliver an extraordinary client experience through its independent thinking, expertise and personalized service. To learn more, please visit our website at 1919ic.com.

1919 Responsible Investment Team

- 6 RI dedicated team members
- Comprehensive RI Committee Process and Investment Review considering Values, ESG factors and Impact
- 45+ years managing Responsible Investments

ALISON BEVILACQUA

Principal, Head of Social Research

Alison is a Principal at 1919 Investment Counsel, LLC and the Head of Social Research. Alison leads the firm's team of Responsible Investing analysts and SRI Committee to provide research and client service with respect to Values-oriented evaluations, Environmental, Social, and Governance factors, and Impact investing. Alison is a member of the 1919ic Proxy Committee.

Alison joined the firm in 1996 after working the staff of a multi-disciplinary university-based group pursuing development of an undergraduate business school curriculum that embraced sustainability.

Alison serves on the Governing Board of the Interfaith Center on Corporate Responsibility. Alison regularly represents the firm at meetings of socially responsible investing-related organizations.

Alison earned her B.A. from the University of Arizona and M.A. in Economics at Miami University.