SORTING THROUGH THE HYPE OF ESG

By Leanne Keddie

As members of the global investment community, you no doubt have heard the growing hype lately about ESG. Listening to some, it will save us all, listening to others, it is merely greenwashing and of no use for anyone. So what is ESG anyways and what makes it good or bad? How can you sort through the hype?

ESG refers to the environmental, social and governance factors of a firm. However, we have yet to settle on an agreed upon definition of exactly what these factors should cover, how they should be measured and what ESG means. This could relate to a firm's greenhouse gas emissions for example under the environmental category or how diverse the management team is for the social category. A broad definition of corporate governance comes from the popular Cadbury Report, which defines it as the system by which companies are directed and controlled. These governance factors cover how the firm is run and includes mechanisms such as the board of directors and executive compensation amongst others.

There is growing excitement over ESG factors as evidence grows that firms that take better care of their social and environmental responsibilities, as well as having good corporate governance structures, tend to perform better financially over the long-run. This has contributed greatly to the rise in sustainable responsible investing (SRI) and the use of ESG information to make investment decisions about a firm. Larry Fink, Chairman and CEO of BlackRock, has seen their assets under management grow to over $9 trillion, in part likely due to their consistent message that ESG factors matter and that firms must become more sustainable.

Where does this ESG information come from and how is it used in making investment decisions? This is where it gets complicated. The vast majority of large firms around the world prepare sustainability reports and this figure is growing every day. Unfortunately, much of this information is voluntary and not audited. So why does this matter? This means that you cannot rely on this information in the same way that you can with financial reporting. The information may not be comparable between firms, may have only portions (if any at all) that are audited, and, due to the voluntary nature, may be missing critical information.

It is also important to understand the perspective that is taken by the firm in preparing this information. For example, the Global Reporting Initiative (GRI) is one of the most popular reporting standards in the world; it takes a multi-stakeholder perspective. This means that many views of the firm are represented, and it likely captures a broader view of the firm than other reporting standards. In likening this to taking a picture of the firm, the GRI provides multiple snapshots from different angles to provide the reader with a more holistic sense of the firm's performance in relation to sustainability. Other reporting options, such as the proposed Sustainability Standards Board (SSB) by the International Financial Reporting Standards (IFRS) or the Sustainability Accounting Standards Board, take a more focused investor view. To continue with the photography analogy, it is more akin to taking snapshots from the views of various investor groups, but this likely will not capture all angles of the business. The risk here is that investors may miss out on key information that could be provided by having a more holistic view. If sustainability is the goal, then a more holistic view is required. Presumably, what is a truly sustainable business, is also a good investment, since it will be around in the long-run.

To sort through the hype of ESG, you need to be clear on the reliability of the information you are using to make your decision. While larger investors, like BlackRock, may be able to engage with management to better understand and verify ESG data, smaller investors may be left to rely on published information to make ESG decisions. Until we have mandatory, audited, multi-stakeholder perspective sustainability data to make our decisions on, we really need to read these sustainability reports, and gather our ESG data, with a critical eye. This makes it especially important to review what a firm discloses, and possibly even more important to identify what they are leaving out.