ESG Investing is Becoming More Mainstream

By Clem Dinsmore

What used to be called socially responsible investing is now commonly referred to as ESG investing. Of the designation "ESG", "E" stands for environmental considerations, "S" for social considerations, and "G" for corporate governance or the fiduciary oversight of a corporation's activities by its board of directors and senior management.

First, I offer some further definitions of ESG investing:

*Environmenta*l considerations potentially include a broad spectrum of issues such as air emissions, water pollution, water use practices including water conservation and recycling, materials recycling, energy consumption, conservation, and efficiency and the behavior of third party suppliers upon whom a company or government entity may rely.

Social considerations potentially include such issues as the labor practices of a company or government entity, whether women and men are treated equally in the workplace, the role a company may play within the communities, where it does business, the charitable activities of a company, and the public policies a company may encourage or support relating to the many constituencies represented among the company's employees or customers.

Governance includes the range of issues for which a company's board of directors is responsible including the compensation of senior management, whether the CEO also serves as the board chairman, whether the company has different classes of stock with a variation in voting rights on corporate issues, the compensation of board members themselves, whether stockholders have a right to vote on compensation policies, and whether stockholders or a group of them can nominate candidates for the board.

The analysis of Governance is less straight forward than that of the Environmental or Social behavior of companies. While there are third parties that earn fees through their assembly of databases on corporate directors, their networks of relationships and outside activities, there is greater subjective evaluation of corporate governance than of environmental and social considerations. This in part is attributable to the greater availability of databases under federal or state programs to evaluate the environmental and social behavior of both public bodies and private corporations.

You and I might opt to pursue ESG investing through mutual funds--whether actively managed or indexed. Of course, the nature of the managers' analysis is likely to vary. What an active fund manager might consider may differ in some material regard from what the designer of an index mimicked by a passive fund might consider. Reading the fund's prospectus including its discussion of the fund's investment strategy is necessary. Given increasing investor interest in passively managed indexed funds there is an emerging cottage industry focused on the design of different stock or bond indices that consider environmental, social, and/or corporate governance policies and practices of public bodies or private companies.

With the rising interest--especially among institutional investors--in climate change and its mitigation there is an increasing focus on how to design indices that screen for those entities that are addressing this pressing subject both in their defensive strategies and pursuit of investment opportunities.

What explains the increasing interest in ESG investing among managers or marketers of mutual funds? The reasons include the following:

1. The interests and concerns of international institutions including the united nations, world bank, international monetary fund, regional international banks and countries' central banks;
2. The emergence of greater policy consensus among nation states on climate change, and other environmental and social issues;
3. The globalization of business and recognition by private companies that they need both to respond to and encourage greater consensus on how to address ESG issues;
4. With the globalization of business the recognition by nation states of the need to consider the corporate governance of both foreign and domestic companies and develop public policies that encourage/require corporate fiduciaries to perform their responsibilities according to internationally recognized norms;
5. The recognition by pension funds, university and other endowments, and other institutional investors that their financial risks and returns are affected by ESG considerations; and
6. The increasing interest and concern of individual retail investors with future environmental and social conditions and the behavior of public entities and private companies that aggravates or mitigates those conditions.

Why participate in ESG investing? There are several key reasons why you might want to consider participating in ESG investing.

First, you may be one of many investors who want to vote for good corporate behavior with their dollars – an alignment of your personal beliefs with your investment strategy.

Secondly, those who manage actively managed ESG funds or market passive, ESG indexed funds believe that consideration of ESG factors helps identify sources of business and financial risk that if not well managed might adversely affect the operations and revenues of a company and if well managed might measurably enhance the investment opportunities, profitability, and return on equity of a company. In other words, ESG focused funds may offer lower risk and potentially higher returns than funds that do not take these factors into account when choosing investments.

While there are no guarantees in investing, history has many examples of how bad decision making can damage a company's reputation and profitability -- with investors ultimately paying that price as their stocks fall on the news of legal liability or corporate malfeasance. Although there are no guarantees, an ESG screen might reduce the likelihood of investing in the next corporate scandal.

In the United States the enactment of the federal superfund law decades ago grabbed the attention of major industrial companies that had long operating histories prior to the maturing of public environmental concerns. Compliance with this law imposed substantial—sometimes draconian—cleanup liabilities upon companies. Companies learned from this experience to look for ways of operating that avoided or substantially mitigated the risk of future cleanup liabilities and related costs.

Many investors know of the federal superfund law's enforcement history. They expect companies today to manage their businesses to reduce their costs and risks of liability or loss and enhance their vision of potentially rewarding investment opportunities.

Where once there were few options for those interested in socially responsible or ESG investing, there are now many choices – with increasing interest from investors driving additional opportunities.

If you would like to review ESG focused investment opportunities that might be suitable for your portfolio, please contact your Potomac Financial advisor.