CURRENT PRACTICAL REALITIES REGARDING ESG INVESTING

By Clem Dinsmore

Selecting investments that consider the environmental, social and corporate governance ["ESG"] behavior of public companies presents many challenges: some technical, some more substantive. Institutional investors, their advisors and academicians are among those who seek to address these challenges.

Climate change has prompted a more urgent interest among pension funds and other institutional investors in the ESG behavior of companies- especially corporate governance. The increased frequency of natural catastrophic events around the world that materially disrupt societies and destroy human and physical capital has caused institutional investors to be more alarmed with the probable momentum of climate change during the lifetimes of their pensioners or shareholder beneficiaries.

The behavior of energy companies has become subject to especially acute focus. This has translated to calls for voluntary corporate carbon emissions targets, transparency in the disclosure of progress in achieving such targets, and critique of companies' business models to consider their evolving more quickly to energy companies from fossil energy companies. Some institutional investors, including Norway's sovereign wealth fund, have begun divestment of holdings in companies that are not among the industry's "supermajors."

Climate change has also prompted an increased willingness of the largest--including competing--institutional investors to confer more among themselves and pursue cooperative action on shareholder proposals affecting corporate governance and voluntary corporate carbon emissions targets.

Institutional investors, whether sovereign wealth funds like Norway's, or managers of the largest collection of indexed and exchange-traded indexed funds {ETFs] like Blackrock, Vanguard, and State Street Global Advisors face practical challenges to their engaging with corporations on corporate governance, climate change, and other ESG issues. Two interrelated challenges are: (1) their ability to engage meaningfully with managers and directors of a material number of companies and (2) their self-interest in controlling their asset management costs and, therefore, the size and compensation of their staffs, who undertake the engagements with corporate managers and directors.

Norway's sovereign wealth fund, for example, owns positions in virtually every publicly traded company in the world. Blackrock and Vanguard through their indexed funds including ETFs hold positions in thousands of companies even within a single fund. With such dramatic monitoring responsibilities these asset managers necessarily must develop engagement priorities among their holdings. They, of course, seek to maintain engagement with the largest companies in their portfolios. But they need to carefully consider whether and how their engagements with corporate managers and directors adequately cover companies in different business sectors and subject to different legal regimes.

The challenge of managing adequate engagement with managers and directors applies also to managers of the larger, actively managed, diversified portfolios like American Funds, Fidelity Investments, and T. Rowe Price. Like Blackrock, Vanguard, and State Street Global Advisors they must determine priorities among their portfolio companies in pursuing engagement with corporate managers and directors.

Institutional investors that seek to encourage companies to adopt ESG including corporate governance principles and practices also face practical challenges in defining clear metrics by which a company and its investors can measure performance. Clearly confusion among institutional and retail investors occurs if companies are held accountable to widely varying or subtly variable standards. Increasingly, institutional investors seek to work cooperatively to prompt the development of common metrics for measuring companies' adherence to ESG principles.

Finally, as all companies operate within the environmental, social, and governance norms and practical realities of the societies within which they do business, the practical benefits to investors of advocacy by institutional investors of corporate adoption of ESG principles may be limited by any conflict between the ESG principles and those societal norms and practical realities.