ESG Investing: What You Need to Know

For many investors, it is important that the money they invest is aligned with their personal values and the impact their investments have on the world. With the advent of **environmental, social, and governance (ESG) investing**, the concept has grown from a niche concern to a mainstream idea. ESG is a set of criteria meant to gauge a company's operations based on their **environmental impact** (how they foster sustainability and combat climate change), **social impact** (how they manage relationships with their employees and the communities in which they operate), and their **corporate governance policies** (the makeup of a company's leadership, and issues like executive pay and shareholder's rights).

ESG Funds

One of the most straightforward ways that investors can participate in ESG investing is by putting their money in ESG funds. ESG funds have exploded in popularity in recent years. Money flowing into funds categorized as sustainable hit a record $51.1 billion in 2020, according to data from Morningstar. That is more than double the $21.4 billion invested in such funds in 2019. Moreover, recent data shows that ESG funds are outperforming other mutual funds. Because the concept is relatively new, however, there is not yet long-term data on ESG funds' performance. Part of the reason for ESG Funds' recent success is that they are usually heavily weighted toward tech stocks, which have dominated the market recently.

ESG funds present themselves as a straightforward way for investors to support causes they believe in. Unfortunately, because there are no standardized criteria for what constitutes ESG, investors may inadvertently be supporting companies that do not further the causes they care about. To begin with, it can be helpful to look at the approaches that fund

managers take when constructing an ESG fund:

Exclusionary: In an exclusionary fund, fund managers refuse to hold assets from companies that do not align with the fund's stated goals. For example, a fund may exclude so-called "sin stocks" like tobacco companies, casinos, or weapons manufacturers. They may also avoid entire industries like fossil fuels.

Single Theme: Single theme funds will pick and choose assets that meet their stated criteria. For example, there are funds meant to foster gender diversity that will only hold stocks of companies that have women on their board of directors.

Best in Class: When taking a best-in-class approach, fund managers select assets from companies that are better than their competitors with regards to the fund's stated goals. So, a fund that bills itself as focused on the environment may still hold stocks from an oil company, so long as that company is viewed as being more "green" than other oil companies.

These various approaches give fund managers a great deal of wiggle room to loosen their criteria and shift priorities to generate better performance and appeal to ESG investors, potentially obfuscating the impact that their investments really have.

As stated above, part of the reason ESG funds have recently outperformed is that many of them are heavily weighted toward tech companies. These companies are often viewed as being more progressive with regards to diversity and inclusion, earning high marks for governance. However, the same companies are also frequently criticized in other areas, for example using non-biodegradable components in their products or outsourcing jobs and treating their non-U.S. workers poorly. This means that even though they fail to meet the environmental and social elements of ESG, they can still be included in many ESG funds.

Without standardized definitions of what constitutes ESG, it is important that investors do their due diligence and research how the fund is created and managed, so that they can ensure that it does truly align with their values.

ESG Rankings

Instead of relying on fund managers who may use inconsistent and sometimes contradictory criteria, some ESG investors may opt to pick and choose an individual company's stocks. There is a myriad of ESG ratings available to inform investors of how well a given company demonstrates ESG principles, but these ratings can vary widely, even for the same com-

pany. Take for example how three of the leading ESG rating firms score Wells Fargo. According to a Wall Street Journal analysis, as of the start of 2021, Refinitiv ranked Wells Fargo in the top 10% of all 917 banking companies its tracks. MSCI gave the company an average rating, and Sustainalytics gave them a poor rating. In the first five months of the year, Wells Fargo stock climbed 57%. An ESG investor who followed Refinitiv's ratings would have been able to take advantage of these gains, while one who abides by Sustainalytics' may have opted not to invest in them and missed out.

Researchers from Harvard have studied how it can be that the same company can receive such varied ratings from different firms. They found a large degree of inconsistency in the **metrics** used by different firms. Take, for example, employee health and safety. Some rating agencies choose to use a flat number of worker injuries to determine how well a company does in this arena, while another may use the number of injuries per 200,000 hours worked. The different metrics can lead to wildly different conclusions. Another issue is with how raters **benchmark** this data. One mining company, for example, may strive to be more environmentally friendly than its competitors, and some ratings agencies may assign it a higher score because of this. Another would compare that mining company's environmental impact to other industries and assign it a poor score accordingly. Finally, the research noted a large discrepancy in how the ratings agencies handled **data gaps**. If a company did not disclose a particular piece of information, some raters would not factor it into their rating. Others would assume an average score or make assumptions based on historical disclosures, all of which would skew the ultimate result.

Investors concerned with protecting the environment, encouraging high social values, and promoting responsible corporate governance may find themselves facing incomplete, inconsistent, and misrepresentative information. The SEC has signaled some intent to codify and potentially regulate the claims of ESG funds and rating agencies. In the meantime, however, it is up to each investor to consider how they can achieve both their ethical and financial goals and be careful not to be led astray by misleading marketing that may obfuscate the real impact of their investments.