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Why ESG Matters (Second of a Series)

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Today's ESG river had many tributaries. Early practices screened out business activities perceived to harm the environment or society. Mosaic law dating back to 1500 BC, Koran precepts, Henry VIII's lending legalization, 18th century England and Methodist movements, and the 20th century's socially responsible investing (SRI) all have embodied "doing good."

In the last fifty years responsible investing has taken on a greater urgency and focus. This period coincided with the rise of mutual funds that owned increasingly large shares of public companies. Beginning with the US civil rights movement, and apartheid in South Africa, fund managers used their growing clout to enact change in social equality and faith-based investing.

Environmental awareness also came to the fore in the 1960's and 1970's, with regulatory agencies such as the newly-founded EPA working with Congress to pass the Clean Air Act and other key legislation. Chernobyl, Bhopal and the Exxon Valdez disasters cemented concerns about lasting damage created by corporate and governmental environmental mismanagement.

The GFC was a brutal reminder that financial markets run for profit alone, without regard to sound governance principles, could cause havoc in the economy and society. Finally Covid and the racial justice movement underlined "S" issues such as racial equity, human capital management, frontline labor, and supply chains.

These historic milestones have contributed to a sense that companies don't exist in a vacuum, but (as one study put it) "there are links between the companies in which we invest and how they (and stakeholders) interact with the environment and society in which they operate."

For a variety of reasons, including a progressive political climate combined with broader debates around fiduciary responsibility, Europe has been a leader in ESG alignment – a decade ahead of the rest of the world. Regardless, fundamental investment analysis generally now includes attention paid to ESG factors.

It's hard to know whether this development is a natural outgrowth of a half-century's experience or a reaction to investor pressure and regulatory scrutiny. That has led to an equal measure of skepticism about the value of ESG inputs and outputs. Using terms like ESG, SRI, and impact investing (II) interchangeably adds to the confusion.

While SRI tends to identify investments based on ethical standards, and II those generating direct and measurable positive social or environmental outcomes, "ESG" embodies an intersection of risk-adjusted returns and societal values. With technological advances allowing data from such esoteric approaches as geospatial analysis, climate value at risk modeling, and natural language processing, ESG signals have become both more exacting and diffuse.

If a quick survey of ESG's history shows anything, it's that assessing financial dealings against environmental impacts and human interest is neither new nor unreasonable. As ESG data and tools develop, our appreciation of that relationship is bound to become more sophisticated.

Next week: We look at current ESG themes such as climate change and DEI.