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Why ESG Matters (Seventh of a Series)

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Now that we've established the broad sweep of ESG's domain as well as the challenges of reporting and disclosure, let's take a look at how it gets implemented across various asset classes.

Traditionally ESG resided in public equities given shareholder's theoretical ability to change corporate behavior. As we saw in our earlier study of the history, leverage could be applied as incentive to adopt sustainability programs or diversity measures. But soon it became apparent that more sophisticated tools would be needed to track ESG compliance and opportunities.

So-called ESG integration describes the process whereby investors incorporate all aspects of environmental, social and governance elements in their risk analysis of a business or manager. Every investor has developed their own framework to measure quality against a spectrum of elements. Critical to this evaluation is whether data can be validated by third-party research.

Underlying this approach is the assumption that companies managing their ESG frameworks effectively over time and against reasonable benchmarks are likely managing other aspects of their businesses competently. The industry has thus moved beyond a negative screening, "box-checking" approach to seeking companies strategically targeting ESG risks and opportunities.

For credit investors, it's less about the upside. The public fixed income market has now adopted and refined ESG datasets and frameworks to mitigate downside risk. Assisted by rating agencies, these questionnaires mirror checklists in financial categories, albeit with a blizzard of details across items such as carbon emissions, supply chains, and shareholder rights.

Sustainability bonds and related types of investments (see our *Chart of the Week*) have multiplied over the years as managers, issuers and investors respond to the enormous global demand for ESG product. "Use of proceeds" bonds fund specific projects like water-filtration plants, while other "linked" bonds finance businesses with sustainability targets.

Applying an ESG lens in private markets is the next frontier for the movement. At least in the middle market, one would be hard pressed to find more potential for beneficial impact than with private equity capital and attention. The clear challenge with smaller companies is being able to extract the data to apply the right metrics, or in some cases, to find data at all.

But as asset classes converge around ESG standards, it's likely that bars being set for one won't be lowered for others. Financing partners know too that ESG focus can add value for private equity investors while protecting lenders from default risks. As one asset sales head put it, "…lenders working together and influencing the decisions of companies is key for improving on ESG."

Next week: We conclude our series with the ESG outlook for private credit.