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# What is ESG and why does it matter?

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### The spectrum of ESG investing

ESG is becoming one of the more widely used terms in the investment landscape despite the lack of a clear definition of what it means or why investors should care. Adding to the confusion, there are many terms including Sustainable Investing or Responsible Investing that are used interchangeably, and they do not all mean the same thing.

Put simply, ESG refers to the environmental, social and governance factors that affect both people and the planet, such as labor rights, climate change, data privacy or financial inclusion. As ESG becomes part of the investment language, it is critical that investors understand the different approaches available so they can make the right choices for their individual circumstances. As illustrated in Figure 1, there is a broad spectrum across ESG investing spanning financial and social outcomes. Beginning with the Integrated circle on the left, the spectrum moves from simply using ESG factors as an additional lens into how a company is run to the Impact circle on the right where there is a specific and measurable outcome impacting society or the environment.

**Figure 1:**


Source: Schroders.

- **Integrated** considers financially material ESG factors as a part of the full investment analysis. This simply means that all of the relevant risks and opportunities, that we know, are factored into the analysis because these factors can have a material impact on a company's performance both in the short and long term, as well as affect the inherent risk of investing in a company. Broadly speaking, environmental factors can provide insights into a company or industry's climate transition risks, physical biodiversity risk and waste management practices. Factors affecting society include labor standards, nutrition and health and safety. Governance includes insights into company strategy, remuneration policies and board diversity.

- **Screened** is investing, or not investing, based on specific criteria. Factors are used to deliberately exclude investments (e.g., companies, sectors, countries) that don't meet these criteria or to intentionally include those that do. Ethics and/or values-based investing is an example of where screening is commonly used.
- **Sustainable** includes defining and measuring intended "sustainable" outcomes. This can include focusing on companies with commitments and proven preparation to sustain business growth while combatting the pressures of regulation, changes in consumer needs or even climate change.
- **Thematic** is investing according to a chosen investment theme such as Health and Wellness, Technology Innovation or Climate Change.
- **Impact investing** seeks to achieve a specific and measurable positive impact to society or the environment. Many investors use the UN Sustainable Development Goals as a framework to guide their impact investing. The 17 goals represent some of the biggest challenges facing the world today.

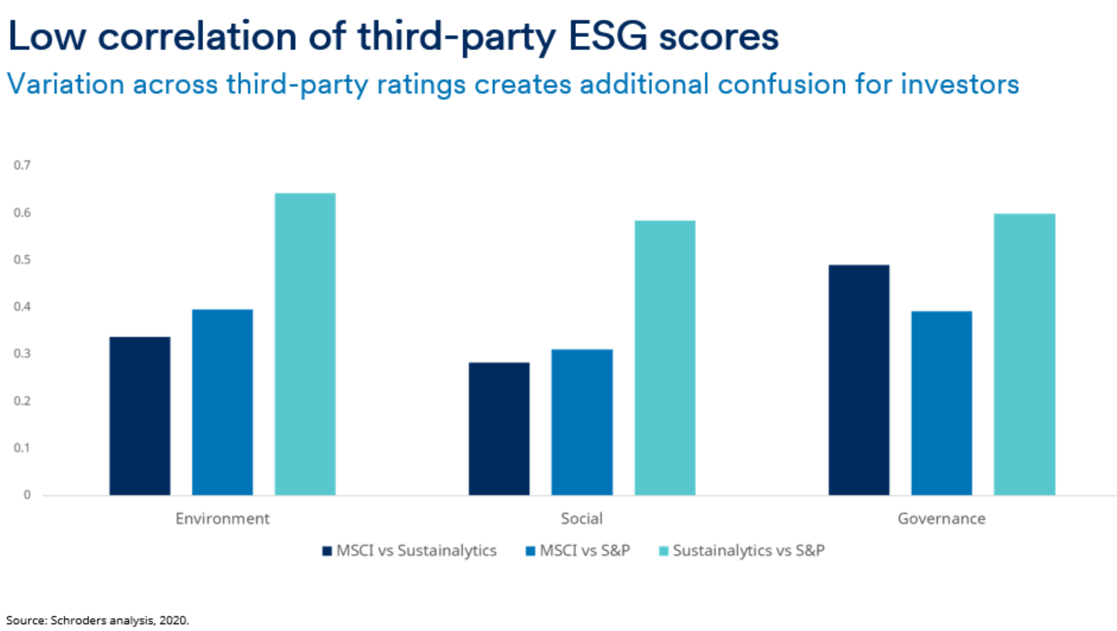
## Why consideration of ESG factors is important in investing

Regulation, policy, consumer behavior and new technology are changing, and investment will be reshaped as capital is reallocated. Regulation around ESG factors is increasing around the world. In 2021 alone, there were more than 225 new or revised policy instruments with an ESG focus established – the highest number ever recorded and more than double any previous year.[1] Shifting capital could create opportunities through identifying those sectors and companies that will benefit from the changing world, as well as risks associated with the adverse financial consequences that companies could face due to changing trends and regulations.

## Making sense of ESG scores

Third-party providers such as MSCI, Morningstar Sustainalytics, Bloomberg, and S&P publish ESG scores for companies and funds. ESG analysis, however, cannot be captured by quantitative analysis alone. There is a qualitative component that considers the importance attached to each ESG factor and that can vary significantly by firm. Despite similar sounding approaches, the main ESG rating organizations can reach very different conclusions for the same company. Unlike bond ratings, the correlation across the third-party rating providers is very low as noted in Figure 2.

**Figure 2:**

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[1] Source: PRI.

One reason ESG scores vary to such a large degree is because the third-party providers are seeking to answer different questions and considering different ESG factors. Across the providers there is no consistent definition of what sustainability or ESG factors are, let alone how to measure them. While they use similar terminology and present their results in similar ways, ESG ratings are fundamentally different from other ratings, like those given to bonds. Bond ratings are designed to measure the risk that companies default and have been reasonably accurate in doing so most of the time. As ESG ratings have no consistent definition of what they are supposed to measure or even a consistent view of what constitutes a material ESG issue, it is impossible to gauge their effectiveness or compare scores across third-party providers. It is important to note that this does not mean that one provider is better than another, simply that they have different perspectives. Company ESG scores drive fund scores and given the wide discrepancy at the company level; fund scores can also be quite different. Understanding third-party ratings is a good starting point but should not be relied upon in isolation.

## Limitations to third-party ESG scores

- Third-party scores are backward-looking. Scores are a poor predictor of future controversies, instead focusing solely on how companies change after the event. Scores may also be infrequently updated.
- As noted previously, third-party ratings are inconsistent. Each provider uses a different methodology and so come up with different answers. When aggregated at the fund level, this can be confusing for investors and financial advisors.
- Third-party scoring systems can only be based on reported metrics and policies, given they need to be deployed across a wide range of companies. A lot of the ultimate score relies on whether a company has certain policies or targets in place. This structure tends to favor larger companies, as these are more likely to have resources dedicated to sustainability reporting and are increasingly legally required to have certain policies and disclosures.

## ESG investing matters because the world is changing

Sustainability and consideration of ESG factors are an increasingly important component of investment planning, as social and regulatory pressures are becoming financial costs for companies. For example, rising carbon prices, or policies around minimum wages or minimum taxes, or new requirements like plastics taxes or sugar taxes will increasingly impact company profitability. ESG Investing is not about finding “good” or “bad” companies, but rather understanding how companies navigate through economic, societal, technological and environmental challenges to support long-term growth.

Many asset managers are incorporating ESG into their investment process, recognizing the potential value for both risk mitigation and return enhancement with strategies encompassing the full spectrum of ESG investing. Investors should evaluate not only the asset manager and strategy, but also be diligent in determining if the approach is consistent with their investment goals.

## Important information