Environmental, Social, and Governance (ESG) Investing: Doing Good to Do Well

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Abstract

The COVID-19 crisis has been a litmus test for old-style shareholder capitalism. As the world emerges from the tyranny of the virus, new standards of organizational behaviors will be expected: one where humankind demands that organizations fulfill a broader purpose and has at its center enhancing societal value and contribution. The environmental, social and governance (ESG) factors of the organizations now become important yardsticks of measuring a resilient organization, and therefore, a sustainable society. Gone are the days when what was good for business, was good for the society. A new frame is evolving which inverses the proposition, i.e., what is good for the society is good for business. ESG is that new frame. The article explores this paradigm shift in thinking. It explores academic literature on the evolution of ESG investing, illustrating its application in one organization as a case study Unilever and then addressing important ways of measuring ESG. The article concludes with challenges that ESG faces today and in moving forward. Overall, the objective of the article is to provide a short synthesis of the evolution of ESG as an important new organizational success measure demanded by the society, particularly due to experience of the pandemic and related crises during 2020.

Keywords

ESG, ESG Investing, COVID-19 Impact

1. Introduction

The COVID-19 health crisis and the subsequent economic and social issues it created have accentuated the need for organizations, boards, and leaders to em-
phasize that they are not just in existence to do “well”; but here to do “good” as well (Ya Ni et al., 2018). The enormity of this shift from financial returns to also include social returns cannot be underestimated. For several decades, organizations stood for shareholder primacy based on Chicago School’s Friedman doctrine; creating value for the shareholder was the only and goal of a business (Friedman, 2007); but the pandemic has sharply shown that a focus on merely the shareholder value is a limited and incomplete agenda for an organization (Carney, 2021). Instead, organizations need to demonstrate that they contribute positively to the upliftment of society (McDonnell & Cobb, 2020).

The pandemic has revealed deep chasms in the world we live in; from debates around diversity and social equity to issues of energy efficiencies, climate change, corporate corruption, and political divisiveness, all creating a sense of urgency in the need to rebalance organizational focus from merely creating economic value, to include and create social values. According to Mark Carney (2021), the world is witnessing a new era of ushering in a virtuous cycle: one where ethical interests, social welfare, and growth happen together. Of course, it is not without risks; nevertheless, increasingly, ESG is not just a nice to do, but a required business strategy and model.

Nevertheless, ESG is not a well-understood construct. Until recently, most organizations and investors considered it a “side condition”, maybe even a distraction to their focus on creating and enhancing shareholder value (Halbritter & Dorfleitner, 2015). There is a need to improve the understanding of ESG in the minds of the larger public and investors. The pandemic and other crises have created a force of change that is calling for urgently lifting organizations’ ethical and moral standards for humanity’s current and future benefit.

Academically, there is a need to lift the focus on ESG investing and make it a part of the mainstream commercial and business conversation so that organizations are not caught unawares about the increasing pressures from a variety of constituencies to prove that they are here for the common good (Carney, 2021). This paper bridges the gap between the paucity of knowledge on ESG investing and what people, especially investors, should know about the subject going forward. It seeks to understand the ESG initiative, its history, and its impact. It starts with what ESG is and how it is defined, and how it has historically evolved. Next, Unilever is presented as a case study for ESG initiatives to illustrate how one organization incorporated ESG within its business model. Finally, it also considers risks and issues that organizations are likely to encounter as they build their ESG capacities. It concludes that the importance of the ESG initiatives cannot be minimized, it can reshape business organizations and elevate human-kind.

2. Definition of ESG

ESG, or Environmental, Social, and Governance, is essentially a broad taxonomy that specifies nonfinancial imperatives for an organization (Johnson Jr. et al., 2020). There are two leading influencers of ESG: one is that organizations, in
many countries, encounter laws and regulations that emphasize that they maintain specific standards and demonstrate efficacy in parameters beyond the financials. The other influence is the increasing attention paid by ordinary citizens for standards of behavior that entitle organizations to be community members. Proper behaviors as per emerging social norms allow for organizations to have a license to operate.

In that sense, ESG is a smorgasbord of constructs. The environmental factors include climate change, carbon and greenhouse gas emissions, ethical management of scarce natural resources like water, air, waste, etc. Social factors involve combating child work, human trafficking, health and safety issues, diversity, inclusion, racial and social equity, data privacy, livelihood, and general employee and human welfare. Finally, Governance factors refer to Board and management control, oversight and independence, purpose, political and social voice, and issues of corruption and compensation (Johnson Jr. et al., 2020). ESG is not a static framework; it is a dynamic discovery process that holds organizations to evolving expectations of ethical, moral, and sustainable excellence beyond mere financial ones. ESG operates under the notion that organizations have stakeholders, and they themselves are stakeholders … So ESG is a litmus test of their reason to exist.

3. History of ESG

It often takes a crisis to make the world conscious of its societal obligations. The great depression in 1929 created, for instance, the US GAAP: establishing clear accounting standards. The financial crisis in 2008-9 resulted in measures to improve risk management and financial exposures. COVID-19 brought with it the agony of the human condition, social, racial, and health-related, and it is shaping the higher expectations from organizations to be involved in being a positive force for good (Carney, 2021).

The term ESG was first used by United Nations in 2004, with an invitation to the financial markets to develop guidelines that integrated the environmental, social, and governance issues in the financial world (United Nations, 2004). As more and more experts spoke about these factors, it became clear that ESG is an umbrella term that covers many different pre-existing nomological concepts including, Corporate Social Responsibility (CSR), Sustainability, Environmental, Health and Safety (EHS), Corporate Social Performance (CSP), etc. (Johnson Jr. et al., 2020). Nevertheless, during the 20th century, some of these terms were still formative, and it was often a voluntary effort on the part of the organization to do good to be seen as good, it did not have the legislative or financial rigor in its enforcement. Consequently, ESG in various connotations remained a secondary focus of an organization, behind the financial focus. Friedman’s philosophy of maximizing shareholder value was enormously influential and held the minds of many CEOs and their Board in their resolve of their prime responsibility being to the shareholders.

It is only in recent times that experts have begun to consider a more enlight-
tened view, where shareholder wealth is the result of maximizing the benefits for all stakeholders, and the purpose, or the reason for an organization’s existence, goes beyond merely profit maximization. By the beginning of 2018, ESG type investments snowballed to $18 trillion worth of assets. According to Carney (2021), many factors contributed to the dramatic increase in these numbers. For example, the rise of millennials who were far more civic and environmentally conscious and the rise of women in the workforce helped propel social causes within organizations and markets. Further, tangible evidence of climate impact and extreme examples of inappropriate commercial and organizational behaviors eroded trust in corporate organizations (McDonnell, 2021).

2019 saw two significant interventions that escalated ESG initiatives to the front end of organizational imperatives. Firstly, a letter by Larry Fink, CEO of one of the world’s largest investment firms, BlackRock, to his shareholders created a galvanizing force towards ESG. Fink drew a line on the sand by stating that his firm would only invest in firms with a vital social purpose and those deliberately endeavoring to create social impact and value-creation (Johnson Jr. et al., 2020). At the same time, the corporate business roundtable, the torchbearer of Friedman’s philosophy of maximizing shareholder value, for the first time in several decades, adopted the stakeholder value principles as the main reason for an organization’s existence. A total of 181 CEOs endorsed the viewpoint that organizations were part of a broader ecosystem, and a stakeholder approach is a shift that will allow for a win-win for all stakeholders within and outside the organization’s circle (Carney, 2021). Both these influential events in 2019 changed the view of ESG, from one that was an “and” to corporate financial performance to now being an integral part of the business model.

COVID-19 has had a further impact on the necessity for ESG. The pandemic has highlighted inequalities and inequities like no other crisis have ever done before, at least in the United States. For instance, the curbs in the food supply chain have affected agriculture, supply chains, and packaged goods companies. The downstream effect of that meant that 40% of American children were food insecure. Such insecurity impacted underprivileged sections of society more than others, particularly the African American and Latino populations (Johnson Jr. et al., 2020). In other words, the pandemic only exacerbated issues related to ESG and awakened people to the need for a more diligent effort to be ESG conscious.

The result of all this is an escalation of investments in ESG assets. What was $30 trillion in 2018 saw a jump in investments up to $100 trillion between 2018 and 2020 (Carney, 2021). In other words, while ESG investments took 15 years to reach $30 trillion since the time the UN report called for it in 2004, it took just two years for it to move up from $30 trillion to $100 trillion. In doing so, organizations are consciously and deliberately moving from a finance-first orientation to a social impact-first orientation.

4. Unilever-Sustainable Living Plan as an ESG Case Study

To be effective, ESG should not be a stand-alone initiative, subordinated to key
financial measures of an organization. Instead, it should be fully integrated into an organization's strategy, execution, Board of Director's agenda, CEO, and executive compensation, of course, its culture (McDonnell & Cobb, 2020). One company that has endeavored to do so is Unilever (Lawrence et al., 2018). For Unilever, sustainability is not just about risk management but about it being a competitive strategic advantage.

The Unilever Sustainability Living plan is positioned as a new model that is a “virtual circle of growth” (Cited in Lawrence et al., 2018). The plan put forth three sustainability pillars: to help one billion people improve their health and well-being, to reduce the environmental impact of Unilever products by half and enhance the livelihood of those in the company’s value chain. The pillars of health, environment, and livelihood further split into focus areas of health, hygiene, and greenhouse gas emissions. For instance, Unilever’s R & D’s efforts to reduce waste and emission resulted in creating a special plastics savings technology that reduced plastics usage by 15%. Unilever waived the exclusive rights to that technology so that other companies can benefit from the technological breakthrough and thereby reduce plastics waste harmful to the environment. Similarly, their ESG program effort to engage with customers in building self-image among women led them to the “Free Being Me” campaign for their Dove soap product to enhance self-esteem among girl children. The campaign grew from 20 countries to over 70 countries, positively impacting its brand loyalty (Lawrence et al., 2018).

The company tracks and reports its accomplishments across these objectives and validates them by third parties for authenticity. The Board’s disclosure committee oversees such tracking. In addition, the Board’s corporate responsibility committee tracks further progress along with the objectives and risks. Finally, the compensation committee checks on performance against KPIs on those objectives and accordingly payout bonuses. The company also has two specially designated officers: the Chief Business Integrity Officer and the Chief Sustainability Officer as part of the corporate governance team. These board and C-suite level mechanisms ensure that the Board and the senior leaders become invested in the operational performance of the ESG strategy (Murphy & Murphy, 2017; Lawrence et al., 2018).

ESG is more than a strategy for Unilever, it is at the core of who they are. The company has embedded its USLP model in its systems, processes, and culture. Constantly reinforcing its message through its website, the foundation, internally and externally, Unilever seems to be fully committed to being a pioneer in the ESG space. Today Unilever is considered a poster child for driving ESG initiatives (Carney, 2021).

5. Measuring ESG

If defining ESG is difficult, measuring ESG is even more difficult, particularly considering the many strands of information that makeup ESG (Carney, 2021). To measure a diverse set of considerations, say, air pollution, on the one hand,
gender diversity on the other hand, and executive compensation at a third level creates a confusing array of information that needs to be made sense of. Friede et al. (2015) point out that less than 25% of investment professionals even look at nonfinancial disclosures to make any investing decision, and just about 10% of them have received training on ESG related metrics. Further, many ESG metrics indicate risk mitigation efforts rather than a focus on returns (Gillan et al., 2021). One increasingly accepted way of measuring ESG is ratings done by third-party firms, who act as aggregators of information from organizations. Three ESG rating providers are popular, namely Asset4, Bloomberg, and KLD, with varying levels of data. A study done by Halbritter & Dorfleitner (2015) across these three rating agencies considered empirical studies and concluded that there is correlational evidence between the financial performance of organizations and their ESG. Other studies also show that those with ESG initiatives could better weather the pandemic (Carney, 2021).

However, despite evidence of a strong positive link between ESG ratings and long-term financial performance, there is considerable skepticism among investors (Friede et al., 2015). This skepticism, per the authors, could be due to the short-termism in the mindsets of many investors as ESG strategies take time to unravel. In addition, many academic studies come out as neutral/negative in terms of their correlation between ESG and financial performance, as they may define ESG parameters more narrowly given the confusion on the number of factors that need to be considered (Friede et al., 2015). There are moves to streamline measures. Carney (2021) reports that 140 leaders of the world’s largest business organizations employed the big four accounting firms (EY, KPMG, Deloitte, and PwC) to develop a standard ESG measurement and tracking framework. This group has come up with twenty-two quantitative core measures, in addition to thirty-four expanded measures to track ESG (Carney, 2021).

It is essential to point out that post-Fink’s Blackrock note, there is an increasing trend to consider ESG ratings as a reason to invest by itself, with financial returns being a secondary measure (Carney, 2021). Doing good has become a primary focus, and doing well, though necessary, is something investors are willing to wait for. In the case of Unilever, for instance, ESG numbers are not reported in financial statements. As a result, Unilever’s financial performance falls short of its competitors. Nevertheless, it also reports that it saved €600 M in energy costs since 2008 and that 46% of brands with purpose grew 69% faster and delivered 75% of growth. Thus, ESG advocates are happy with Unilever’s performance, while financial investors are not (Murphy & Murphy, 2017).

6. So, Where Are We on ESG Investing?

While significant progress has been made in ESG, it is still an evolving field. Many executives and investors think that the connection between ESG and financial returns is still an assumption (Porter et al., 2019). The main reason is that much of the ESG criteria do not establish a causal connection between fi-
nancial performance and ESG gains. Also, many CEOs embark on the ESG journey as a public relations exercise or attract socially minded investors. Besides, many investors may still believe in the principle of maximizing shareholder returns and may mark the stakeholder value as a self-preservation PR exercise on the part of organizations rather than a genuine effort at increasing social impact. Cheng et al. (2013) posit that many companies that invest in ESG end up with lower valuations, a disincentive to invest in ESG factors.

Another problem is that the criteria often used in ESG valuation are off the mark. For instance, carbon emission measures for a bank are less critical than predatory lending practices but counting the first and not counting the second reduces the ESG impact evaluation as a set of nice to-dos (Porter et al., 2019). Finally, many purpose statements are stand-alone “feel-good” platitudes that rarely tie up with the operational levers of the company.

These issues show that the jury is still out in terms of ESG to measure organization economic performance. While nobody doubts that ESG does enhance social impact, its lack of direct correlation with the financials continues to embolden the skeptics. Porter et al. (2019) suggest an entirely new way of measuring ESG, which they call the shared-value measure, in other words, measuring profit-driven social impact. They suggest that shared value will help organizations create a product that solves social or ESG issues, drives productivity by finding new efficiencies in its ecosystem, and improves the ecosystem in the organization’s communities. Nike producing shoes with zero waste, or Xylem using software to identify water leaks, or Unilever’s Lifebuoy product consuming 50% less water to reduce environmental impact are examples of organizations creating a shared value by differentiated product offerings (Porter et al., 2019).

The limited research on ESG investing shows that while the interest in ESG investing has surged, it is still a nascent subject. However, it is heading in the right direction with the acceleration of money flowing into ESG focused investments during the pandemic (Carney, 2021). Unfortunately, many still see it as a leap of faith and still try and fit their existing ESG initiatives into their business strategy rather than reconfiguring their business strategy to fit into ESG (Bansal & Desjardine, 2014). The business world needs more proof points of success in ESG investing so that both companies and investors can commit themselves more strongly to it.

7. Conclusion

In conclusion, the study of ESG investing is a fledgling field in need of systematic research. However, the recent increase in ESG investing just before and during the pandemic period (between 2018 and 2020, ESG investing went up from $18 Trillion to $100 Trillion) should help with enough raw material for future research. Three types of research are paramount. First, more research is needed to show a causal relationship between ESG investing and organizational growth in revenues, margins, and investor value. Likewise, research that also correlates or-
ganizational strategy and success to broader societal impact will be necessary. In addition, longitudinal studies that measure ESG impact over time will also help prove effects over a sustained period rather than just a short period.

Porter et al. (2019) warn that when organizations fail to wake up to the realities of social pressure on ESG, they erode the legitimacy of capitalism. Among other things, lack of focus on ESG is one factor responsible for a drop in trust in business organizations. On the other hand, when organizations tackle and advance ESG issues and profitably, they unleash the true power of capitalism (Carney, 2021). Organizations often consider that the only things which get done are those issues that are measured easily. However, as Einstein is supposed to have said, “not everything that counts can be counted, and not everything that can be counted counts” (cited in Carney, 2021: p. 423). Social drivers of value are as important as economic drivers. Not focusing on ESG is likely to create operational risks and erode the credibility of the Board and the leadership of the organization (McDonnell & Cobb, 2020).

Over the years, the business metaphor has become a focusing device on our world. Commercial measures pervade everything we do—our conversations are seeped in the language of performance, efficiency, waste, evidence, return on investment—all business terms that now have come to measure the success of society till recently. Only recently, we are speaking about issues of sustainability, fairness, justice, equality, equality, and inclusion. This shift in frame is now captured in form of ESG. What is good for the world, therefore becomes the principal lens and defines what is good for business, not the other way around (Block, 2013). In the future, for organizations to do well, they will need to do good, it is not a choice but a duality that we need to reconcile to.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

References


