

Introduction to Environmental, Social and Governance

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The term Environmental, Social, and Governance, abbreviated to ESG, relates to the investing sphere. In all sectors, companies look for investors. ESG is an important concept for all kinds of people, including employees, CEOs, investors, and government officials.

By the end of this track, you'll know what ESG is, how it looks in practice and its advantages and disadvantages. You will also be able to identify the dilemmas businesses that want to pursue ESG principles come up against.

ESG is a framework that third-party companies and research groups use to identify whether a company is a viable investment opportunity. Dr Jean Rogers, founder of the Sustainability Accounting Standards Board, created the framework so that ['investors could compare performance on critical social and environmental issues, and capital could be directed to the most sustainable outcomes.'](#)

ESG is an alternative to the widely held belief that companies can only be sustainable when they focus on the environment. In the investing sphere, ESG is a set of criteria (or standards) that socially and economically conscious investors use to decide whether they want to invest.

ESG is split into three elements: Environmental, Social, and Governance. The environmental criteria analyses how well a company protects and maintains the environment. The social factor explores how well a company treats employees, suppliers, and customers. Lastly, the governance criteria analyses management, salaries, audits, and shareholder rights.

Let's look at a few examples.

For the environmental section of ESG investing, a third-party research group might look at a company's treatment of animals, rules and regulations around habitat conservation, and history of waste pollution. They might ask questions like, is this company properly disposing of waste? Does this company comply with environmental regulations?

The social factor is just as broad. For this principle, a research group may consider how the company interacts with internal and external stakeholders. They might ask, does this company offer volunteer opportunities to employees? Does this company protect employees when they are on-site?

Lastly, governance is the management of organisations. For this factor, it's important to consider how accurate and transparent a company is. This can apply to accounting methods, diversity, and conflicting interests.

Sustainable investing and ESG investing are often mistaken for each other. There is a lot of overlap between these two concepts. By analysing a company on the basis of social practices, environmental ethics, and governance, we can assess how sustainable it is. Sustainability asks, does this company maintain the environments that it sources materials from? Does it maintain and support the habitats that it builds on?

The ESG framework encourages companies to act responsibly, and within the best interests of themselves, their employees, and potential investors. In fact, it's sometimes referred to as responsible investing, impact investing, or socially responsible investing (SRI). When we talk about the ESG framework, we are looking at how compatible a company is with an investor.

The ESG principle is popular because it provides investors with a broad (yet carefully considered) overview of a company's ethics. It is so popular that some brokerage firms have begun offering exchange-traded funds (ETFs) and other financial products that follow the principles of ESG investing.

ESG principles aren't absolute. Investment firms create their own set of principles that follow the ESG framework. Trillium Asset Management, an American investment firm that manages over \$5 billion annually, is selective in its choice of ESG principles. Rather than creating broad, sweeping rules that aren't relevant to all sectors and companies, Trillium Asset Management hires experienced analysts who identify problems in each situation. Following Trillium's ESG criteria, their clients can't invest in [companies involved in major or recent controversies over human rights and companies that operate in higher-risk areas or those that have exposure to coal or hard rock mining](#). These criteria might eliminate some of the most profitable investment opportunities, but it also ensures that your investments are morally justifiable.

There are advantages and disadvantages to ESG investing. To start with, let's take a look at the benefits.

The ESG framework provides us with an ethical, researched basis for investing. By only investing in companies that meet the principles set out in the framework, you can rest assured that your money is being used for good and that you are not profiting from immoral actions.

Companies that are ESG approved are far less likely to be involved in scandals surrounding slavery, trafficking, and other human rights violations. Investors who follow the ESG method don't have to worry about backlash, which can be very costly, both socially and financially. A recent example is Nestlé, which made headlines for facing a [child slavery lawsuit in the US](#). When the news broke, companies and investors who previously supported Nestlé faced public backlash, along with the expectation that they would move their money and no longer invest in the company.

Another benefit of supporting an ethical investing structure is that it encourages companies to follow suit. If most investors choose to boycott companies that don't prioritise the ESG framework, companies will invest in socially, economically, and environmentally sound practices.

Now, let's move on to the disadvantages.

Some people consider ESG controversial for placing equal weight on all three factors when they believe environmental considerations should take precedence.

The upward trend of eco-conscious consumerism blossomed after the COVID-19 pandemic. A recent study from Deloitte found that [four out of five UK consumers adopt more sustainable lifestyle choices during the pandemic](#). An even more recent study found that only [8% of people in the UK don't concern themselves with sustainability in their consumption habits](#).

It's no secret that organisations are under massive pressure to comply with widely-held beliefs about the environment. The push for green practices, rules, and regulations has been at the forefront of public consciousness for years. When the [UK government announced its Net Zero Strategy](#), decarbonisation came under the spotlight. Now, every sector of the UK economy aims to be decarbonised by 2050.

But what does this mean? In simple terms, decarbonisation is the process of removing carbon dioxide output from a country's economy. In practice, companies can decarbonise by instituting a range of small-scale and large-scale changes. They can create a sustainable supply chain, hire strategic specialists who will identify the weak spots in their business, and choose energy-efficient alternatives.

One study from Oxford found that a ['faster transition to clean energy is cheaper than slow or no transition'](#) and that 'achieving a net zero carbon energy system by around 2050 is possible and profitable.' Many believe that decarbonisation is the key to saving the environment, which is why they are hesitant to accept

the ESG model. If investors focus on all three factors (environmental, social, and governance) they are funnelling their money into companies that may have average environmental practices, but excellent social and governance policies. Critics ask, isn't it better to funnel funds into companies that prioritise environmental ethics above all else?

Another disadvantage of ESG investing is that it excludes a few of the most lucrative stocks. Tobacco and defence stocks produce above-average returns, but they are not compatible with a lot of ESG frameworks. However, one study found that half of the [people who specifically seek out ESG financial products are willing to accept a 10% loss to invest in a company that aligns with their values.](#)

Eco-conscious values are on the rise. As more and more people become conscious consumers, we expect to see more ESG investing in the future. Conscious consumerism is sometimes called ethical consumerism, and it involves shopping in a way that has a positive social, environmental, or economic impact.

Now that you know what ESG investing is, you can explore the concept more fully. There's a lot more to think about, including the main ESG investing strategies. Research *negative screening*, *positive screening*, *portfolio tilt*, and *ESG integration* to get a comprehensive understanding of the types of ESG frameworks.

If you want a quick overview of companies and their ESG ratings, you can use MSCI's [Fund Ratings and Climate Search Tool](#). It contains ESG ratings for more than 8,500 companies.

When it comes to investing, you need to reframe your mindset. In the past, investing was just about making the biggest profits in the shortest timeframes. In 2023, investing is overlaid with considerations of sustainability, human rights, and other ethical concerns. ESG acts as a pathway for people who want to consider a complex range of issues before they invest their money into a company.