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Environmental, Social And Governance: What Is ESG Investing?



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When you choose ESG investing, you're putting your money to work in companies that strive to make the world a better place. This type of [ethical investing](#) strategy helps people align investment choices with personal values.

ESG stands for environment, social and governance. ESG investors aim to buy the shares of companies that have demonstrated a willingness to improve their performance in these three areas.

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What Is ESG?

ESG criteria consider how well public companies safeguard the environment and the communities where they work, as well as how they ensure management and corporate governance meet high standards.

“At its core, ESG investing is about influencing positive changes in society by being a better investor,” says Hank Smith, head of investment strategy at The Haverford Trust Company.

According to Smith, ESG investing assumes that there are certain environmental, social and corporate governance factors that impact a company's overall performance. By considering ESG factors, investors get a more holistic view of the companies they back, which advocates say can help mitigate risk while identifying opportunities.

How Does ESG Investing Work?

Here's a closer look at the three criteria used to evaluate companies for ESG investing:

- **Environment.** What kind of impact does a company have on the environment? This can include a company's carbon footprint, its abstinence from or mitigation of toxic chemicals involved in its manufacturing and other processes and its pursuit of sustainability throughout its supply chain.
- **Social.** How does the company improve its social impact, both within the company and in the broader community? Social factors include everything from LGBTQ+ equality to racial diversity in both the executive suite and staff overall, and inclusion programs and hiring practices. It even looks at how a company advocates for social good in the

- wider world, beyond its own limited sphere of business.
- **Governance.** How does the company’s board and management drive positive change? Governance includes everything from issues surrounding executive pay to diversity in leadership as well as how well that leadership responds to and interacts with shareholders.

Why ESG Is Important

For many people, ESG investing is more than a three-letter acronym. It is a practical, real-world process for addressing how a company serves its stakeholders: workers, managers, communities, customers, shareholders. Many ESG advocates consider the environment a stakeholder too.

“Identifying the impact, positive or negative, on these stakeholders is what should become the measuring stick for quality ESG investing,” says Mike Walters, CEO of USA Financial. “This is important for the obvious impactful reasons relating to each stakeholder, but it also can be used to identify the strength and sustainability of the company itself.”

Walters says that companies that put in the work to pursue ESG goals for each of their stakeholders become well-run companies. And well-run companies become good stocks to own.

How Are ESG Scores Calculated?

ESG research firms produce scores for a wide range of companies. Those scores provide a clear and handy metric for comparing different investments.

“ESG scores represent ratings that research firms assign to individual companies,” says Linda Zhang, Senior Advisor at SoFi and CEO of Purview Investments, an investment advisory firm that specializes in global investing and impact investing. “The rating firms tend to rely on multiple criteria to evaluate each of the individual E, S and G components.”

Bloomberg, S&P Dow Jones Indices, JUST Capital, MSCI and Refinitiv are well-known companies that provide ESG research. Scores generally follow a 100-point scale: The higher the score, the better a company performs in fulfilling different ESG criteria. Scores may vary among firms, which may employ different metrics and weighting schemes.

While the specific factors assessed vary by company, ESG rating firms commonly review things like annual reports, corporate sustainability measures and board structure. Ratings firms also look at management of resources, employees, compensation and finances. Further, rating firms score companies that develop, produce, maintain or sell weapons, especially when those weapons are illegal or controversial.

Why Should You Choose ESG Investing?

Ensuring that your investment choices are aligned with your priorities is one reason to pursue ESG investing.

“Many clients are very concerned about environmental and social problems, such as climate change leading to more and severe climate crises, gender and racial inequality, data security and privacy,” says Zhang. “They want to make sure that they don’t invest in firms that exacerbate or contribute to these problems and would rather invest in those that are champions in leading ESG movements.”

But aside from helping to fight climate change and social injustice, an ESG investing strategy can offer higher returns as well.

Look at the Vanguard ESG U.S. Stock ETF (ESGV). It’s popular, having garnered \$7 billion in total net assets. Over the past five years, including 2023 through December 4, ESGV has outperformed the broad U.S. stock market embodied by the diverse S&P 500 Index three of those five years.

Year	Vanguard ESG U.S. Stock ETF (ESGV)	S&P 500 Index	
2019	33.4%	31.5%	
2020	25.7%	18.4%	
2021	26.4%	28.7%	
2022	-24.0%	-18.1%	
2023 YTD	24.8%	21.4%	

Source: Morningstar Direct, data through December 4, 2023.

So, if you invested in an [exchange-traded fund](#) like ESGV—hardly the only U.S. stock focused ESG that has outperformed

the S&P 500 Index in recent yearsâ€”youâ€™d be putting your money to work in companies with strong ESG scores as well as earning a decent return on your investment.

â€œThereâ€™s a misconception out there that you need to be willing to give up returns in order to invest responsibly, but a growing body of research shows that ESG actually helps mitigate risk,â€ says Smith.

It should be noted, though, that while many ESG indexes and index funds have recently outperformed broad indexes, like the Russell 1000 or [S&P 500](#), theyâ€™ve done this in part because of the greater percentage of tech companies they contain.

In generalâ€”and especially when investing with fundsâ€”itâ€™s important to have a mix of sectors represented in your investments to decrease the risk that poor performance in one drags down your overall investment results. You may wish to speak with a financial advisor about how you can offset investment risks introduced by a strategy like ESG that overweights certain sectors.

Is ESG Controversial?

Assailing ESG investing as a â€œwokeâ€ strategy that prioritizes leftist political goals over investor returns, several states have limited the use of ESG in public retirement system investments. In recent years, numerous conservative candidates for congress have also attacked ESG investing as part of their campaigns. And in recent House hearings, Republican members of congress hammered ESG investing.

In addition, conservatives have criticized a new Department of Labor rule that lets workplace retirement plans like 401(k)sâ€”which allow employer matching contributionsâ€”consider ESG factors when selecting investments.

Still, many financial leaders have defended their embrace of ESG investing.

Larry Fink, CEO of BlackRock (BRK)â€”the worldâ€™s largest asset managerâ€”wrote to fellow business executives in his annual CEO letter, â€œStakeholder capitalism is not about politics. It is not a social or ideological agenda. It is not â€œwoke.â€ It is capitalism, driven by mutually beneficial relationships between you and the employees, customers, suppliers, and communities your company relies on to prosper.â€

How Can You Find ESG Investments?

If youâ€™re ready to put your money to work in an ESG strategy, there are multiple ways to identify investments that fit the bill, including do-it-yourself research and use of robo-advisors as well as financial advisors.

Do Your Own ESG Research

For investors looking for individual stocks, various websites and publications produce â€œbest ofâ€ lists of the top ESG-rated stocks each year. You can start with those lists to identify potential investments that might align with your goals.

From there, you can build a [diversified portfolio](#) with an [asset allocation](#) strategy that fits your investment horizon.

What Are ESG Funds?

You donâ€™t have to limit your hunt for ESG-worthy investments to individual ESG stocks. You can also aim for funds, just as you can with non-ESG investing.

This saves you the effort of picking individual companies. Instead, you let the professional manager of a fund or index make choices for you. And you can find many online tools for researching and buying ESG ETFs and mutual funds.

A wide variety of brokerages and fund families offer highly rated [ESG funds](#), including ETFs.

And various websites rank funds for their adherence to various ESG goals. [Morningstar offers a snapshot](#) of each fundâ€™s exposure to ESG-sensitive products.

[As You Sow](#) is another website that gives funds a letter grade for their fidelity to goals such as avoiding companies that manufacture or sell guns. The site also shows the percentage of ranked fundsâ€™ holdings that do engage in the targeted practice. In addition, the site shows which values mandate the fund follows. And the site lets you compare various fundsâ€™ financial performance.

Walters says investors should take note of expense ratios for ESG funds. â€œESG characteristics are important, but so are more traditional metrics like cost,â€ he says. â€œExpense ratios for ESG funds have decreased over the years, but they are still higher than other funds on average.â€

That means you may be paying a slight premium to invest in funds that are targeting ESG criteria. You may be OK with paying a small surcharge to invest your values, but itâ€™s important to bear in mind that you may be hit with extra cost. Higher expense ratios that arenâ€™t associated with at least slightly higher performance may reduce your long-term returns.

ESG-Savvy Robo-Advisors

Investors who want to blend a DIY approach with some guidance should check out [robo-advisors](#) that offer ESG-conscious portfolios.

Guidelines about ESG investing criteria vary among robo-advisors. But those that do offer some guidance include

[Betterment](#), [Ellevest](#), Wealthsimple, Sustainfolio, Earthfolio and OpenInvest.

Fees with a robo-advisor may be higher than a do-it-yourself approach. Further, you may find yourself directed into ETFs that you could have invested in on your own. But a robo-advisor may still offer you investment research and automated investment management that you might not obtain on your own without extra cost.

ESG Financial Advisors

There are plenty of good reasons to work with a [financial advisor](#). Help with ESG investing strategies is one of them. Another is that financial advisors aim to get a high-level view of your entire financial life. That can include details that a robo-advisor might overlook, like personal values that could be used to tailor an ESG strategy to your worldview.

If you already have an advisor, they should be able to guide you toward investment choices with high ESG ratings that are aligned with your investment goals. If you're [searching for a financial advisor](#), ask candidates what kind of ESG options they've recommended to their clients in the past.

While the costs are higher than self-directed research or robo-advisors, you're gaining a full-service relationship and a trusted ally to make investments with a positive impact on the world.

Other Strategies for Socially Conscious Investing

While ESG offers one strategy for aligning your investments with your values, it's not the only approach.

Socially Responsible Investing (SRI)

[Socially responsible investing \(SRI\)](#) is a strategy that also helps investors align their choices with their personal values. SRI presents a framework for investing in companies that agree with your social and environmental values.

ESG investing is a broader approach to choosing securities. ESG investing takes into account how a company's practices and policies impact profitability and future returns, SRI is more tightly focused on whether an investment is more precisely in line with an individual investor's values. ESG factors in corporate performance while SRI solely focuses on the investor's values.

For example, if health and well-being are key values for you, one possible SRI strategy would be to completely avoid investments in companies that make alcoholic beverages or tobacco products. An ESG strategy might be fine with investing in tobacco or alcohol manufacturers so long as the companies' social and management policies met high standards, and their environmental record was strong.

Impact Investing

Impact investing is less focused on returns and more focused on intent. With impact investing, investors make investments in market segments dedicated to solving pressing problems around the globe. These sectors could include those making advancements in green and renewable energy, housing equity, healthcare access and affordability and more.

The [Global Impact Investing Network \(GIIN\)](#) has four published guidelines for impact investments:

- **Intentionality.** Investments are made with the intention to affect positive social or environmental change.
- **Investment with return expectations.** Of course, investments should generate a return of capital at a minimum.
- **Range of return expectations and asset classes.** Impact investors have diverse financial return expectations. Some settle for below-market-rate returns in order to achieve their strategic ESG objectives. Others want their ESG investments to outperform the broad market or at least be competitive.
- **Impact measurement.** Investments should have an exceptional level of transparency so investors can assess how their dollars help achieve meaningful change.

Compared to ESG, impact investing may generate lower returns, depending on the targeted sector. Lower returns can be part of a trade-off that impact investors make to support [earlier-stage ventures](#) in less developed markets.

For dedicated impact investors with a sincere interest in effecting social equity, impact investing offers a more direct approach to affecting change with highly focused investments.

Conscious Capitalism

Created by Raj Sisodia, a marketing professor, and John Mackey, the co-founder of Whole Foods, conscious capitalism is the belief that companies should act with the utmost ethics while they pursue profits.

The four guiding principles of the movement, as defined by [Conscious Capitalism](#), are:

- **Higher purpose.** Profit for these companies is a reward for a well-built conscious company, not the end-all, be-all. They strive toward a higher purpose and larger impact on the world beyond money and market share.
- **Stakeholder orientation.** A company and its leaders should develop an ecosystem that balances the needs of all stakeholders equally, not overweighting shareholder returns at the expense of other stakeholders.
- **Conscious leadership.** Leaders should work toward developing an inclusive culture and weigh equally the interests of all stakeholders in the business—from employees to shareholders to customers.
- **Conscious culture.** Companies should intentionally create a culture within their businesses that promote their values and purpose.

Conscious capitalism is strikingly similar to ESG”with one notable difference. The principles of conscious capitalism are typically embodied by the leader of a company, which often leads to them running a company with a high ESG score. Thus, when investors practice an ESG-guided investment strategy, they”re likely choosing companies that embody conscious capitalism principles.

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