What is Environmental, Social, and Governance (ESG)? Definition & Examples

Updated on May 24, 2024

Over the years, more and more investors have shown a growing interest in putting their money where their values align. If youâ€™re a socially responsible investor, using ESG criteria to screen your investments is integral to your decision-making. Hereâ€™s everything you need to know about this earth-friendly and socially aware investment indicator.

Table of Contents

What is Environmental, Social, and Governance (ESG) Investing?

In a nutshell, ESG measures the ethical and sustainable impact of an investment in a company or business. Today, socially responsible investors use ESG criteria to screen investments, as it allows them to evaluate the behavior of companies while determining their future financial performance.

As its name suggests, ESG considers environmental, social, and governance issues. Imagine, for example, a socially responsible investor looking for a company to invest money in. Before deciding to invest, the investor does research on the companyâ€™s ESG to answer several questions:

- Is the company taking steps to reduce greenhouse gas emissions?
- How is the company promoting employee diversity?
- Does the corporation have a history of abusing animals?
- Does it have accurate and transparent accounting methods?

Through thorough ESG screening, investors can safely put their money in earth-friendly and socially aware companies that align with their values, and theyâ€™re not just doing this as a mere act of virtue signaling.

Research has proven that investors who select ESG-screened investments receive a â€˜double dividendâ€™: a better rate of return with a lower risk. ESG investments are also constantly shown to outperform traditional investments.

The history of ESG

How old is the Environment, Social, and Governance standard? The term itself is more than a decade and a half old. In 2004, former UN Secretary-General Kofi Annan invited over 50 CEOs of major financial institutions to cooperate under the auspices of the UN Global Compact.

The initiative aimed to find creative ways to integrate ESG into capital markets.

See Related: Delta Air Lines, Inc. ESG Profile (DAL): Is It Sustainable?

Reports backed up its effectiveness

In 2005, the initiative birthed a landmark study entitledÂ â€œWho Cares Winsâ€, and the term â€˜ESGâ€™ investing was coined for the first time.

The report made a strong case: integrating environmental, social, and governance factors in capital markets leads to better sustainability, generates positive social impact, and makes good business sense.

During the same time, the â€˜Freshfield Reportâ€™ was also drafted by the UNEP/Fi, which displayed how ESG issues are integral in financial valuation.

Two of these reports spurred the 2006 Principles for Responsible Investment (PRI) launch at the New York Stock Exchange and established the Sustainable Stock Exchange Initiative the following year.

See Related: Iron Mountain Incorporated ESG Profile (IRM): Is It Sustainable?

Steady growth through good results

The continuous growth of ESG investing accelerated between 2013 and 2014 when studies based on ESG investments showed that good corporate sustainability performance led to stellar financial results.

Today, ESG investing has boomed to over $20 trillion in assets under management and is still expected to rise over the coming decade. However, even before ESGâ€™s inception, Socially Responsible Investments, or SRI, has been a solid movement.

However, unlike SRI, which focuses on moral and ethical criteria with negative screens like not investing in firearms, tobacco, or alcohol, ESG investing is based on the notion that ESG factors have strong financial relevance.

In 2018, ESG grew even more in popularity when thousands of professionals held the title â€˜ESG Analystâ€™. Suddenly, the investment performance indicator turned into a major specialty, and ESG investing became the topic of news articles in some of the worldâ€™s leading newspapers.

Today, established investors know that determining a corporationâ€™s ESG information is important in understanding its strategy, purpose, and management quality.

Year	Assets Under Management	Notable Events
2006	$639 billion	Launch of the UN Principles for Responsible Investment (PRI)
2010	$3 trillion	SEC issues guidance on climate change disclosure for public companies
2015	$8.7 trillion	Paris Agreement on climate change adopted by 195 nations
2018	$12 trillion	European Commission releases action plan for financing sustainable growth
2020	$17.1 trillion	BlackRock announces sustainability as its new standard for investing
2022	$35 trillion	EU Sustainable Finance Disclosure Regulation (SFDR) comes into effect

See Related: Best Impact Investing Apps

A deeper look at ESG factors

To properly assess a company based on ESG criteria, investors need to investigate a company through different lenses. Asset management companies who want to know how to write an ESG policy must fully understand these ESG factors to develop responsible investment processes.

Hereâ€™s everything you need to know about it.

See Related: McCormick & Company, Incorporated ESG Profile (MKC): Is It Sustainable?

Environmental criteria

Tree growing in a broken glass sphere

When screening for ESG, investors look deeply into the companyâ€™s environmental impact. This may include the companyâ€™s treatment of animals, waste, pollution, natural resource conservation, and energy use.

Several questions investors ask themselves before investing are the following:

- Does the company own contaminated land?
- How does it dispose of its hazardous waste?
- Does it manage toxic emissions well?
- How does it comply with government environmental regulations?
- Where does it source its raw materials, and do they contribute to deforestation?
- What are the companyâ€™s attitudes toward climate change?

See Related: Zepp Health Corporation ESG Profile (ZEPP): Is It Sustainable?

Case in point: Disney

Disney utilizes zero-net direct greenhouse gas emission policies in all its established facilities while working hard to reduce indirect greenhouse gas emissions by reducing electrical consumption.

With a company policy of having a net positive environmental impact, this multinational mass media conglomerate also has a zero-waste policy. It uses technology to save water while lowering the footprint of its product distribution and manufacturing.

See Related: Best Sustainable Business Examples to Follow

Social criteria

The social criteria bring to light a vast range of potential issues. While there are many social aspects of ESG, all of them are connected to social relationships. The companyâ€™s relationship with its employees is the most vital among these social relationships.

Here are some questions investors may ask themselves when screening for ESG.

- Are employees paid fairly, and how does their compensation fare when compared to other companies and positions throughout the industry?
- What perks and benefits are employees provided with?
- What are the companyâ€™s policies regarding inclusion, diversity, and the prevention of sexual harassment?
- Does the company offer training and education programs? Does it offer financial support for higher education, and are employees offered flexible hours to pursue further education?
- How much power are employees given within their respective departments? Are their inputs considered valuable?
- What are the companyâ€™s attitudes toward human rights issues? Do they donate to charitable causes?

See Related: Yucaipa Acquisition Corporation ESG Profile (YAC): Is It Sustainable?

Case in point: Accenture

Accenture, a multinational consulting and processing company, has one of the worldâ€™s most admirable workplaces, consistently earning it a spot on Fortuneâ€™s Best Companies to Work For.

With a focus on diversity and inclusion, Accenture continues to improve its workplace gender ratios to have an equal number of male and female employees by 2025. It also pledged to have at least 35% female managing directors.

See Related: Zendesk, Inc. ESG Profile (ZEN): Is It Sustainable?

Governance criteria

In the context of ESG, the governance factor measures how a company is managed by its higher-ups. Accounting and financial transparency are also integral aspects of great corporate governance. Here are some questions investors may ask themselves when screening for governance.

- Do the board of directors and executive management consider the interests of the companyâ€™s stakeholders, including the shareholders, employees, and customers?
- What are the companyâ€™s advocacies on giving back to the community where they are located?
- Are board members acting in a genuine fiduciary relationship with their stockholders to avoid conflicts of interest?
- Are the members of the board of directors an inclusive and diverse group?
- For many ESG investors, executive compensation is a primary focus. Are executives given million-dollar bonuses while their employees are in a salary freeze? Or are executives offered extra compensation to increase the viability and profitability of the business?

See Related: Triton International Limited ESG Profile (TRTN): Is It Sustainable?

Case in point: Xerox and Advanced Micro Devices

American printing corporation Xerox features a 90%-independent board of directors and a comprehensive list of corporate governance guidelines. The board of directors is tasked to serve on no more than four other boards while holding meaningful equity ownership in the company.

Advanced Micro Devices has a long list of governance principles, which states that directors need to be reelected every year with no more than two employees as directors at the same time. Members of the Compensation Committee and the Audit and Finance Committee are also expected to serve on only one public board. At the same time, directors are expected not to overcommit themselves on too many boards.

See Related: Velocity Financial, Inc. ESG Profile (VEL): Is It Sustainable?

Putting them all together

Of course, no company will pass every test in all categories, so investors need to focus on values that are important to them. A good example is Trillium Asset Management â€“Â a Boston-based company that uses ESG factors to determine which companies are poised for long-term performance.

Trillium follows ESG criteria that prevent companies from deriving a certain percentage of their revenues from weapons or nuclear power or those that dabble in coal mining. The company also avoids putting its money in institutions with ongoing animal abuse, workplace discrimination, and corporate governance controversies.

See Related: Best ESG Artificial Intelligence Software

Why do investors care about ESG?

A man checking out the stock market

More and more investors are realizing the value of ESG investing and how it delivers what everyone longs for: great, risk-adjusted performance in the long run.

While assets under management in EST investments are on a steady rise, some investors are still clueless: why should I care about making investments that generate a positive impact? Here are some reasons to consider.

See Related: Webster Financial Corporation ESG Profile (WBS): Is It Sustainable?

1. Millennials are in on it

According to popular opinion, millennials are a great fit for impact investing. ESG is aligned with virtually all the aspects of a millennialâ€™s decision-making, from consumer habits to jobs and finances. Millennials often prioritize the environmental and social impact of everything they do.

According to a 2018 US Trust survey, 87% of millennial investors believe ESG investing should play a strong role in deciding which companies to invest in. Millennials have a wealth of about $30 trillion â€“ their passion for impact investing could be largely transformative.

See Related: Ubiquiti Inc. ESG Profile (UI): Is It Sustainable?

2. ESG may improve company financials

According to research, employing ESG criteria in your investment decisions has a positive impact on financial performance. In one meta-study, ESG performance was measured in over 2000 individual analyses across regions and asset classes between 1970 and 2014.

The study discovered that nearly 50% showed a positive relationship between corporate financial performance and ESG (only 11 found a negative relationship). This is, however, a study done at the company level, which is more likely to find a positive relationship between financial performance and ESG.

See Related: Uber Technologies, Inc. ESG Profile (UBER): Is It Sustainable?

3. Thereâ€™s a positive relationship between ESG and financial performance in emerging markets

A growing number of studies are finding a positive relationship between corporate financial performance and ESG in emerging markets than in developed markets. This is mainly because lower ESG standards in these markets resulted in larger potential gains.

See Related: U.S. Silica Holdings, Inc. ESG Profile (SLCA): Is It Sustainable?

4. The trade-off between fund performance and sustainability is a myth

Some investors believe that doing the right thing with their money will sacrifice the performance of their funds, but studies say otherwise. A study conducted by Morningstar found that ESG funds have successfully outperformed the wider market over the long term.

Out of 4,900 funds analyzed in the research, over 77.3% of sustainable funds made available to investors more than a decade ago are still around today, compared to just 46.4% of traditional funds.

Experts attribute this performance to several reasons, but most believe it could be because ESG funds are typically biased towards higher-quality companies that operate more efficiently and sustainably.

See Related: What is the Theory of Change?

Whatâ€™s in it for you?

A contribution to the global good. Investors put their money in ESG companies that do good for the world. If values are important to you, then ESG investing allows you to talk the talk and walk the walk.

An opportunity to invest in better-performing companies. A growing amount of research proves this. ESG companies are showing annualized returns of 5.46%, a slightly better performance than the S&P 500â€™s 5.43% over the same period.

A lower risk. By following ESG criteria when choosing your investments, you may be able to avoid companies with practices that could signal a risk factor. Investors know how much a scandal or controversy can rock stock prices, resulting in losses.

Starting an ESG portfolio can be challenging for the uninitiated, but it doesnâ€™t have to be difficult. Since building an investment portfolio takes time, investors can seek the help of robo or in-person advisors to build and manage investment portfolios based on their goals and risk tolerance.

While itâ€™s good to rely on advisors when choosing companies to invest in, it also pays to conduct your research, especially if youâ€™re an investor that puts huge importance on values and ethical practices.

Read reviews from independent research firms to determine how a company or funds score in the ESG department. Be aware of the ESG Investing Trends so that you wonâ€™t be left behind.

See Related: What is the Sharing Economy? Important Pros & Cons to Know

How to understand an ESG score

A tree shaped into a rising trajectory

Trying to make sense of an ESG score, especially when around 10 to 15 major ESG rating agencies have their rating scales and reporting formats, can be very challenging. Thereâ€™s a lot of research for investors, especially if you create an ESG-style investment portfolio yourself.

When portfolio managers develop an environmental, social, and governance investing strategy, they typically consider ESG ratings from over three agencies when creating their models.

The report a portfolio manager chooses to base his research on is entirely based on his preference. Here are some of the most popular third-party ESG reports and rating providers.

See Related: Venator Materials PLC ESG Profile (VNTR): Is It Sustainable?

1. Bloomberg ESG Data Service

Bloomberg offers a rating scale of 100, while also providing scores from third-party rating agencies, including Sustainalytics, RobecoSam, and ISS Quality Score.

The company evaluates companies annually while collecting public ESG information they disclose through CSR reports, websites, annual reports, public sources, and company direct contact.

The companyâ€™s ESG data covers over 120 ESG indications, including carbon emissions, pollution, community relations, human rights, executive compensation, and shareholder rights. Bloomberg had over 12,200 ESG customers in the past year.

See Related: Veoneer, Inc. ESG Profile (VNE): Is It Sustainable?

2. Corporate Knights Global 100

This Toronto-based company is responsible for publishing the Corporate Knights magazine, which includes a list of the 100 most sustainable companies in the world. Corporate Knights are the worldâ€™s largest magazine on sustainability and responsible business.

Corporate Knights update their ESG scores annually and rates on a 0 to 100 scale against other companies in the same industry.

Rankings considering 14 key performance indicators, including employee management, financial management, and supplier performance, are based on publicly disclosed data with all geographies and industries considered.

See Related: Triumph Group, Inc. ESG Profile (TGI): Is It Sustainable?

3. DowJones Sustainability Index (DJSI)

This is the first global index to track a companyâ€™s sustainability. DJSI partners with RobecoSAM to calculate and publish ESG indices. With a rating scale out of 100, DJSI annually ranks companies with their peers in the same industry.

The DJSI World Index represents the top 10% of the largest companies in 60 industries. Industry-specific questionnaires which cover ESG factors are sent to all participants.

See Related: U.S. Xpress Enterprises, Inc. ESG Profile (USX): Is It Sustainable?

4. Institutional Shareholder Services (ISS)

This company offers institutional investors myriad ESG solutions to help them integrate and develop responsible investment practices in their investment decisions.

The ISS Quality Score rating scale ranks from 1st to 10th decile, analyzing 200 factors divided into four pillars: shareholder rights, board structure, audit & risk oversight, and compensation or remuneration.

Scores in the 1st decile show higher quality governance practices and lower governance risk, while scores in the 10th decile show higher governance risk.

See Related: Corporate Governance: Reasons for Effective Management

Frequently Asked Questions

What does ESG stand for?

ESG stands for Environmental, Social, and Governance criteria. ESG is an established set of standards that socially conscious investors measure to screen good investments.

The environmental criteria measure how a companyâ€™s business practices and initiatives respect the environment. The social criteria examine a companyâ€™s relationships with its suppliers, customers, employees, and community. The governance criteria measure a companyâ€™s leadership, audits, executive pay, shareholder rights, and internal controls.

See Related: Parker-Hannifin Corporation ESG Profile (PH): Is It Sustainable?

Is ESG Investing Good?

ESG investing is good and in more ways than one. Aside from having a more ethical portfolio that contributes to a positive impact, thereâ€™s growing evidence that ESG investments can deliver similar (if not higher) returns than traditional investments while carrying less risk.

According to a study by the Morgan Stanley Institute for Sustainable Investing, the total returns of sustainable ETFs and mutual funds were similar to traditional funds from 2004 to 2018.

The same study also discovered that sustainable funds carried lower risk than traditional funds, regardless of the asset class.

See Related: The Kroger Co. ESG Profile (KR): Is It Sustainable?

What is the difference between ESG and SRI?

Among those creating a sustainable investment portfolio, socially responsible investing (SRI), ESG, ethical investing, and impact investing are often used interchangeably. In reality, there are a few differences you should know about.

Both ESG and SRIâ€™s goals are to create more responsible portfolios. Historically, however, SRI developed a more exclusionary-only approach to filter out negative investments like alcohol or tobacco. ESG investing, on the other hand, also excludes the same assets but also considers and includes companies that create a positive impact.

While youâ€™ll still find providers who follow an exclusionary approach in creating socially responsible portfolios, youâ€™ll find providers who exclude certain investments and include ESG funds.

So you already know the difference between ESG and SRI, but how about Impact Investing? One must also learn about it. One must also learn about the history of Impact investing and its importance.

Why is ESG so important?

ESG is important to investors as it offers several financial benefits. Companies that display an excellent ESG score often perform well financially. Socially responsible investors and green investment funds are more likely to support companies with good ESG standings.

According to MSCI, high-ESG companies experience less volatile earnings, lower cost of capital, and smaller risks than companies with poor ESG standings.

What is an ESG strategy?

An ESG strategy is a companyâ€™s overall game plan of building an ESG policy while developing actionable guides to achieve sustainable operations. When a company creates an ESG strategy, it assesses and identifies the ESG factors it considers aspirational presently and in the future, both from a financial and non-financial standpoint. This may include understanding ESG risks and how to amend them while developing a program with measurable targets.

Related Resources

- Best Solid State Battery Stocks
- Best ESG Stocks to Invest in Today
- Best ESG Exchange-Traded Funds

The Impact Investor

Kyle Kroeger, esteemed Purdue University alum and accomplished finance professional, brings a decade of invaluable experience from diverse finance roles in both small and large firms. An astute investor himself, Kyle adeptly navigates the spheres of corporate and client-side finance, always guiding with a principal investorâ€™s sharp acumen.

Hailing from a lineage of industrious Midwestern entrepreneurs and creatives, his business instincts are deeply ingrained. This background fuels his entrepreneurial spirit and underpins his commitment to responsible investment. As the Founder and Owner of The Impact Investor, Kyle fervently advocates for increased awareness of ethically invested funds, empowering individuals to make judicious investment decisions.

Striving to marry financial prudence with positive societal impact, Kyle imparts practical strategies for saving and investing, underlined by a robust ethos of conscientious capitalism. His ambition transcends personal gain, aiming instead to spark transformative global change through the power of responsible investment.

When not immersed in the world of finance, heâ€™s continually captivated by the cultural richness of new cities, relishing the opportunity to learn from diverse societies. This passion for travel is eloquently documented on his site, ViaTravelers.com, where you can delve into his unique experiences via his author profile.

FacebookTwitter Pinterest Email

Filed Under: ESG Investing

Primary Sidebar

Search this website Search this website Search

Start ESG Investing

Best Impact Investing Apps

Best ESG Investment Funds

ESG Investing Trends

What are the Core ESG Principles?

Investment Product Reviews

Earthfolio Review

Betterment SRI Review

Axos Invest Review

Nutmeg Review

Wealthfront SRI Review

Recent Posts

- Beyond Profits: The Transformative Power of Progressive Investing
- Investing in Nature: The Bioeconomyâ€™s Path to Sustainable Prosperity
- 20 Most Eco-Friendly, Sustainable Banks & Investment Apps for 2024
- 17 Best Low Interest Credit Cards: Top Choices for Affordable Financing
- Labor Value Theory: Unraveling its Economic Impact

Polar BearPolar Bear on Ice on Ice

-
-
-