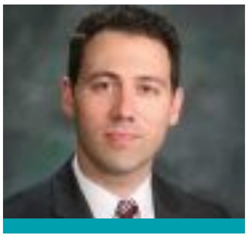
ESG was hijacked. Now it requires a social about-face

The marketing is hard to fault, but the make-up of ESG investment products means they fail to match the high ideals of socially responsible investors



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Many institutional and individual investors demand social and environmental responsibility. In response, investment organisations created screens and checklists to measure social responsibility and multinational corporations instituted Corporate Social Responsibility (CSR) and 'shared values programs' to demonstrate their commitment to communities. Incorporating social factors into investing has taken many names: socially responsible investing (SRI), social impact investing, triple bottom line, and probably the most popular standard, environmental, social and governance (ESG). Although ESG is a great marketing campaign to attract socially conscious investors, it often falls short of fulfilling its intent: to provide measurable and comparable metrics on investments' social benefits.

Investment firms have dedicated research groups and created indices and investment vehicles to fulfil demand for ESG exposure. There is no industry standard, however, and each organisation defines ESG differently. For instance, Morgan Stanley incorporates self-reported firm information – compiled by Bloomberg – into a screen that equally weighs three ESG factors: environmental, social and governance. Morgan Stanley does not explain, however, why separation of the CEO and chairman roles (governance factor) should be given the same weight as evidence of human rights violations (social factor). Sustainalytics, a firm used by Morningstar, weighs environmental, social and governance factors differently for each sector, resulting in a similar lack of comparability. For Facebook, the weighting for environmental, social and governance variables is 30%, 45%, and 25% respectively, while 3M's ratings are 40%, 35%, and 25%. The above demonstrates an industry-wide challenge of using a single variable to compare social benefit across different sectors, geographies and political environments.

The 'S' component of ESG is the factor investors need to measure properly in order to understand the actual social impact of their investments. Environmental and governance are subsets of the

APPLE CASE STUDY: HOW ESG FAILS TO INCORPORATE SOCIAL VARIABLES

Morgan Stanley's Sustainable Impact Model Portfolio includes Apple as a first-quintile ESG performer and a leader among its peers. Apple is lauded for its supplier responsibility report, recycling program and "progress" in its supply chain management. Yet one of its main suppliers [in China], Foxconn, has treated workers so poorly that 12 employees jumped to their deaths from factory rooftops and remaining employees threatened mass suicide – a threat that was met not with negotiation, but with the installation of suicide nets. If firms screen companies for vices such as alcohol, tobacco and guns, shouldn't Apple be disqualified for condoning socially harmful and inhumane labour practices?

social factor; they are significant because of their social implications. Environmental impacts, such as oil spills, matter because they affect the health and livelihood of the population. Poor governance may indicate poor management results, but at its core, governance impacts, like stealing funds from company accounts, are most significant because of the financial implications on stockholders, suppliers or other stakeholders.

ESG measurements are skewed because analysts can measure and quantify environmental and governance events more easily than 'social' events (e.g. protests, strikes, looting, violence). An oil spill costs $X billion to clean up, a carbon credit costs $Y, a corrupt official steals $Z million from company accounts, or a board has less than 50% of independent directors. The difficult, yet more pressing question is: how do socially responsible investors measure the benefits of creating several hundred jobs at a cigarette factory compared with the negative effects of greater healthcare costs, diminished life expectancy and heightened pollution from increased cigarette smoking? Concentrating on environmental and governance factors ignores the original intent of what socially responsible investors are seeking: socially beneficial and impactful investments.

PHILIP MORRIS CASE STUDY: HOW SCREENS ARE UNREPRESENTATIVE OF SOCIAL BENEFIT

The face of the tobacco industry, Philip Morris, is screened out of most, if not all ESG funds, indexes and portfolios. Yet its Rural Communities initiatives support small-scale, family-owned farms around the world. Programmes provide community- specific basic needs like clean water, eco-pit latrines and fuel-efficient stoves in Malawi, Mozambique and Tanzania. Rainwater collection tanks supply fresh water to more than 300 villages year-round in the drought-stricken northeast of Thailand. The social benefits of programmes that provide sustainable food, water and education to communities in the poorest areas of the world should be given due consideration when ESG screens are applied.

ESG investing requires a 'back to basics' approach to refocus socially conscious investors on their original intent: to benefit society. This requires a methodology that consistently measures and quantifies firms' social benefits and risks across diverse sectors and geographies. The solution is a population-centric analysis that quantifies: (1) the social risk in environments where firms operate (i.e. social tensions and basic needs of the population); and (2) the management's risk mitigation strategies (i.e. how the firm reduces social risks and provides community-specific solutions).

This approach creates two consistent variables that can be measured and compared across any industry. This combination provides a standalone Social Benefit Rating that delivers a buy, hold or sell recommendation to investors.

For firms with a long-term investment horizon, focusing on social risk through a population-centric methodology is an easy financial decision. Firms will be able to demonstrate their commitment to shareholders and investors and achieve the original spirit of ESG by creating positive social impacts for communities. By understanding social risk, firms also limit conflict (i.e. protests, strikes, litigation and violence) that threaten investments and improve their reputation (i.e. CSR and public relations) to increase share price.