100 HYMANS # ROBERTSON

Understanding why ESG matters

An introduction

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What is ESG?

When you invest in a company, a variety of factors can affect its performance. How competitive are the company's products or services? Is the management team of good quality, and is the company adapting well to change? For many years, professional investors have been considering these questions. But more recently, investors have identified another set of factors that can affect the performance of a company. These are environmental, social and governance (ESG) factors.

ESG factors represent the various sources of risk and opportunity that can have a bearing on the performance of individual companies, assets and portfolios. In this guide, we introduce each factor and explore how it can affect investment performance. We also touch on the regulations that affect pension schemes.

Introducing ESG

The 'E' – environmental
Environmental factors include climate change, pollution, water scarcity and biodiversity. Climate change will have momentous consequences for human life and the natural world, so we treat this as an all-encompassing issue, rather than merely an environmental one. The other environmental factors tend to be specific to an industry or company.

The 'S' – social
Social factors often receive less attention, but they are just as important. They include issues such as diversity, data protection, issues of exploitation and health and safety.

The 'G' – governance
Governance factors relate to the management and oversight of companies and include the structure of a company's board, executive pay, and bribery and corruption. This is a key consideration for all companies, because strong governance is typically associated with the effective management of risks.

Environmental factors

- Environmental factors
- Resource scarcity
- Water stress
- Biodiversity
- Pollution
- Energy efficiency
- Waste management

Social factors

- Customer satisfaction
- Community relations
- Working conditions
- Diversity
- Health and safety
- Employee wellbeing
- Data protection

Governance factors

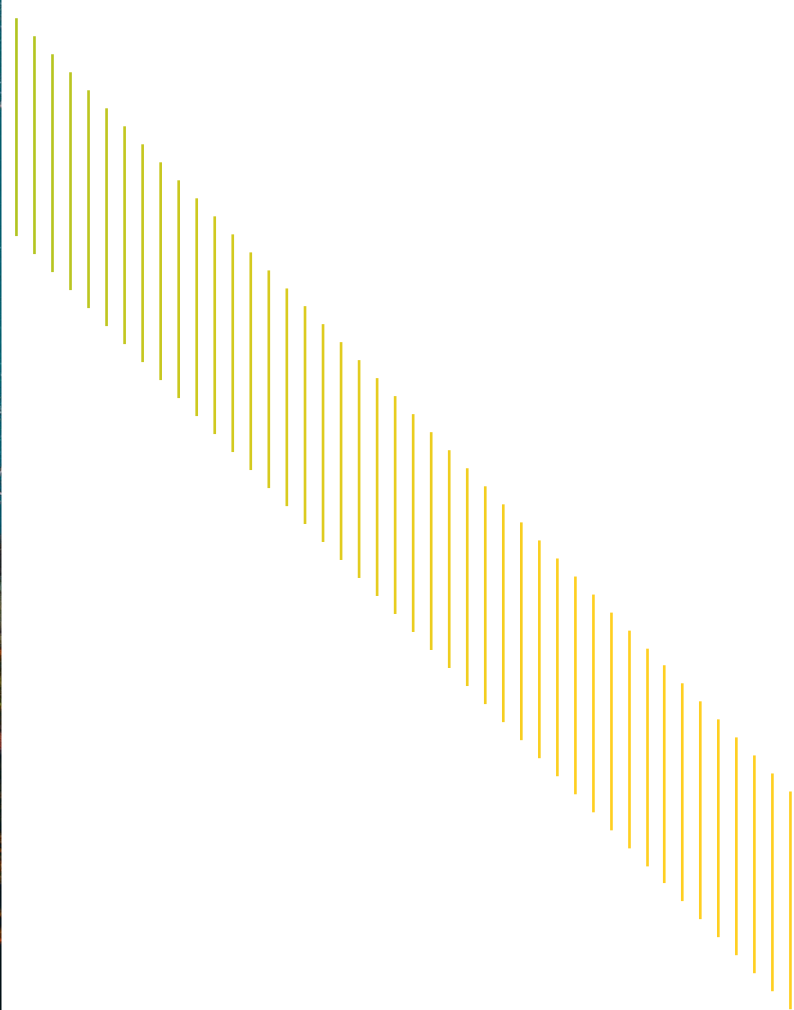
- Board Structure
- Accounting and audit
- Executive remuneration
- Bribery and corruption
- Shareholder rights
- Transparency
- Political contributions

Why is ESG important?

You can consider ESG factors in two ways – an ideological or ethical position, or one of risk management. As a trustee, you may have received queries from scheme members asking if their pension fund is investing in companies that are benefiting the environment and society. Alternatively, you might be approaching ESG in the context of meeting (or exceeding) your regulatory obligations. Either way, it's important to understand the basics of ESG investing and how they can affect your scheme.

A note about 'materiality'

It's also important to note that not every ESG factor will be relevant to every investment. The job of professional investors is to ensure they focus on the issues that could have a material impact on risk and returns.



Climate change: the all-encompassing ESG issue

At first glance, the most obvious categorisation of climate change is as an environmental risk. But the consequences of climate change are so profound and far-reaching that we see climate change as a systemic risk. If unchecked, it will impact all aspects of society. In the table below, you can see the ways in which climate change intersects with the environment, society, and issues of corporate governance.

Environment	Direct carbon emissions are the obvious area of focus in addressing climate risk. Evolving policy, societal pressure, and technological change are likely to penalise those companies that do not take steps to address emissions. Other environmental factors include land-use change (deforestation is a significant contributor to emissions); exposure of key assets to physical climate effects (particularly where assets are not readily relocated); and resource stress, as the availability of key resources may be affected by climate change.
Social	Climate change is also a fundamental concern for people. Livelihoods may be disrupted by changing weather patterns creating migration, while a shift away from an economy dependent on fossil fuels is likely to affect employment prospects in many locations. There is a need for a 'Just Transition', where people are placed at the centre of the changes that must be made. This could range from the way in which people are trained and acquire skills to support a new economic paradigm, to the development of an economic system that is fair and equitable.
Governance	Are organisations giving climate change enough attention? The implications of climate change are likely to be broadly felt, but some groups will be affected more. Companies that operate within, or service more, carbon-intensive sectors will need to develop strategies for change; those that don't may get left behind. Company boards and management need to be held accountable by shareholders and investors. Are disclosures comprehensive, has a strategy been developed, and is the remuneration of key decision-makers tied to making progress against these issues?

Climate change regulations

At a high level, climate change represents a risk to the global economy. The Financial Stability Board, an international body that identifies vulnerabilities in the global financial system, set up a body to increase the quality of climate-related reporting, called the Task Force on Climate-related Financial Disclosures (TCFD). In 2017, the TCFD published recommendations to help companies define their strategy, identify areas of risk, and set targets. From October 2021, pension scheme trustees need to assess, manage and report on climate-change risk. As the window to act on issues of climate change closes, we expect to see increasingly stringent regulations. It's important for investors to keep up to date with these.

Environmental factors

The stakes are high when it comes to environmental risks. Not only can neglecting such risks have a devastating effect on the natural world, they can irrevocably damage a company's reputation and financial performance.

You might remember the BP Deepwater Horizon disaster of 2010, which released over 200 million barrels of oil into the Gulf of Mexico. The disaster cost BP an estimated £65 billion[1], and its shares have yet to recover to their pre-catastrophe levels. And in 2018, the faulty equipment of Pacific Gas and Electric, a US utility company, was responsible for a wildfire in California that claimed 84 lives. In early November (the month of the wildfire), the company's share price was trading at $47. The company entered administration and was restructured, with the new entity taking a hit on its credit rating – it was downgraded from investment grade to junk.

These high-profile incidents represent the considerable risks and potential costs to firms that neglect or badly manage environmental risks. But environmental risks also arise in ongoing business activities, and these need to be managed. For example, many companies interact with the environment by taking raw materials from it, or by discharging waste. The impact on the environment arising from such activities is known as an "externality", and companies have often not incurred costs associated with externalities. However, this is changing.

Regulation driving change

Regulations govern how much material companies can extract from a given resource and the limitations on how waste materials may be discharged into the environment. Where companies discharge pollutants, they may need to ensure that their processes meet minimum standards, placing a direct cost on the organisation. The higher the standard, the greater the cost.

Carbon pricing: the cost of pollution

One mechanism that governments can use to address climate change is by placing a price on carbon emissions. The idea is that by charging companies for their emissions, they are incentivised to cut emissions and/or develop technologies that allow them to maintain current processes. The EU Emissions Trading Scheme is one such mechanism, under which the price of one tonne of emissions has risen to around €50 in 2021.

[1] https://www.reuters.com/article/us-bp-deepwaterhorizon-idUSKBN1F50NL

Differences in environmental regulation around the world mean that companies might be operating in locations where lower standards are in place. In this scenario, financial costs are lower, but the impact on the local environment could be greater. This creates litigation risks for companies as populations then seek recompense for failures to mitigate the impact of industrial activity. The behemoth mining company Vale is a cautionary tale in this regard. The Brumadinho dam in Brazil burst in 2019, killing 270 people and leaking iron ore waste into the Paraopeba river. As well as being on the hook for a $7bn compensation payment to local communities, Vale must put right the environmental damage wrought in the area.

Interconnectedness

A key consideration for environmental risks is their interconnectedness, with one factor having a direct impact on another. For example, we know that climate change is likely to impact on global weather patterns and consequently rainfall. This could lead to increased levels of drought, and companies that rely on water for their production processes in areas with high levels of water stress could find their operations affected.

Biodiversity: an underappreciated risk

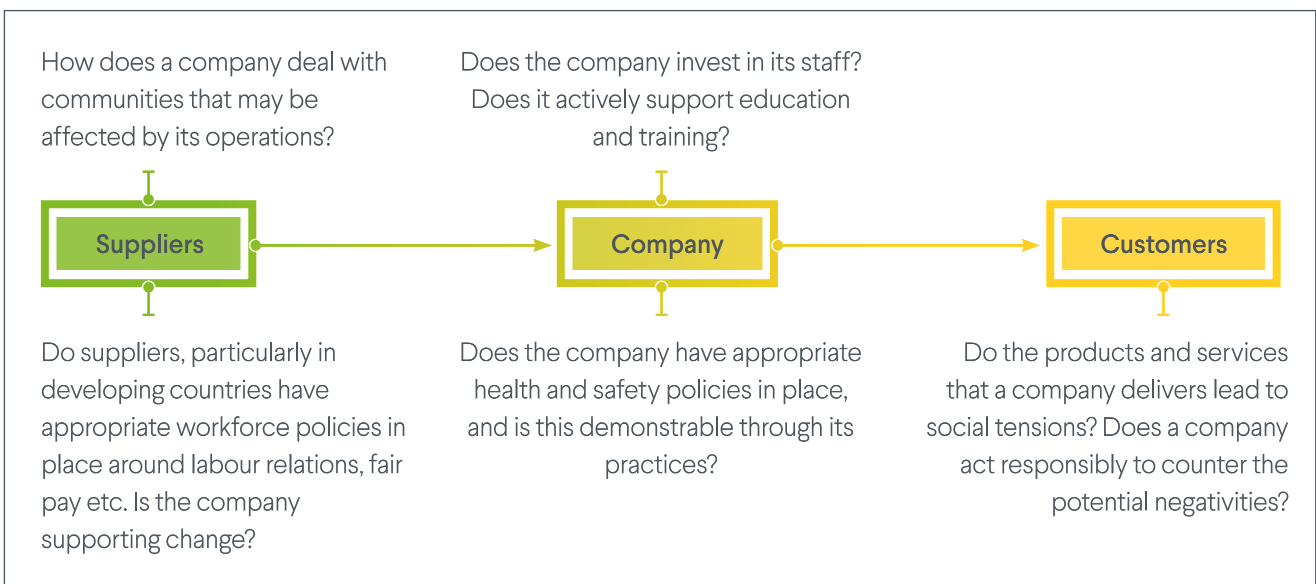
Biodiversity, or the biological diversity of life on earth, is under threat from multiple sources including climate change, changing land use, pollution and urbanisation. We perhaps fail to appreciate the importance of biodiversity and the interconnected nature of different ecosystems, yet we rely on the services they provide. For example, our agricultural systems rely on pollinators that support our basic existence. Business practices that damage the environment and biodiversity therefore offer broader risks which need to be understood and managed.

What this means for investors is that they can't think about each risk in isolation, but need to consider all the impacts that different risk factors may have, including the interaction between different sources of risk. Companies need to do the same and ensure that they have a comprehensive approach to risk management, including the management of ESG risks.

Social factors

The 'S' in ESG represents the human dimension within investment decision-making – issues that have an impact on, or potential cost for, people. Many businesses highlight people as their most important asset, so how a company treats its direct workforce is likely to have some bearing on the attractiveness of that company as both an employer, and a potential investment. Further, how a company develops and implements policies that impact on people within its supply chain, customer base and beyond could impact its reputation.

The infographic below considers the social touchpoints in a company's operations – from its suppliers, its staff, to its customers. As you can see, there are important questions to be asked about the company's interactions with its suppliers and customers and, of course, how it treats its own people.



Social factors manifest in different ways and, as society demands higher standards and behaviours, some practices may become unacceptable. Legislation can often underpin such changes, such as equality. Other rights, such as the ability to be treated as an employee within the gig economy, have to be fought for. More recently, issues of social justice through campaigns such as Black Lives Matter have highlighted the need for change. Feminist issues around representation and discrimination (for example, towards working mothers) are also driving change.

Working conditions: an issue at home and abroad
Boohoo, a fast-fashion company, hit the headlines in 2020 when poor working conditions in its suppliers' factories in Leicester were highlighted. The investigation and press coverage significantly damaged Boohoo's share price, and the firm has come under pressure to ensure that workers are paid fairly and standards improved.

Similarly, the development of new services creates risks that may not have been foreseen. This is particularly notable within social media, where protections against abuse and harassment, and broader issues around the use of data have been notable.

Working practices overseas are often less visible, but no less important. Suppliers of both raw materials and manufactured goods often face scrutiny on the pay and working conditions of their employees. However, often only disasters or litigation reveal the true costs incurred.

Companies showing their mettle

Social factors were notable during the COVID-19 pandemic, with companies being praised or castigated for their treatment of staff and the protections of health and employment that were made available. Many recognised that people would be essential to the successful running of businesses once lockdowns were eased. Our own discussions with investment managers highlighted this, with one stating, "what a company does tells us a lot about the quality of management in how it reacts in a crisis."

Diversity: more than representation

Diversity is much more than a corporate buzzword. A company employing people from different ethnicities, socioeconomic backgrounds, and genders, brings a wide range of perspectives and insights. When it comes to decision-making, there is diversity of thought. Conversely, a company dominated by people of the same race, gender, and socioeconomic background risks groupthink stemming from a common set of perspectives. Diversity of thought also makes good financial sense. Research from McKinsey[2] found that companies scoring well on gender diversity (in the top quartile) were 25% more likely to be more profitable than companies ranked poorly (in the bottom quartile).

Moreover, in a less diverse workforce, business ideas and products that are questionable/risk reputational damage are less likely to be identified and challenged. For example, in 2019, fashion brand Gucci was castigated for introducing a 'blackface' jumper. Questions were asked about diversity, specifically around the company's lack of black designers. Withdrawing the item, Gucci acknowledged the part that a lack of diversity had played in the incident[3], saying "we are fully committed to increasing diversity throughout our organization and turning this incident into a powerful learning moment for the Gucci team and beyond." For investors, issues like this matter, because reputational damage can translate to financial loss.

[2] https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters

[3] https://www.nbcnews.com/news/us-news/gucci-creative-director-says-unintended-racist-imagery-890-sweater-causes-n971261

Governance factors

The role of the board

The 'G' in ESG - governance, encompasses the way that organisations are managed, overseen and scrutinised. It covers board structures, accounting and audits, executive pay, bribery and corruption, shareholder rights, and political contributions.

Fundamental to governance is the role and composition of the corporate board. It's responsible for the big decisions, setting the corporate strategy, succession planning, and managing risks. The ideal corporate board should be diverse and include independent directors, who do not financially benefit from the company (apart from their sitting fees). Independent board members offer an objective perspective that helps to prevent 'groupthink'. It's also important that there are no conflicts of interest that could compromise board members' decision-making.

[4] https://www.unpri.org/sustainability-issues/environmental-social-and-governance-issues/governance-issues/corruption

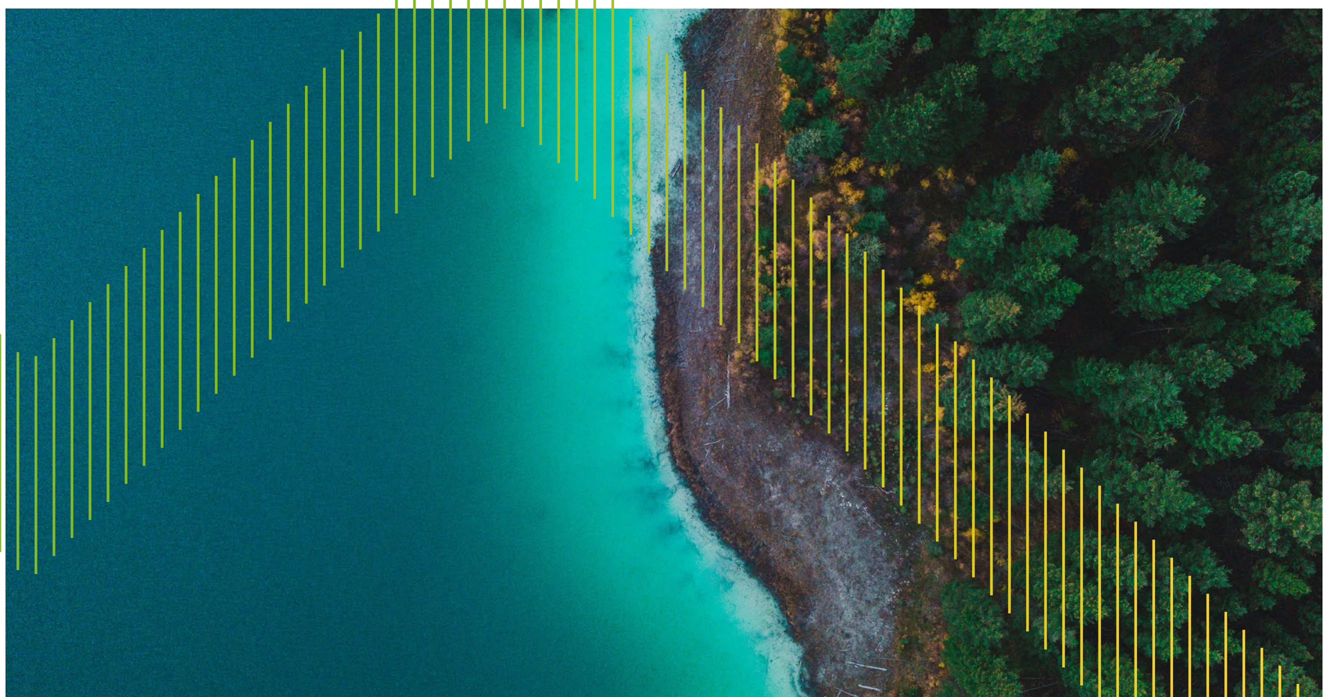
Paying the price of corruption

According to the UNPRI, US$2.6 trillion is lost every year due to corruption. We've already seen how neglecting environmental risks can wreak havoc on companies' share prices. Governance issues, including corruption, can be similarly damaging. A high-profile example of this is Volkswagen.

Back in 2015, it emerged that Volkswagen had fitted an emissions-testing device that essentially falsified results. Eleven million cars were affected, and Volkswagen's reputation was irrevocably tarnished. The scandal has cost Volkswagen an estimated $87billion[4], and the respect of customers and shareholders alike.

Executive pay

Shareholders in a company are often asked to vote on issues of pay and remuneration for executive staff. Increasingly, shareholders take a dim view of requests to pay large bonuses and grant pay rises when a company has failed to meet its financial targets. For example, some companies accepted 'furlough' support from the government, yet have been seeking to increase executive pay. This type of request might not be in the company and shareholders' best interests.



How we can help you manage ESG issues

We believe that long-term investors can achieve more consistent returns by integrating ESG and Responsible Investment (RI) considerations into their strategy. We can help you understand the relevance of Responsible Investment at all stages of the investment process.

Building knowledge	ESG issues, and their financial significance, are unfamiliar to many and building understanding is critical to the development and implementation of a coherent policy and strategy. We run educational sessions with our clients, often working with third parties, to ensure they have the knowledge they need to make informed decisions.
Setting beliefs	Our clients' beliefs around all aspects of investment, including ESG issues, drives their decision making. We'll listen to find out what ESG risks matter the most to you.
Framing objectives	Having worked to understand the extent and quality of RI practices in your current arrangements, we help set appropriative objectives and measure progress against them.
Strategy development	We'll work with you to develop an investment strategy that will achieve your performance goals. The strategy will ensure ESG risks are accounted for and managed at all times.
Manager assessment and implementation	We assess all managers on an absolute basis, rather than relative to their peers. We consider how managers evaluate and understand the ESG risks and opportunities that are posed by individual investments within the context of their own policies, and how these are captured in portfolios. We request detailed evidence from managers showing they implement their policies and processes through case studies and examples.
Portfolio monitoring and stewardship	We recognise that our clients are increasingly focused on monitoring both the ESG and climate characteristics of their investment portfolios. We have worked with an external data provider to deliver ESG and climate analytics to our clients, supporting them in understanding where mandates are exposed to breaches on global norms or have unexpected exposure to carbon risks. We work to embed the consideration of such analysis into our advice and reporting, to meet our clients' needs. We also help our clients understand what ESG data means in practice and how it may affect the decisions they take.

Contacting us

To find out more about how we can help you set and achieve your ESG objectives, please speak to your local Hymans Robertson consultant.

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