Understanding ESG: Where to Start?
By Sophia Fossali (L’24)

While ESG remains a popular topic of conversation, increasing discussions are not necessarily bringing clarity to the space. To the contrary, the lack of clarity continues to be one of the most challenging parts of the ESG movement. Supporters and dissenters alike will agree that there is still a lot of work to be done to define and refine ESG.

So, what is ESG?

ESG is more than just climate issues. While environmental considerations often take center stage, the three categories of ESG include separate and overlapping factors. Common factors include:

- **E** Environmental: carbon footprints and greenhouse gas emissions, biodiversity, climate change, pollution mitigation and waste management.
- **S** Social: labor standards, workplace and board diversity, racial justice, human rights, community relations, supply chain management, privacy and data security.
- **G** Governance: board composition and structure, executive compensation, lobbying and political contributions, corruption issues.

Depending on the company and/or investment, factors are integrated into decision making and analysis to varying degrees. Because each of the three categories include distinct risks and societal concerns, it is important for investors and decision-makers alike to clarify which of the three areas is in focus or if specific factors under each category are being considered together. This is where industry materiality, an assessment exercise that identifies the likely impact of various ESG factors to the financial condition or operations of a company, becomes paramount. The SASB Materiality Map and MSCI Industry Materiality Map, among others, offer comprehensive overviews of key materiality issues by industry.

ESG v. Impact Investing. ESG and impact investing are often blurred in public discourse. While both concepts involve investment decisions, emphasizing the distinctions between the two is crucial to bringing clarity to the industry as a whole. ESG is most commonly associated with public company management and governance, whereas impact investing is most often linked to start-up funding and smaller, private company strategies. While many use the term “ESG” to describe impact investing relating to environmental and social factors, ESG is more appropriately considered a risk assessment framework in and of itself. ESG frameworks focus on measuring a company’s risk factors beyond financial metrics. As a result, ESG may lead to

---


aligning portfolios with specific values or integrating nonfinancial factors into investment strategies to generate greater returns. Impact investments, on the other hand, focus on targeting companies and/or sectors that have environmental or social impact. While ESG is a way for investors to price risks into profit-driven investment decisions, impact investing, on the other hand, can be market-rate or concessionary, whereby financial returns are sacrificed to achieve social benefit.

But, is ESG a new trend?

While the popularization of ESG is somewhat novel, corporate focus on social and environmental impact has an extended lineage. ESG stems from “investment philosophies clustered around sustainability.” In fact, ESG began as Socially Responsible Investing (SRI), in line with the political, social, and environmental movements of the 1960s. SRI, however, was an investment strategy whereby investors excluded companies or stocks based on unsustainable business practices. Since then, SRI grew into “Corporate Social Responsibility” (CSR) and today, “Environmental, Social and Governance” (ESG). In contrast to SRI, ESG is now a practice of favorably distinguishing companies that are making positive contributions or treating ESG factors as central to their decision making.

The term ESG was first coined in 2005 in a joint study by the United Nations, several financial institutions and banks, and the Swiss government. This report, called Who Cares Wins, states that the “endorsing institutions are convinced that a better consideration of environmental, social, and governance factors will ultimately contribute to stronger and more resilient investment markets, as well as contribute to the sustainable development of societies.”

Then, why so much debate?

Much of the debate around ESG is due to the murkiness of the concept. The balanced tenets of environmental, social, and governance are too frequently approached as singularly focusing on climate. Additionally, the conflation of ESG and impact investing has led to the two distinct

---

3 The Key Differences Between SRI, ESG and Impact Investing, Pitchbook Blog. (September 1, 2021)
4 ESG and Impact Investing, Goldman Sachs Asset Management. Available at: https://www.gsam.com/content/gsam/us/en/institutions/strategies/explore-by-solution/esg-and-impact-investing.html#tabpanel_f9a0=dGFicGFuZWxfZjihMF8xL3B1YmxpYy8x
concepts being used interchangeably, to the detriment of both and the confusion of all. Some even argue that ESG should be renamed given its tarnished reputation. While multiple frameworks exist to clarify and codify the concept, it is not out of the dark yet. In fact, the numerous frameworks may have led to oversaturation and thus much of the pushback. Current measuring frameworks include Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), United Nations Global Compact (UNGC), Task Force on Climate-related Financial Disclosures (TCFD), among others. While supporters do not necessarily agree on the need to rename ESG, much of the discussion around its lack of clarity is valid.

In fact, The Economist released a recent report arguing that instead of creating industry-wide frameworks, we should be taking a more tailored approach. The argument follows that by streamlining reporting requirements, we are increasing its efficiency. Thus, corporate non-financial disclosures would include only considerations particularly material to the industry. And, asset-manager’s products would be tailored to the investor’s needs and asks, such as a climate funds instead of broad ESG or sustainable funds. To some extent, the SEC newly proposed rule follows this approach, focusing solely on climate-related disclosures for now.

On the other hand, we should also be conscious not to over-streamline frameworks. While simplicity is key, there are also many levels of considerations at play. As London Business School’s Professor Edmans explains, we run the risk of “hit[ting] the target and miss[ing] the point.” For example, an electric vehicle company with low emissions but a high lithium-mining footprint is not necessarily lowering the company’s material ESG issues, just shifting its considerations.

Lastly, many critics argue that it is actually the government, not corporations, that should be responsible for tackling climate and social issues. The argument holds that by focusing on corporate ESG, we are falling short in holding politicians accountable. However, while current practices may not be perfect, a coordinated and complementary approach by both the public and private sectors is necessary. And both government and corporate ESG would benefit from increased clarity.

---