

Environmental, social, and governance concerns: Do U.S. investors care about sustainability and ESG scores?

01 November 2018

Investors' focus on environmental, social, and governance (ESG) factors has risen dramatically in the U.S. in recent years. This reflects a global effort to bring ESG into the mainstream as important aspects of investment discipline, despite the reputation of Wall Street as the heart of unbridled capitalism and despite the lack of U.S. law requiring disclosures on many, if not most, sustainability topics. Today, some estimates claim that sustainable industry investing in the U.S. encompasses almost US\$8 trillion.^[1]

Stockholder activism

Perhaps the most remarkable and accelerating change in the investor response to ESG factors relates to sustainability and environment. In 2018, over 90 stockholder proposals focused on environmental topics like climate change, carbon emission targets and disclosures, 2 degree scenario reporting, and renewable energy use reporting. In addition, 27 stockholder proposals related to sustainability. Many of these proposals garnered support at levels of 30 percent and 40 percent^[2], which would have been unheard of only a few years ago.

Not to be left out, the governance aspect of ESG has been a key focus of investors in the United States since Enron and the Sarbanes Oxley Act (2002) and has been reinforced by the governance mandates of the Dodd Frank Act following the 2008 market debacle. ISS, the proxy advisory firm relied on by many institutional investors, has provided governance scores for companies and recommended against the election of directors based on governance shortcomings for at least the last decade. Over the last 20 years governance activists have succeeded in getting rid of most takeover defense mechanisms (e.g., poison pills and staggered boards) among the S&P 100 and the era of the "imperial CEO" has been eclipsed by the era of independent directors and close supervision and accountability for CEOs to their boards (Elon Musk notwithstanding).

Today, the primary governance focus has turned to the importance of gender diversity on boards and corporate culture. Vanguard, for example, one of the two largest institutional investors, has joined a coalition to support gender diversity on corporate boards. The cultural focus of investors and, increasingly, of boards, has been avoiding a culture tolerant of sexual

discrimination and harassment. Case in point, the #MeToo movement has been a powerful voice for changing the attitudes of the general public and the culture in many companies. The focus on zero tolerance for sexual misconduct has cost any number of prominent CEOs their jobs in 2018.

Reporting frameworks

ESG reporting frameworks appear to finally be getting the attention of investors. Global Reporting Initiative (GRI), an independent international organization, has pioneered sustainability reporting since 1997 and covers not just ESG factors, but also human rights and social well-being. GRI is the most widely adopted ESG reporting system to date. The Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB) are two other key organizations building standards for sustainability reporting.

At the same time, many investment banking firms are providing research and valuation analysis taking account of ESG factors. One example is Morgan Stanley's Sustainable and Responsible Equity Research team, which enhances traditional financial analysis by taking into account ESG factors that are material to specific industries, including oil and gas - one of the most "ESG heavy" sectors in the economy, given its high carbon footprint, overall impact on the environment, risks to employees, and potential social disruption.^[3]

Morningstar, the ubiquitous mutual fund rating and investor data analytics company, has done a study on investor funds flow and ESG factors with their Morningstar Sustainability Rating System. Morningstar found that investors do consider sustainability factors when picking a mutual fund. Perhaps more interesting, investors appear to pay the most attention to avoiding funds that score poorly in the rating system, rather than seeking out funds that score well. It would therefore seem that investors pay attention to sustainability information, particularly when it is unfavorable.

Numerous data analytics companies provide ESG data and analysis to investors as part of their bundle of investor services: Bloomberg Professional Services Platform, Thomson Reuters Eikon, MSCI ESG Research, and ISS E&S Quality Score Disclosure and Transparency, are among the best known. These companies or platforms seek to incorporate ESG data into valuation models for companies and assist institutional investors in analyzing risk in their portfolios.

Conclusion

The fact that ESG has been integrated into many large and influential investors' decision-making processes demonstrates the importance for energy and natural resources companies to take sustainability metrics seriously. Many companies have sustainability policies in their corporate governance materials, but the time appears to be ripe for boards of directors to do more than have a policy plank. ESG factors

are increasingly penetrating the boardroom and it is often appropriate to include those factors in the board's oversight of risk, strategic direction, and the future the enterprise.

It is therefore clear that energy and natural resources companies should make the effort to seriously evaluate how they handle ESG factors, how they score on various analytical and reporting services ESG ratings, and to make sure the board of directors is involved in understanding and evaluating the company's ESG efforts and its investors' perspectives on its efforts to improve its ESG standing.

[1] Hale, J. (2018). *Sustainable Funds U.S. Landscape Report*. Morningstar Research. Available [here](#).

[2] Donnelley Financial Solutions (2018). *Ten key ESG and Other investor Concerns from the 2018 Proxy Season*. Available [here](#).

[3] Morgan Stanley (2014). *ESG Framework: Oil & Gas – Executive Summary*. Available [here](#).

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