ESG And Responsible Due Diligence

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Over recent decades, the definition of corporate responsibility has expanded, increasing the importance of accounting for all stakeholders, including employees, the public and the environment. Along with this shift has emerged a new investment philosophy, dubbed “ESG,” which stands for environmental, social, and corporate governance. ESG investing focuses on the sustainability and societal impact of companies and investments therein. Socially responsible investing is not new; examples way back from the 1700s outline discussions on the ethical use of money and avoidance of industries with dangerous workplaces such as chemical production. Investment managers, looking to meet the recently increased demand for ESG-friendly investment options, have created a variety of products, including ESG ETFs, mutual funds, and more. The emergence of these products brings about an important question: how does one properly conduct ESG due diligence?

The first step is defining ESG and selecting which factors of the E, S, and G are most important. In other words, ESG is, to date, subjective. One individual may consider a business to be ESG-friendly, while another may not. Recently, multiple asset managers have faced scrutiny for offering ESG funds that hold equity positions in some of the largest global oil producers. These portfolio companies may fall under the ESG umbrella due to certain factors, such as achieving the social goal of treating workers well, or the corporate governance goal of hiring a diverse board of directors. But, these companies may break an individual’s ESG definition by investing in non-environmentally friendly companies.

Once broader goals have been established, it’s time to begin your research on the fund holdings. A prime starting point is the SEC’s EDGAR database, containing the 10-K (annual) and 10-Q (quarterly) reports for all public companies. These reports provide excellent information to determine where a company stands on the ESG scale. This may seem daunting but can provide an accurate picture as to whether a product is as ESG-friendly as its issuer claims.

For those who cannot find the time to parse through individual company filings, the good news is that a vast sampling of ESG due diligence has already been completed for you. A multitude of broker-dealers, investment research shops and databases publish readily available lists of ESG-friendly companies, funds and investment managers that can be used as reference points during your due diligence process. Some of these resources incorporate highly sophisticated data analytics and machine learning models that pull data from a wide variety of sources. One pitfall, of course, of using third-party resources is that a certain company or product may be included on one list, but not on others. As a best practice, call upon a multitude of sources to determine who does or doesn’t view a particular product as ESG-friendly.

Despite a wealth of publicly-available information, there are certain pitfalls of which to be aware. One such roadblock is the lack of formal industry standards surrounding ESG investing. To solve this problem, various industry organizations are putting together a universal code to formally define ESG and weed out the firms that utilize ESG verbiage in marketing but not in practice. The United Nations supports the Principles for Responsible Investment, an international network of investors that signed the organization's principles promoting the incorporation of ESG philosophy into a firm's investment strategy. Those who signed, in theory, have an ESG mandate; however, the rules are not entirely specific, and do not serve as an industry standard for claiming to be ESG compliant. Until these standards are formed, be prudent and draw upon a variety of sources to ensure that ESG philosophy is not just a marketing effort of an investment manager, but a mandate.

In conclusion, conducting ESG due diligence can be a tricky endeavor. The question as to whether a product is ESG-friendly lies somewhere on a spectrum. This must be defined by the individual conducting due diligence, focusing on what factors of the E, S, and G are most important. Furthermore, it's not enough to just accept an ESG-branded product on face value. Question whether the fund described as "sustainable" is making investments that will be environmentally sustainable, for example. Utilize a wide number of sources and look both vertically and horizontally to determine where ESG truly fits for the company or fund.