

WHAT IS **ESG**?

Environmental, social and governance (ESG) are the criteria used for assessing the impact of the sustainability and ethical practices of a company on its financial performance and operations.

Initially, the ESG framework was only used by impact investors to determine if companies were suitable investments. More recently, these criteria are being widely used by investors, in part because of the greater attention of governments and regulators to ESG factors, and a stronger public awareness of the environmental and social influence of companies. The majority of large publicly-traded companies now publish sustainability reports which include information about their ESG initiatives and metrics.

ESG factors can significantly impact the company's financial performance. For example, Volkswagen's emission scandal in 2015 cost the company \$7 billion to cover the costs and more than \$4 billion in penalties. The company also experienced dramatic declines in its stock price and damage to its reputation.



ENVIRONMENTAL FACTOR

The environmental factor considers how a company impacts the environment and its ability to mitigate various risks that could harm the environment. Generally, a company is assessed by its energy use, waste generation, pollution, natural resource utilization and conservation, and treatment of animals.

These criteria can also be used in evaluating the environmental risks a company might face and how those risks are managed. The environmental conscience of a company can directly influence its financial performance.



SOCIAL FACTOR

The social factor considers how a business manages its relationships with employees, suppliers, customers and the communities where it operates. For example, does the company encourage employees to perform volunteer work in its local communities, work with suppliers that hold the same values as the company, and provide safe working conditions for its employees? Are other stakeholder's interests taken into account?

The social factor can affect the company's operational success by attracting and retaining customers and talented employees, and maintaining relationships with business partners and communities affected by the company's operations.



GOVERNANCE FACTOR

Corporate governance is concerned with a company's leadership, executive compensation, audits, internal controls and shareholder rights. Investors and other stakeholders want to know that a company uses transparent and accurate accounting practices, its directors have the appropriate skill set to advise the company, its shareholders are given an opportunity to vote on important issues, and it complies with the law.

The proper and transparent corporate governance can help avoid violations of law, financial inaccuracies and conflicts of interest between the company's stakeholders, which can potentially result in large litigation expenses, fines and penalties, reputational damage and loss of business.

WHY DOES **ESG** MATTER?

YOU CAN DO GOOD AND DO WELL

ESG could boost your returns by a significant amount: a strategy of buying stocks that rank well on ESG metrics have outperformed the market by up to three percentage points per year over the last five years.

A TSUNAMI OF ASSETS IS POISED TO INVEST IN 'GOOD' STOCKS

Three critical investor groups care deeply about ESG: women, millennials and high net worth individuals. Based on demographics, it's estimated that over \$20 trillion of asset growth is in ESG funds over the next two decades – equivalent to the size of the S&P 500 today.

70% OF U.S. ASSETS CAN'T BE ANALYZED WITHOUT USING ESG

Intangible assets – assets tied to reputation, brand and intellectual property – have reached record highs for the S&P 500 companies. Analyzing financial metrics alone simply won't suffice anymore.

HAPPY EMPLOYEES = BETTER RETURNS

Companies with high employee satisfaction ratings on the job and recruiting site Glassdoor.com have outperformed those with low ratings by nearly five percentage points per year over the past six years.

A GOOD SIGNAL OF EARNINGS RISK

Traditional financial metrics, such as earnings quality, leverage and profitability, do not come close to ESG as a signal of future earnings volatility or bottom-line risk.

ESG COULD HAVE HELPED AVOID 90% OF BANKRUPTCIES AND OTHER MAJOR LOSSES

Fifteen out of 17 (90%) of bankruptcies in the S&P 500 between 2005 and 2015 were of companies with poor environmental and social scores five years prior to the bankruptcies.

Major ESG-related controversies during the past six years were accompanied by peak-to-trough market capitalization losses of \$534 billion for large U.S. companies. Loss avoidance is key for portfolio returns over time.

'GOOD' COMPANIES ENJOY LOWER COST OF CAPITAL

Just like consumers have credit scores, companies pay different rates depending on their risk profiles. The cost of debt for "good" versus "bad" companies based on ESG scores can be nearly two full percentage points lower.

YOUR CUSTOMERS CARE ABOUT ESG

Many operators now require or prefer their suppliers to be ESG-compliant in order to work for them. Having a robust ESG program could help a company gain trust with customers and can help differentiate you from your competition by building brand reputation.

CLIMATE CHANGE IS TOP-OF-MIND FOR INVESTORS

Climate change is the number one issue for ESG asset managers, according to US SIF (The Forum for Sustainable and Responsible Investment), with \$3 trillion of ESG assets considering climate change as part of their investment decisions.

YOU ALREADY CARE ABOUT ESG

ESG is not new. Your company is already addressing many of the key questions: Is management compensation aligned with shareholders? Is key talent happy or at risk of moving to a competitor? Does lax environmental behavior mean elevated legal risk?

Stocks have been bought and sold on ESG concerns for decades. Today's ESG discussions are largely focused on standardizing or codifying these considerations.