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A Content Guide to Environmental, Social and Governance Investing for Faculty and Students

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Abstract. Environmental, Social, and Governance (ESG) investing is increasingly popular (Giese, Lee, Melas, Nagy, & Nishikawa 2019), and is now percolating into sustainability textbooks and pedagogy. This is problematic because many faculty teaching sustainability do not have a background in finance, and thus find teaching ESG challenging. This paper develops pedagogical resources to teach the fundamentals of ESG investing, be that in a Foundations of Sustainable Management course or a Business Ethics course. We do this by developing four learning objectives: (1) Understand the ESG basics, including why ESG investing is important to investors and, for faculty, outlining where it might be appropriately placed in an ethics or introduction to sustainability class, (2) Define ESG Investing and discuss how ESG investing strategies differ from regular investment strategies, (3) Identify the primary methods to choose ESG investments, the related ESG rating systems, and the primary proprietary investment options based on these screening rules, and (4) Identify ESG options available to investors that meet their risk preferences.

Keywords: sustainability, ESG, investing, finance.

1. Introduction

As more and more investors and investment firms become focused on Environmental, Social, and Governance (ESG) investing (For example, see BlackRock's commitment to sustainability investing principles at BlackRock, 2022b), it becomes increasingly important that faculty teaching sustainability and ethics courses discuss this material in their classes. However, that presents many such faculty with a conundrum: how can they teach ESG investing principles when they may have little training in investment finance themselves? This disconnect between deep knowledge and course requirements may produce discomfort among these faculty and a consequent reluctance to teach the topic to their students.

This paper is designed to address this problem by presenting basic information to faculty in an approachable manner reminiscent of a "teaching note" that allows them to understand both the basics of investments and finance

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as well as an introduction to Environmental, Social, and Governance (ESG) investing approaches. In this paper, we assume that faculty have at least a rudimentary knowledge of finance and investment concepts, such as would be provided in an introductory corporate finance course. For faculty who lack such understanding, we provide a cursory overview of fundamental finance and investment concepts in Appendix A ("Help! I Don't Know Finance! What Do I Do Now?"). We begin by highlighting the importance of ESG investing and examine where it could be best positioned in a sustainable management or business ethics class. Then, we outline the principles of ESG investing, discuss the different types of filters used in selecting ESG investment portfolios, and finally, discuss ESG investment options available to individual investors. We develop four learning objectives to assist faculty in delivering information to students on investment principles and ESG investing:

- **LO1**: Understand why ESG investing is an increasingly critical concept to examine in sustainability and business ethics courses, and outline where it is best positioned in these classes.

- **LO2**: Define ESG Investing and discuss how ESG investing strategies differ from regular investment strategies.

- **LO3**: Identify the primary methods to choose ESG investments ("investment screens"), the related ESG rating systems, and the primary proprietary investment options based on these screening rules.

- **LO4**: Identify ESG options available to investors that meet their risk preferences.

In addition, in Appendix B we provide answers to a series of frequently asked questions. We organize this appendix by learning objective.

LO1: What is ESG investing, why it is important, and where to position it?

What is ESG investing?

ESG investing explicitly incorporates the firm's environmental and social performance and how well it is managed (its "governance", see GovernanceToday 2022) in the investment decision. The main objective of ESG investing is generating comparable financial performance to investments not selected on this basis, combined with attention to environmental and social sustainability (Napoletano & Curry 2021). The belief underlying ESG investing is that good corporate behaviour results in better business performance (Napoletano & Curry 2021) so that investors may be able to invest in "good" companies without sacrificing investment performance. Although evidence is still mixed, several studies have found that investing in high ESG portfolios

produces returns either as good as (e.g., Bello 2005) or superior to (e.g., Kempf & Osthoff 2007; Verheyden, Eccles, & Feiner 2016) portfolios not based on ESG selection criteria.

The environmental dimension of ESG considers how well a firm performs as a steward of nature. This can include a firm's energy use, waste and pollution generation, natural resource conservation and treatment of animals (Napoletano & Curry 2021). The Social dimension refers to how a firm manages its relationships with communities, customers, suppliers and employees (Napoletano & Curry 2021). Governance refers to how a firm deals with things such as shareholder rights, overall management, audits and executive pay (Giese *et al.* 2019). An investor who is concerned with ESG issues will decide whether to include a company in their portfolio considering these three non-financial dimensions of performance alongside the firm’s financial performance. ESG investing allows investors to achieve their investment goals without sacrificing their personal values. This can be done either positively (e.g., investing in firms concentrating on green energy) or negatively (e.g., avoiding firms with poor human rights records).

Why ESG investing matters:

Investors are increasingly choosing an ESG approach to investing (Goodsell 2022), partially because studies find that ESG investing reduces portfolio risk but generates competitive returns (Goodsell 2022). The recent pandemic has strengthened the case for ESG investing. While Covid generally increased market turbulence, companies with strong ESG criteria performance were less volatile than those with poor ESG criteria performance (Nuveen 2020). The pandemic also highlighted the “social” component of ESG, as it raised awareness of social issues such as worker health and safety.

Currently, half of all investors own socially responsible investments and the same number would be willing to convert their entire portfolios to sustainably responsible investments (Nuveen 2020). More specifically, between 2018 and 2020, sustainable, responsible, and impact investing grew at a more than 42% rate, rising from $12 trillion in 2016 to $17.1 trillion in 2020, according to the U.S. Forum for Sustainable and Responsible Investment. Moreover, perhaps because of Millennials’ concerns about environmental and social issues, it appears that ESG investing is growing in popularity among investors of that demographic (Nuveen 2020).

Clearly, this increasing attention to ESG investing mandates that faculty teaching introduction to sustainability or business ethics courses cover this material in their courses. The case is likely somewhat more compelling for sustainability courses, as the environmental and social dimensions of ESG clearly parallel sustainability course material. For example, Elkington (1997) was an early proponent of the so-called triple bottom line (environmental, social, and financial, or “people, profits, planet”), and the Natural Step highlights a similar

approach (Baxter, Boisvert, Lindberg, & Mackrael 2009). However, because there is also a close tie between CSR and sustainability (Carroll & Shabana 2010), discussing ESG investing also plays a role in business ethics classes.

Because the link between sustainability and CSR is relatively straightforward (Carroll & Shabana 2010), that suggests the placement of an ESG segment in a business ethics class is similarly straightforward – it should be placed as part of, or immediately following, the discussion of CSR in the course. However, the placement in a foundational course in sustainability is more challenging. In my (the first author's) class, I do not use a textbook, but rather two trade-press books (Hitchcock & Willard 2015; Taticchi & Demartini 2021) and a series of supplementary articles. Given that, I introduce the topic relatively far into the course, after students have had time to understand what sustainability is and how it relates to firm strategy. That way, students have learned the basic concepts and see ESG investing as a way to capture potential profits from sustainability.

LO2: Fundamentals of ESG investing.

ESG Investing Strategies:

Once an investor has decided to pursue an ESG investing approach, they must decide what potential investment alternatives would qualify as an ESG investment and which would be excluded from their potential investments. While ESG investing strategies focus on the environmental, social and corporate governance impact of a firm, how can an investor distinguish between "high" ESG performers and "low" ESG performers? To do so, investors need criteria for their investments. The United Nations Principles of Responsible Investing (UNPRI) has identified three primary methods to choose investments using ESG criteria: integration, screening, and thematic (PRI 2020). In addition, investors may use a best-in-class approach (ROBECO 2022).

ESG integration involves "explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns" (PRI 2020). As noted by Blackrock (BlackRock 2022a), this may occur regardless of whether or not the investment manager's strategy explicitly has a sustainability mandate, and considers the materiality of ESG issues.

In screening, an investor uses filters or rules to include or exclude investments based on their values or ethics. Although normally thought of in terms of negative screens (avoiding investing in companies whose practices violate the investor's beliefs and values), they can also be positive (specifically including an investment because the company's practices align with the investor's values and ethics). For example, the investor may choose to exclude from consideration companies involved in the production of alcohol or tobacco, because the investor believes such firms weaken the social fabric of society. Conversely, an investor may choose to include in their portfolio the stocks of companies that guarantee equal pay for work of equal value, avoid structuring employee hours to minimize the number of employees qualifying for health care, purchase products such as fair trade coffee that supports less fortunate populations, etc.