The ESG Opportunity

In recent years, the investment industry has increasingly used "sustainability" as a criteria for deciding how to deploy capital, and finance companies and governments. The definition of sustainability adopted by financial intermediaries is broad, and it encompasses the expectation that individual companies will manage themselves responsibly in relation to the environment, to society and to their own staff. The acronym ESG (Environmental, Social and Governance) summarizes these three areas of concern and is rapidly becoming the word used in financial markets to characterize the scrutiny of investment opportunities. ESG represents a potent incentive for corporations to maintain higher standards of conduct.

This document is designed to help SPARC members understand what ESG is, why it is important and how the academic community might consider leveraging it to align the behavior of commercial vendors more closely to its goals and values.

WHAT IS ESG?

The acronym ESG was first used in a 2005 document which summarized the proceedings of a conference titled "*Who Cares Wins"* organized by the Global Compact of the United Nations, the International Finance Corporation (a unit of the World Bank) and the Swiss Foreign Ministry[1]. The title and subtitle of the conference (*"Investing for Long Term Value - Integrating environmental, social and governance value drivers in asset management and financial research"*) itself provides an excellent summary of the goals and the means through which the UN and the World Bank hoped the financial community could be motivated to support sustainability in the normal course of its business. The explicit reference to long term value, in fact, was meant to underscore that sustainable investment would also be profitable and that the environmental, social and governance concerns are drivers of value creation for investors.

ESG is not the first attempt to build sustainability into the actions of the investment community. Socially Responsible Investment (SRI) is a predecessor to ESG, and some believe its roots arch back to the Methodist movement and to John Wesley, its founder, who asked his followers to avoid investing in activities that hurt their neighbors (like manufacturing and selling alcohol, tobacco products and firearms, or organizing gambling). SRI was particularly successful in the 80s, when widespread refusal to invest in companies doing business with South Africa contributed to the demise of its racist regime.

The main difference between SRI and ESG is that while SRI was based primarily on screening businesses and refusing to invest in specific industries (or countries) for moral reasons, ESG is viewed as a necessary indicator of the long-term success of companies. Sustainable behavior is now seen as an important contributor to better financial returns, rather than a "silver bullet" that investors would use to shun specific businesses regardless of the lost opportunities.

[1] https://www.ifc.org/wps/wcm/connect/9d9bb80d-625d-49d5-baad-8e46a0445b12/WhoCaresWins_2005ConferenceReport.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-9d9bb80d-625d-49d5-baad-8e46a0445b12-jkD172p

WHY IS ESG IMPORTANT?
Virtually all companies that grow to become leaders in their respective fields need access to capital markets. In recent decades, even nascent companies have increasingly sought access to external sources of capital beyond the money provided by their founders. Today, a complex web of angel and seed investors, early stage, expansion and late-stage venture capital and some innovative tools like crowdfunding mean that even new or young small companies rely for a significant part of their funding on the financial market. By the time a company reaches the size of RELX or Pearson, an average of **60 to 80%** of their funding comes from the financial markets in the form of leases, loans, bonds, equity and retained earnings (which are capital that shareholders decide to leave in the company, rather than receive in the form of dividends)[2].

Pensions & Investments, a leading newsletter for professionals in the asset management industry, reported in July 2020 that ESG investing across all asset categories and regions accounts for about $40.5 trillion[3], or about 45% of the total assets under management around the world ($88.9 trillion in 2019, according to the Boston Consulting Group[4]). ESG accounts for an estimated 70% of all assets under management in Europe, while in the US this percentage is much lower (33%, according to the Forum for Sustainable and Responsible Investment[5]). However, even in the US the growth of ESG investing is significant: in 2016, all sustainable investing in the US totaled about $9 trillion, and this number had almost doubled to $17.1 trillion by 2020. Deloitte forecasts that, by 2025, as much as 50% of US assets could be invested on the basis of ESG analysis.[6]

These numbers highlight the importance of ESG investing. Even more interesting is the tone of some of the commentary coming from the financial industry in recent years. The annual "Letter to CEOs" published by Larry Fink (the CEO of BlackRock, the largest asset manager in the world) is often seen as an indication of where the financial community is heading and what are its concerns. In January 2021, Larry Fink chose to highlight ESG as a tectonic trend. He had done so before (in January 2020, for example, Fink had highlighted in his letter the importance of addressing climate change, one of the most important ESG issues). In 2021, Fink has gone beyond climate change, and highlighted the broader range of issues posed by sustainability:

> *"It is clear that being connected to stakeholders – establishing trust with them and acting with purpose – enables a company to understand and respond to the changes happening in the world. Companies ignore stakeholders at their peril – companies that do not earn this trust will find it harder and harder to attract customers and talent, especially as young people increasingly expect companies to reflect their*

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[2] As of 21/31/2019, Pearson funded 77% of its $9.4 billion in assets through the financial markets and RELX 62% of its $17.9 billion. The balance was a mix of customer advances, debt towards suppliers and governments (i.e. taxes due) and pension obligations.

[3] https://www.pionline.com/esg/global-esg-data-driven-assets-hit-405-trillion

[4] https://image-src.bcg.com/Images/BCG-Global-Asset-Management-2020-May-2020-r_tcm9-247209.pdf

[5] https://www.ussif.org//Files/Trends/2020%20Trends%20Report%20Info%20Graphic%20-%20Overview.pdf

[6] https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-performance.html

> *values.* ***The more your company can show its purpose in delivering value to its customers, its employees, and its communities, the better able you will be to compete and deliver long-term, durable profits for shareholders.***
>
> *I cannot recall a time where it has been more important for companies to respond to the needs of their stakeholders. We are at a moment of tremendous economic pain. We are also at a historic crossroads on the path to racial justice – one that cannot be solved without leadership from companies. A company that does not seek to benefit from the full spectrum of human talent is weaker for it – less likely to hire the best talent, less likely to reflect the needs of its customers and the communities where it operates, and less likely to outperform."*[7]

Fink is essentially warning CEOs that companies that do not adhere to high ESG standards will be less likely to attract both capital and human talent, and they will become unattractive for investors. These are serious words, in light of the dependency of corporations (and governments) on financial markets for funding their activities. Fink's words are also supported by data, although the validity of these studies still needs further confirmation over the long term[8] In fact, ESG is the analysis of a mix of factors that are easily quantifiable (for example, the total carbon emissions associated with a company and its suppliers), and events that are difficult or impossible to quantify because they are rare (for example, risks associated with disregard for safety standards) or new (for example, product liability revealed by advances in science).

Of course, sceptics can point to the fact that the financial community is likely to do this just because it expects adequate returns, and that a shift in expectations could dampen the interest of investors for holding companies up to ESG standards. However, in many industries the impact of ESG and community engagement is so large and affects so much of the expected profits that it becomes difficult to reverse the rise of ESG as a key factor in investment decisions. A McKinsey report issued in November 2019[9] estimates that across a range of industries, between 25-30 and 50-60% of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is dependent on government intervention. In other words, as citizens become more sensitive to issues related to the environment, social justice and ethical behavior of corporations, they can affect a vast pool of corporate profits. The investment community is simply adapting to this power shift by scrutinizing companies more closely.

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[7] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

[8] For example, see
https://www.michiganfoundations.org/sites/default/files/ESG%20Matters%203.25.2020.pdf
https://www.merrilledge.com/article/why-esg-matters
https://esgclarity.com/can-esg-outperformance-continue/
https://www.internationalinvestment.net/news/4023136/stocks-bonds-esg-ratings-outperform-2020-fidelity-research

and, for a contrarian argument (based, however, on questionable arguments and data), see
https://blogs.cfainstitute.org/investor/2020/09/16/the-esg-performance-paradox/

[9]
https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Five%20ways%20that%20ESG%20creates%20value/Five-ways-that-ESG-creates-value.pdf?shouldIndex=false

HOW DOES ESG INVESTING WORK?

At its core, ESG investing is the integration of environmental, social and governance factors as crucial elements in the analysis that supports investment decisions. Traditionally, asset managers have tended to look exclusively at a number of financial and business elements - cash flow generation, asset intensity, financial leverage, etc. - to decide whether to buy, hold or sell an asset. They are now adding ESG as an input with equal (or in some cases, higher) weight, in the expectation that screening companies with these criteria will lead to better returns, or lower risk for the same expected returns.

The criteria for evaluating companies on ESG are multiple. In the case of Environmental concerns, climate change comes first. However, all activities that have potential or real negative impact on air, water, land, ecosystems and its health, and the health of humans also fall in this category. Conversely, all activities aimed at reducing or eliminating potential or actual impact across any or all these categories improve the ESG screening of companies.

Social risks refer to the impact that companies have on society. These activities include, for example, failing to promote health and safety, maintaining poor labor-management relations, perpetuating pay gaps because of gender, using child labor (even indirectly, by outsourcing activities to third parties), failing to treat customers with respect, etc.

Finally, governance scrutinizes how companies structure their management. Typical concerns include lack independence and diversity among board and senior management ranks, excessive executive compensation, inadequate reporting disclosures about corporate activities and financial data, etc.

Asset managers, of course, cannot closely scrutinize every company and every investment opportunity. A large number of companies that analyze ESG data have emerged in recent years to provide the asset management industry with rankings, in-depth reports and data that asset managers can incorporate as they see fit in their investment processes. In addition, large asset management companies also field their own internal teams that can screen advisers in order to pick the ones that appear most insightful, collect their own additional data and produce their own rankings of sectors, companies and/or investment projects.

The ESG data business may grow to $1 billion in revenues in 2021, according to an Opimas report published in March 2020[10]. There is a wide variety of companies that operate in this field, ranging from broad suppliers of data and analysis to the financial industry, like Bloomberg, MSCI and Moody's, to ESG specialists, often with a specific focus on one of the three elements, or a specific industry or geography, to stock exchanges and even to asset managers interested in monetizing their research by selling their analysis and data to other asset managers. For practical purposes, a small number of leaders - Sustainalytics (a company owned by Morningstar), MSCI and Bloomberg – currently carry the most weight with large investors. This is important as we discuss what are some of the possible strategies open to the academic community.

[10] http://www.opimas.com/research/547/detail/

HOW CAN THE ACADEMIC COMMUNITY LEVERAGE ESG?

Media companies tend to score well in ESG rankings, and the companies serving the academic and scholarly market currently score particularly well. For example, in the Sustainalytics rankings, RELX ranks #2 out of 275 media companies and #21 out of 13,559 companies across all sectors. Pearson ranks #3 and #27, Wolters Kluwer #5 and #71. Thomson Reuters #6 and #100, Informa #7 and #130 and Wiley #21 and #369 (all data as of 2/10/2021).

These rankings may surprise many people in the academic community who have been very vocal about the many questionable practices (high subscription prices for scholarly journals, high prices for textbooks and courseware, etc.). In part, this reflects the low environmental footprint of an industry that has largely transitioned to digital technologies and produces small amounts of print products, as well as the fact that these companies obviously do not engage in some of the most blatant activities that violate social standards (like using child labor or ignoring safety measures in the workplace). In addition, these companies win support with the argument they enable the activity of educational and research institutions.

However, rankings are also driven by the degree of attention that ESG data companies focus on specific companies. In fact, academic research shows how the divergence in ratings is explained by various differences in how each data provider evaluates the ESG categories (in scope, in measurement criteria and in relative weight), as well as by "judgmental" views[11]. To illustrate this, we have compared the relative rankings of News Corp across three data providers that are sharing publicly their rankings of this company. For Sustainalytics, News Corp is a low-risk company, ranked #47 among 275 media companies, and #773 among the 13,559 companies covered (i.e.in the best 6%). However, CSRHub ranks News Corp in the best 42% of the 17,760 companies it covers, and GMI Ratings ranks it at very bottom of its rankings, with a score of 1 out of a possible 100 (in spite of an environmental score of 92 out of a possible 100) because of low social and governance scores (4 and 1 out of a possible 100, respectively).

This example illustrates the possibility to influence rankings by highlighting for the financial community the most objectionable practices of individual scholarly and courseware publishers. Arguably, the academic community might choose to pursue one of three approaches:

1) **Ignore the ESG trend altogether.** This means accepting that the commercial vendors will likely continue to have unfettered access to the capital markets. This appears a poor choice, as it would ensure that there are no repercussions for what the community often views as egregious violations.

2) **Target specific activities that represent the most egregious violations of social norms**. In recent years, and even more so in recent months, several reports have emerged highlighting activities that could and should affect the social score of some publishers. Initiatives like installing spyware in libraries to monitor what materials researchers access, collecting data from researchers and then repackaging it for governments, discriminating female employees in terms of compensation, threatening retaliation against academic libraries that abandon collections subscriptions, behaving

[11] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

abusively towards junior members of academic negotiating teams, if confirmed and properly documented, could be made available both to ESG data providers and to large institutional investors (as well as to the press). The goal of this approach would be to encourage commercial vendors to operate more in tune with the values of the academic community.

3) **Target the foundations of the business model**. It could be argued that the business models of the journal and courseware vendors are a violation of socially acceptable behavior. The periodical crisis, triggered by the aggressive pricing and bundling practices of scholarly publishers along with the pursuit of OA models that require very expensive payments for articles published in leading journals, can be viewed as conflicting with the basic right of human beings to have equitable access to knowledge, equitable opportunities to contribute to knowledge and the right to benefit on an equitable basis from it. Similarly, the prohibitive cost of textbooks and courseware and the attempt to incorporate their cost in student tuitions could all be viewed as contributing to negate the basic right of accessing education for the most disadvantaged segments of society. Pursuing this agenda would be more controversial: commercial vendors could be expected to mount an even stronger defense against what they would likely perceive as an existential threat, and segments of the academic community that have become "comfortable" in their relationships with the vendors (because of editorial board positions or because of royalties for best-selling textbooks) could be expected to defect and defend current practices. On the other hand, past boycotts and initiatives undertaken by the academic community to protest current practices have focused primarily on these fundamental issues, and this fact could highlight the risks posed to investors by these business models and their questionable sustainability.

The choice between approach #2 and #3 may prove more a matter of degree than an "either/or." Nothing precludes a report aimed at the financial community from addressing both the more obvious violations as well as the broader issues posed by the business models. In fact, because ESG data vendors tend to differ in their scores and ratings, bringing the full weight is likely to yield better results. In many ways, the real issue is whether the academic community can be expected to support with sufficient unity both arguments or whether the broader one may trigger an internal "war of reports". In any case, ESG investing is an opportunity to pressure commercial vendors to abandon their most objectionable practices and adopt behavior that is most consistent with the values of the academic community.