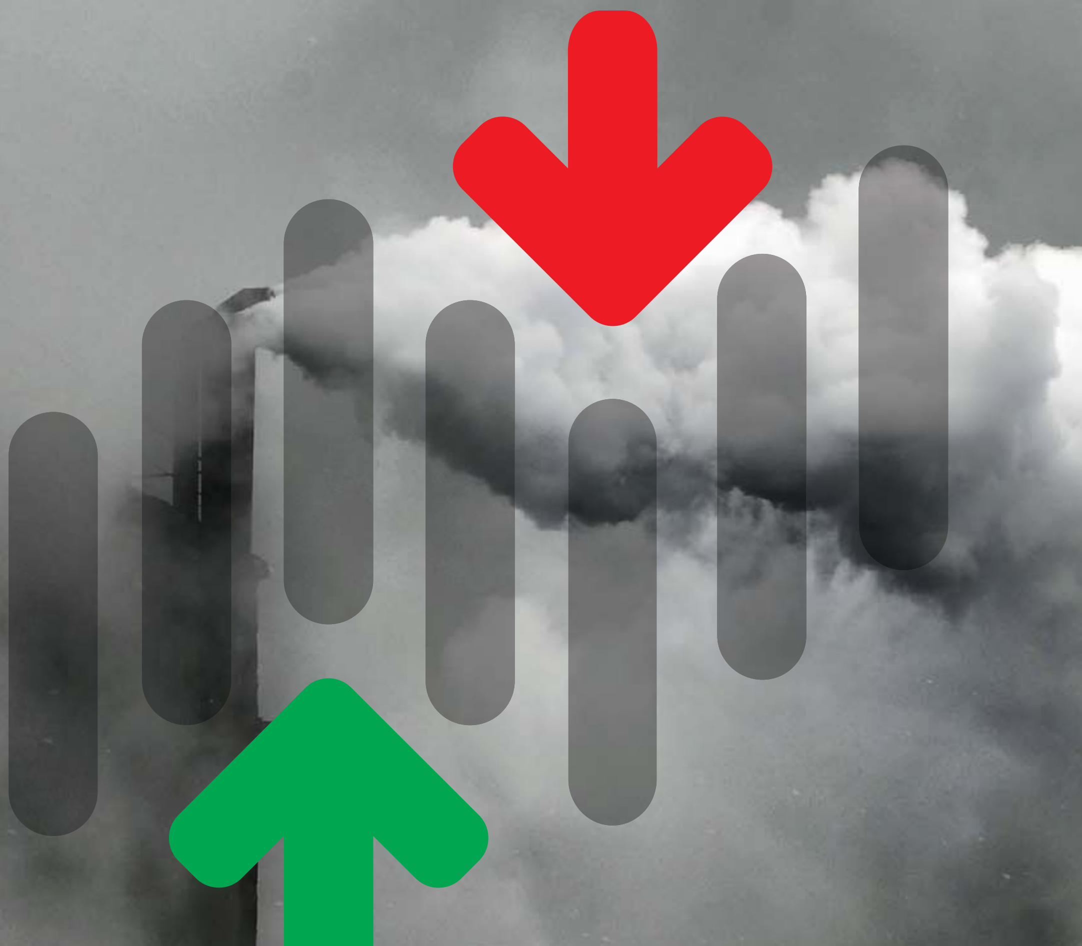
Values at Work

Sustainable Investing and ESG Reporting



Edited by
Daniel C. Esty
Todd Cort

Values at Work

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Editors

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Values at Work *is dedicated to all those striving to harness the power of markets and finance to protect the natural world, promote human well-being, and create a more equitable economy and society.*

Acknowledgments

We are deeply grateful to a number of people and organizations that made *Values at Work* possible. First, of course, we would like to thank the 21 authors who contributed their time, expertise, and perspectives to this book. Their efforts within and insights about the field of sustainable finance demonstrate the leadership needed to create and fund a more sustainable planet. We are especially appreciative to our *Values at Work* editorial team led initially by Timothy J. Mason, Associate Director of the Yale Center for Environmental Law and Policy, and later by Tyler Yeargain and Maximilian W. Schreck, our Editorial Manager. Despite the COVID-19 pandemic, our group of Yale student editors excelled under pressure, ensuring the quality of the content in this book: Taryn Akiyama, Liam Chun Hong Gunn, Kara Hoving, Brett Cozzolino, Andy Xie, Omar Motala, Alexandra L. Wisner, Charles W. Harper, Robin Happel, Gillian Cowley, Maliya Ellis, Daiana Lilo, Ben Santhouse-James, and Margaret K. O'Leary.

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Finally, we want to express appreciation for all those who have been part of the Yale Initiative on Sustainable Finance programs and conversations on how to advance environmental, social, and governance (ESG) metrics and reporting as well as to understand the prospects for and obstacles to a world of expanded sustainable finance that would provide greater flows of capital to clean energy infrastructure and other elements of a sustainable future.

New Haven, CT | Daniel C. Esty
July 2020 | Todd Cort

Further Praise for *Values at Work*

"With authors whose knowledge of sustainable investing and business practices is second to none, *Values at Work* cuts through the confusion and complexity surrounding ESG reporting to pinpoint what really matters, where the industry is going, and how serious investors can take full advantage of the trends."

—Martin Whittaker, *Chief Executive Officer, JUST Capital*

"The trend towards sustainable investing has accelerated. But measurable impact on the planet hasn't followed. *Values at Work* offers a clear call to action in outlining what's needed for the sustainable investment community to create meaningful change in the coming critical decade."

—Charlotte Kaiser, *Managing Director of NatureVest, The Nature Conservancy*

"At the heart of sustainable finance is the need to connect capital flows to the corporate actors who are true innovators in developing best practices and leading the way to a sustainable future by incorporating ESG values into their operations and policies. *Values at Work* offers the roadmap for investors who want to get to this future."

—Robert Jenkins, *Global Head of Research, Refinitiv/Lipper*

"More than a decade ago, Dan Esty led the way in teaching the capital markets how to drive corporate sustainability. His commercial sense and pragmatism helped us move from ideology to implementation. He and his team of authors in *Values at Work* are now bringing this same leadership to sustainable investing."

—Erika Karp, *Founder & CEO, Cornerstone Capital Group*

"Sustainable investing is not about financial products, it is about fulfilling the financial sector's fiduciary responsibility toward investors and asset owners. Professors Esty and Cort's book should get everyone speaking the common professional language that will enable the finance world to accelerate the transition toward a more sustainable global economic model."

—Patrick Odier, *Senior Managing Partner, Lombard Odier Group*

"Investors need information about what matters. If you are not asking for information about climate change, natural systems, how the workforce and community are treated, how power is used at the Board level, you are investing in a fantasy financial world or for another planet which we haven't got. *Values at Work* will get you on the right track."

—James Cameron, *Founder, Climate Change Capital*

"*Values at Work* is a masterful collection of great minds laying out a simultaneously practical and fascinating roadmap for the essential changes needed to improve sustainable investing and integrate sustainability into our capital markets."

—Mindy Lubber, *CEO and President, Ceres*

"Dan Esty and Todd Cort and their team of *Values at Work* authors have made a critical contribution to the market for sustainable investing. They underscore the urgent need for more accurate and quantitative ESG information to allow investors to make informed decisions on allocating capital."

—Matthew Arnold, *Global Head of ESG and Corporate Responsibility Engagement, JPMorgan Chase*

"*Values at Work* shows how financial regulations might be recast to ensure that capital flows to companies that are helping to address challenges such as climate change and sustainable development—and advancing transatlantic values more generally."

—Edouard-François de Lencquesaing, *President, European Institute of Financial Regulation*

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Part I

Introduction

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Sustainable Investing at a Turning Point

Daniel C. Esty and Todd Cort

Abstract Sustainable investing has expanded from a niche interest to a mainstay of investment strategies around the world. With a growing number of investors focused not just on the financial promise of the companies in their portfolios but also the environmental, social, and governance performance of these enterprises, the demand for better ESG metrics and reporting has skyrocketed. This book explains the critical concepts, trends, risk frameworks, and investment tools that investors of all kinds—including those in stocks, bonds, private equity, infrastructure projects, and impact investing—need to know. With informative essays from a range of scholars, policy experts, and investment practitioners, it explores the state of play in sustainable finance with particular focus on the data, guidelines, legal standards, and principles required to make ESG reporting more trustworthy and thus sustainable investing more mainstream.

Keywords Sustainable investing · ESG reporting · Sustainability imperative · Financial regulation · Sustainable Development Goals · 2015 Paris Climate Change Agreement · Sustainable finance · Impact investing

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Intro

Sustainable investing has become a booming investment category. According to the Morningstar 2020 Sustainable Landscape Report, there are now more than 300 sustainability-oriented mutual funds and Exchange Traded Funds (ETFs) in the United States with total assets as of 2020 just under $150 billion—up nearly 35% in the past three years.[1] While stock markets tumbled as a result of the COVID-19 pandemic, sustainability funds showed much greater resilience than other investment vehicles. And as markets recovered, the flow of capital into sustainable equity funds outpaced competing conventional equity funds.[2] As attention shifted from the public health crisis to economic recovery, a growing emphasis emerged in many circles on the need to "build back better"[3]—meaning more sustainably. In addition, the Black Lives Matter protests that erupted around the world in 2020 threw into high profile a series of social concerns including racial justice and economic inequality and raising questions about corporate cultures and workplace diversity. All of these recent events offer a signal of just how significant sustainable investing and finance have become—and explain why interest in *environmental, social, and governance* (ESG) metrics has taken off.

This interest spans the world. Indeed, the Global Sustainable Investment Alliance estimates that the assets under management (AUM) in funds that deploy some form of sustainability screening in their investment strategy now exceed $30 trillion.[4] While this figure may be an overestimate—because the depth of the sustainability focus considered by these funds varies widely—the scale of these numbers suggests that sustainable investing must be seen not as a fad but rather the new essential lens for investors in the twenty-first century.

Tracking Trends

The growing interest in sustainable investing reflects a number of trends that this book seeks to map and explain. Most notably, an ever-expanding number of mainstream investors have begun to insist that their portfolios better reflect their *values*—including their concerns across a spectrum of environmental, social, and governance (ESG) issues. Of course, investors range widely in their specific interest in ESG performance, with some focused narrowly on single issues such as climate change or diversity in the workplace. Others want to exclude companies that produce goods or services that they find objectionable, so some funds engage in *negative exclusions*—divesting from whole industry categories such as alcohol, tobacco, gambling, and firearms, or from poor performers on select issues such as greenhouse gas emissions or respect for human rights. And yet others simply want their investments tilted toward companies that are moving the world toward a sustainable future and to underweight those that are not helping to shift society onto a sustainable trajectory.

The rising interest in sustainable investing and finance, and the related focus on ESG reporting, has begun to reshape not just equity markets but the world of fixed income investments as well. So-called *green bonds*, for example, grew from $2.6 billion in 2012 to $257.7 billion in 2019.[5] As this volume demonstrates, a similar push toward sustainability can be found among private equity investors, hedge funds, and other specialized investment vehicles.

Investors vary not only in the sustainability issues they care about but also in how they deeply they want to lean into sustainability factors and their tolerance for risk, leading to a wide range of sustainable investing strategies. Some strategies seek to deliver outsized returns or *green alpha*. Others simply tilt toward sustainable companies using *smart beta* strategies. And some are aimed at investors who will accept sub-par returns because their focus is on *impact investing*, which means they prioritize societal benefits alongside their financial gains.

A second factor driving interest in the flow of capital toward support of a sustainable future can be traced to two landmark 2015 agreements: the UN Sustainable Development Goals (SDGs) and the Paris Climate Change Agreement. The 17 SDGs spell out a set of clear policy priorities for governments across the world, highlighting the need for improved results on a diverse set of critical challenges including hunger, poverty, clean water, economic development, human rights, and climate change.[6] Beneath the 17 topline goals, the UN effort specifies 169 quantitative targets to sharpen the focus on what needs to be done by not just governments, but also the business community and non-governmental organizations of all kinds. In this regard, the negotiations that led to both the 2015 Paris Agreement and the SDGs made it clear that success in achieving progress would require substantial flows of capital toward meeting the needs that had been defined.[7] Both agreements specifically indicate that traditional development assistance and other government funds will be insufficient to the task—and thus that private capital will be essential for expanded sustainability efforts in general and to the global response to climate change in particular.

Policymakers estimate that as much as $3 trillion per year in new investments will be needed to shift society toward a sustainable energy future and to meet the targets set by 2030 Sustainable Development Goals.[8] Delivering capital at this scale necessitates a vast increase in *sustainable finance*—with funds flowing toward sustainable projects, infrastructure, and companies. The UN Secretary General has outlined various barriers to the scale-up of funding for sustainability projects[9] with particular emphasis on "misaligned incentives and regulations, limited awareness, and difficulties in identifying, measuring, and reporting on sustainable investments."[10] Various chapters in ***Values at Work*** offer suggestions about how to overcome these obstacles.

Investment Logic

Both more data on corporate ESG performance and expanded incentives to channel capital toward companies and projects are needed to facilitate the transition to a sustainable future. But whether sustainable investing makes sense from a *financial* perspective continues to be debated. In the chapters that follow, we review the issues under contention. In particular, we explore the theoretical logic for investing in sustainability leaders, including the pathbreaking work of Harvard Business School professor Mike Porter, who hypothesizes that sustainability efforts can spur innovation.[11]

We also look at the empirical studies that purport to demonstrate a correlation between the integration of ESG indicators into portfolio choices and investment outperformance.[12] But while cutting-edge corporate environmental strategy and sustainability leadership leads to financial success in some instances,[13] not every claim of sustainability pays off. And the exact causal relationships and correlation circumstances remain unclear.[14] Moreover, some analysts theorize that companies focused on sustainability will underperform their peers, especially in markets that do not regulate effectively and permit pollution harms to go unaddressed (or as economists would say, for externalities to go *uninternalized*), thus damaging the competitiveness of companies that run out in front of the market in terms of their commitment to greenhouse gas emissions control or other sustainability actions.[15]

Some investors clearly anticipate a sweeping societal transformation toward a more sustainable future. They hope that a focus on ESG metrics will allow them to capture the upside of the economic shifts driven by this *sustainability imperative*.[16] They may seek to invest in renewable power companies or those selling energy efficiency goods and services that stand to benefit from the transition toward a clean energy future. Others will focus on divesting from companies that are heavily invested in fossil fuels that create *carbon exposure* and the risk of *stranded assets* such as oil and coal reserves that might never get to be exploited.

Yet other sustainability-minded investors see high scores on ESG metrics as a signal of resiliency and the capacity to outperform under difficult circumstances or in a down market. And indeed, the COVID-19 epidemic provides some evidence in support of this hypothesis, as sustainability funds weathered the market drop much better than their conventional counterparts.[17] In a world where resilient companies are more likely to deliver long-term growth, investors have shown increasing interest in ESG screening as an important signal of likely future marketplace success.

Ramping up Sustainable Investing

In this book, we review and explain the tools, standards, frameworks, and tangible efforts that will be needed to make ESG screening more effective and trustworthy—thus building the confidence of investors who want to bring a sustainability emphasis to their portfolios, which in turn will translate into scaled-up sustainable investing.[18] In Part II, we explore the current state of play in terms of measuring corporate ESG performance as well as the impact of sustainable investments. We highlight how ESG metrics will need to evolve and improve to allow greater comparability across companies—thereby permitting *real* sustainability leaders to be distinguished from those engaged in *greenwashing*—as well as to generate deeper insights for investors, providing ESG signals that are meaningful and likely to translate into long-term financial value.

In Part III, we look at the changing world of financial products in the sustainable investing marketplace. While sustainability-oriented fixed income products, such as green bonds, have scaled-up dramatically in recent years, bond funding will be insufficient to the scale of infrastructure that must be built. Thus, several chapters analyze how an ESG focus is being brought to other asset classes. In particular, we assess what will be required to expand equity investments, both public and private, to deliver the capital flows required for sustainable future growth.

In Part IV, we explore the complex and interdependent worlds of financial regulation, sustainability disclosure, and legal liability. ESG disclosures in the context of financial reporting represent one of the fastest changing elements of the sustainable investing realm, as investors demand increasingly detailed and decision-useful ESG performance data. Meanwhile, companies face difficulty in balancing potential legal challenges and business risks from