Environmental, Social And Governance Investing Is Gaining Steam And Changing Minds

Alex Sauter , Benzinga Contributor
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The recent clash between the Harvard and Yale football teams was noted for much more than being the season finale in the 136th meeting of the rivalry simply known as The Game. During halftime, climate change activists from both schools rushed the field calling on the universities to divest from fossil fuel companies as well as those holding Puerto Rican debt. The game was delayed for 45 minutes and served as a ready reminder of the heightened concern and activism around ESG investing, a strategy that puts an emphasis on evaluating investment choices based on environmental, social and governance factors.

It should not be lost on anyone that the generation represented by those students on the field that day will soon be deciding how those investment choices are made. But the truth is the pendulum already has swung significantly in the direction of ESG, also known as socially responsible investing (SRI).

Apollo, for example, already has ESG funds operating alongside more traditional vehicles, understanding that investors are not just concerned about solid returns but how those returns are achieved. They want to be sure the companies they invest in are behaving in a socially responsible way.

ESG Investing Is Exploding

The Forum for Sustainable and Responsible Investment's 2018 report found that by the end of 2017 more than one out of every four dollars under professional management in the United States — at least $12 trillion— was invested according to SRI strategies.

Further pushing the pendulum was the recent declaration by the Business Roundtable, which reversed decades of policy when it announced in August that the purpose of corporations was no longer strictly to promote shareholder value. The Roundtable, comprised of CEOs of the nation's largest companies, redrafted its Principles of Corporate Governance to commit to leading their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders.

This provides fuel to the socially responsible investing movement. It is a message to fund managers and their would-be companies that they are expected to act differently.

You know this is a gamechanger when consumers are asking where their diamonds were mined, where their clothing was stitched, where their food was grown, what the laborers were paid and how they have been housed.

Greater Returns Are Driving Change

More private equity fund managers are going to increasingly feel pressure to adhere to ESG values. Importantly to investors, the companies that take into account social impact are increasingly generating higher returns, as ESG is acting as a tailwind for both company performance and valuations.

Assets and industries that have been the target of negative attention on social or environmental fronts are in a tough spot. Expect a gradual devaluing of these type assets relative to where they've been historically, or at least over the last couple of decades. We are in the first inning of what this will mean for investors and upstream LPs.

Consider fossil fuels. People controlling the flow of capital are growing more supportive of ESG concerns and pushing against further investment in traditional energy. It is inevitable that asset prices will decline.

A recent barometer has been the price of lithium batteries used for electric cars or the price of solar power. These alternatives to coal-generated power are close to a cost point almost equal to fossil-fuel burning sources.

Once the cost of renewable energy sources falls below traditional sources, even more money will pour into these new energy companies and products. Suddenly, the most financially effective investments will be the ones with the greatest social or environmental outcomes.

The U.S. pulled out of the Paris Climate Accord, but 199 other countries are still trying to keep the global temperature increase this century to 1.5 degrees Celsius. Despite the official U.S. stance, the momentum hasn't been broken. Backing for renewables and other ESG concerns are growing as risks build with traditional energy sources. Considering risk profiles alone, stronger cases can be made for migrating to social and environmental assets more frequently.

ESG Awareness Has Huge Upside
Energy innovation only represents part of the movement. Bain Capital, a leading global private investment fund, launched Bain Capital Double Impact (BCDI) to invest in a variety of mission-driven companies ranging from education to healthcare to nutrition. And not only are they measuring the financial outcomes of their portfolio companies, but they've just begun to publish and evaluate the kind of social impacts of them as well.

This trend, in large part, has also been driven by mid-market, private equity limited partners — college and university endowments, pension funds, foundations, and other institutions with stakeholders demanding social responsibility. Advisors for some investors won't even mention fossil fuels or gun manufacturers, regardless of the returns.

Research by McKinsey & Co. has determined that addressing ESG concerns can help companies tap new markets and expand existing ones, drive consumer preference, help combat rising expenses for raw-materials and result in less regulatory pressure.

By allocating capital to more promising and sustainable opportunities, McKinsey predicts enhanced investment returns. And McKinsey anticipates that socially responsible companies will attract and retain quality employees, enhance worker enthusiasm and increase productivity.

Stubbornly refusing to embrace the trend could come with consequences beyond simple protests. Legal & General Investment Management (LGIM), one of Europe's largest asset managers, was one of Exxon Mobile's top 20 shareholders. But when the oil giant rejected its suggestions on addressing climate change, LGIM dumped $300 million in Exxon shares.

The spectacle at the Harvard-Yale football game just served to underscore the shifting landscape.
Alex Sauter is a Principal of MHT Partners focused on mergers & acquisitions in healthcare services and technology.