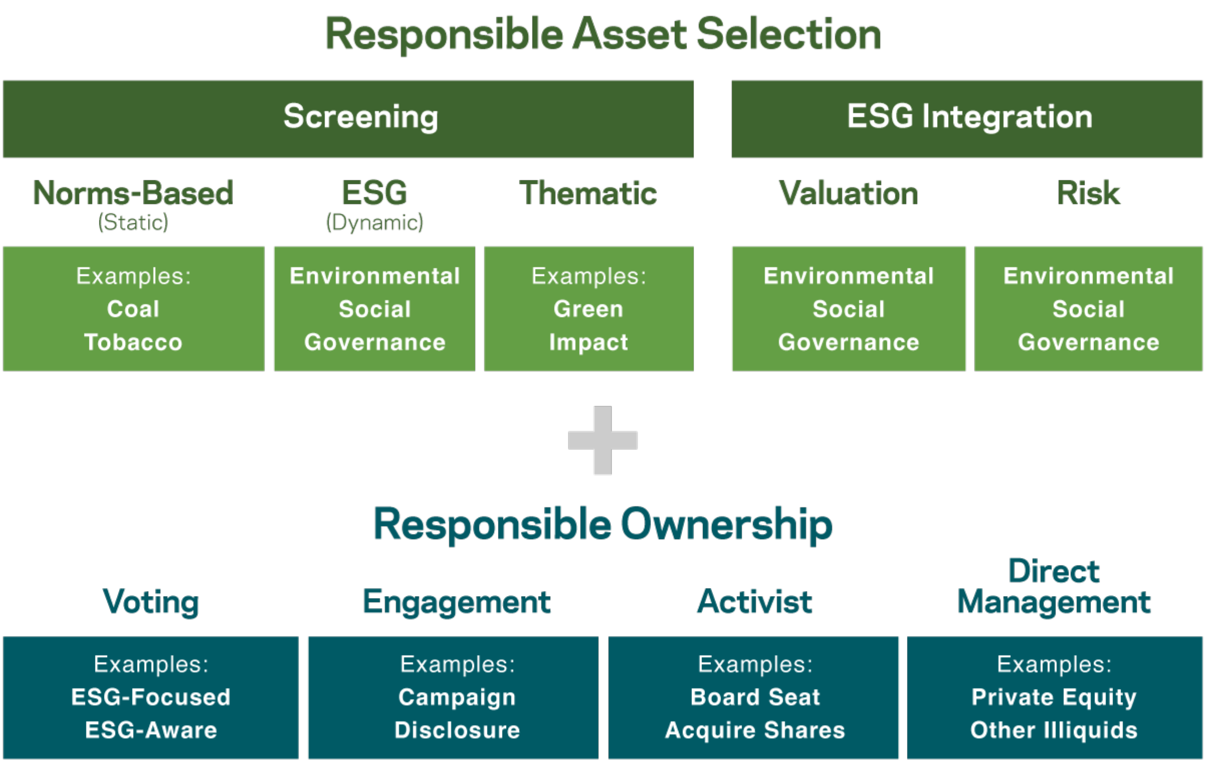
ESG Defined

Responsible Investing's reach is vast. However, so too is confusion around the meaning of the concept. We partnered with UNPRI to help “clear the air” by creating a framework of the various approaches and terms necessary to have an informed discussion on Responsible Investment.

The framework is grounded in the United Nations Principles for Responsible Investment. The framework is designed to allow for the application of multiple approaches while adhering to the applicable principles, because in practice investors pursue many different implementations and combinations of the approaches. While the full framework goes into greater detail, we’ve provided structure and definitions to some of the most common terms below.



Responsible Asset Selection: The consideration of ESG issues that may affect the long-term pricing of an asset as well as the long-term sustainability of the issuer’s business model. It manifests itself in two broad categories:

•**Screening:** choosing to exclude some subset of assets because they do not meet certain predefined standards. Standards may be based on norms (and generally static) or a more dynamic approach to ESG.

-*Norms-based*: Exclusions applied to specific companies (e.g., a cluster munitions manufacturer), entire industries (firearm industry), or other assets. This is ostensibly a simple translation of ethical values into a Responsible Investment policy. However, it should be noted a blanket screen approach is price agnostic.

-*ESG (dynamic)*: An approach that excludes assets based on an ESG score, which is determined by a company’s exposure to ESG factors. A Dynamic ESG screen can be more flexible than a norms-based approach, as it can allow for investment in different companies over time, depending on their changing ESG policies and procedures.

-*Thematic*: A screen that is more focused on a specific objective and is implemented as either a negative (rules investments out) or positive (rules investments in) screen. A common example is “green investments,” which invests in companies committed to the conservation of natural resources.

•**ESG Integration**: A holistic assessment of an investment’s prospects using all available traditional and ESG-related data. It does not ex-ante preclude any investment. A manager may hold a company ranked poorly on ESG if it is sufficiently attractive on other metrics. There are two avenues for ESG integration:

-*Valuation and Risk*: Key metrics that reflect a company’s health and are easily combined with existing measures that are not specifically ESG. Companies with strong valuation and risk attributes may fit into an ESG integration approach to compensate for securities with inferior ESG profiles.

Responsible Ownership: A thoughtful awareness of the avenues available to interact with companies to influence their business, beyond the simple decision of whether to invest (i.e., asset selection).

Responsible ownership is commonly exercised in four ways:

• **Voting:** Proxy voting is a privilege of equity ownership, where equity owners can vote on important company issues.
“Responsible” approaches to voting vary. Broadly, there are two approaches to “responsible” voting:

-*ESG-focused*: ESG considerations are the primary focus of proxy votes

-*ESG-aware*: ESG is a factor in a broader set of considerations that determine voting

• **Engagement:** Entails a dialogue between an investor or group of similarly-minded investors and a company. Commonly, engagement has the aim of campaigning for change or enhanced disclosure on issues related to ESG factors.

• **Activism:** An approach that seeks to effect change within a company by getting a board seat or acquiring a number of shares. Activism itself doesn’t amount to responsible ownership – that requires a commitment to promoting sustainable outcomes along ESG dimensions.

• **Direct Management:** A form of responsible ownership that involves taking ownership of a controlling stake in a company, such as commonly practiced by private equity managers. The investor or group of investors seeks to effect change by directly managing the company, with an opportunity to enhance the company’s sustainability and improve along ESG dimensions in an efficient manner.

Source: *Clearing the Air: Responsible Investment* (Dunn, Hernandez, and Palazzolo, 2020).