**If ESG is Considered Green –
Why is There So Much Gray?**

**February 2023**

**Challenging Debates Not Easily Resolved**

Life’s most difficult debates are seldom straightforward to resolve – and that assumes resolution is achievable. Underlying arguments are often filled with gray symbolized by the combination of valid counter-viewpoints and conflicting beliefs and priorities represented by opposing parties. Making those gray areas even more troublesome is a void (or dare we say avoidance) of clear and mutually accepted information to which all sides agree. In recent months, we have seen an uptick in headlines related to Environmental, Social and Governance “ESG” investing that, on the surface, have begun to paint the issues as starkly delineated – almost akin to right vs. wrong. Perhaps in an effort to sensationalize, some opinions have gone so far as to describe ESG investing as a “sham” and others have encouraged immediate divestment/boycott of ESG due to perceived conflicts of interest.

**Nascent State of ESG Investing**

Given the still young and developing state of ESG investing and its plethora of interpretations and definitions, such controversy is unsurprising. It is both healthy and worthwhile to continue the dialogue concerning ESG investing or, more precisely, the actual ESG risks/factors themselves and their potential influence on investment decisions. We encourage individuals and committees to acknowledge the inherent complexities as well as to be wary of those looking to stir controversy to serve self-interest; as with most complex matters, the truth lies somewhere between the good and bad news with some important details in between.

**Good News | Bad News**

There is a growing movement represented by industry participants (investors/advisors/managers, et al), data providers, as well as market regulators determined to help shine a light on the issues and support broader understanding. Crucial to the movement is the evolving body of data intended to capture ESG-related risk criteria for individual companies and the effort to make that information useful to investors. Good news: ESG data is out there and available; bad news: the data is largely self-reported, unregulated and unaudited. For it to become beneficial, data capturing ESG risks must continue to evolve, including becoming more standardized.

The information that matters most when it comes to investment analysis is factors that are material enough to influence the potential future value of the asset(s). In ESG terms, determining materiality will likely prove challenging at least in the near-term. As Factset research suggests “the analysis of ESG materiality has led to some innovative findings on the dynamic nature of materiality, with some research suggesting that financial materiality is not a ‘state of being’ [material] but a ‘process of becoming.’”[[1]](#footnote-1) So perhaps the exercise will remain a bit of a moving target.

**Necessary and Positive Evolution**

Figure 1 SASB Materiality Map (www.sasb.org)

In the meantime, those organizations that seek to develop and set accounting standards for sustainability and ESG reporting have advanced and reached an important milestone. In June 2021, the Sustainable Accounting Standards Board (SASB) and International Integrated Reporting Council (IIRC) merged to create a new entity, Value Reporting Foundation (VRF). The “VRF is concerned mainly with communicating how ESG factors affect a company's performance so that investors can make better decisions about them. [It] might be better understood as "enterprise value reporting," where ESG factors are one of the many things that can influence the value of a company and its activities.”[[2]](#footnote-2) In August of 2022, International Financial Reporting Standards (IFRS) Foundation merged with VRF to assume responsibility for SASB Standards.[[3]](#footnote-3)

**And who’s watching?**

Regulators including the Securities and Exchange Commission (SEC) certainly have an important role in shaping the type/level of data and disclosures required by public companies concerning ESG factors and management. We expect they can get it more right than wrong – though other market participants including investment practitioners (like managers/consultants, etc.) and the leaders of companies must play a role.

Last fall, the CFA Society Boston held its annual Sustainable Investing Conference. Key sessions included separate discussions of both regulatory reporting as well as disclosure standards related to ESG. Among the highlights were recent initiatives put forth that could support positive developments. The SEC currently has two rule proposals under review geared towards improving disclosure as well as increasing transparency for investors.

The Enhancement and Standardization of Climate-Related Disclosures[[4]](#footnote-4) will require domestic or foreign registrants to include certain climate-related information in their registration statements and periodic reports, such as on Form 10-K. The Amendments to the Fund “Names Rule”[[5]](#footnote-5) will expand the current requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund’s name suggests as well as provide new enhanced disclosure and reporting requirements. The former will establish greater transparency for a corporation’s exposure to climate risk; the latter will help mitigate the effect of “greenwashing” by placing greater scrutiny on fund naming conventions and underlying holdings/strategy. These seem to us like encouraging steps forward in improving transparency for investors without unnecessarily hindering companies or fund managers.

**Still “a ways to go”**

On the other hand, with regards to “ESG scoring”, Fiducient Advisors has noted in the past that ratings among various providers are, at a minimum, inconsistent[[6]](#footnote-6). Some have gone further to argue that motivations, if not the math, producing such ratings are misaligned. We don’t place any emphasis on such metrics and advise investors use this type of information as a tool rather than simply taking them at face value. There remains optimism that one day such evaluations could be as informative (if not consistent) as those provided by credit rating agencies – though even those are prone to having gaps.

In practice, we found that a majority of active asset managers we cover incorporate some level of ESG into their investment process. However, in our view less than a third do so in a way that is consistent and material to final investment decisions.[[7]](#footnote-7) With that in mind we remain leery of those in the industry seeking to capitalize on ESG assets with modest follow through on an ESG product – also known as “greenwashing.” Nonetheless, the motivation to incorporate ESG remains. The attempt to optimize exposure to companies that offer the most attractive long-term return profiles has intuitive alignment with many long-term ESG objectives. As proponents of the mosaic theory, it’s about the use of the whole picture.

**Where does that put us today?**

Our philosophy and process toward ESG investing is embedded within what we describe as mission-aligned investing. It is structured to be client-centric and driven by the specific values prioritized. For almost all investors, it is about education and creating a shared understanding of the terms, risks and opportunities. Our role is to listen first to our client’s concerns, understand their unique value system and provide a path toward aligning said beliefs with their investment portfolio in a pragmatic way.

While there is no specific reference to ESG investing in his book *Pioneering Portfolio Management*, the late David Swensen provides advice on the investment process that may aid how we approach (READ not solve) this dilemma: “Creating a governance process that encourages long-term, independent, contrarian thinking represents a critical undertaking for endowed institutions.[[8]](#footnote-8)” We echo such sentiment and urge investors to continue to think long-term, ask and discuss difficult questions and avoid sensationalism. Reality tends to live in the gray and if these topics matter to your institution they are worth the effort. Despite a desire to think green – ESG is likely to remain gray for some time to come.

Please reach out to any of the Associates at Fiducient Advisors for additional information on ESG or mission-aligned investing.

1. [*Integrating SASB Standards Into a Dynamic ESG Composite Score - SASB*](https://www.sasb.org/blog/integrating-sasb-standards-into-a-dynamic-esg-composite-score/#:~:text=The%20analysis%20of%20ESG%20materiality%20has%20led%20to,%E2%80%9Cstate%20of%20being%E2%80%9D%20but%20a%20%E2%80%9Cprocess%20of%20becoming.%E2%80%9D)*, October 14, 2021* [↑](#footnote-ref-1)
2. [*IIRC/SASB Merger Complete, New Value Reporting Foundation Takes Flight (nysscpa.org)*](https://www.nysscpa.org/news/publications/the-trusted-professional/article/iirc-sasb-merger-complete-new-value-reporting-foundation-takes-flight-060921)*, June 9, 2021* [↑](#footnote-ref-2)
3. [*IFRS - SASB Standards*](https://www.ifrs.org/issued-standards/sasb-standards/) [↑](#footnote-ref-3)
4. [*SEC.gov | SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors*](https://www.sec.gov/news/press-release/2022-46)*, March 21, 2022* [↑](#footnote-ref-4)
5. [*SEC.gov | SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names*](https://www.sec.gov/news/press-release/2022-91#:~:text=The%20Names%20Rule%20currently%20requires,80%20percent%20investment%20policy%E2%80%9D).)*, May 25, 2022* [↑](#footnote-ref-5)
6. [*ESG Data Perspectives - Shared Purpose May Not Lead to Shared Interpretations - Fiducient (fiducientadvisors.com)*](https://www.fiducientadvisors.com/research/esg-data-perspectives-shared-purpose-may-not-lead-to-shared-interpretations)*, December 7, 2020* [↑](#footnote-ref-6)
7. [*Greenwashing in ESG: Don’t Judge a Book by its Cover - Fiducient (fiducientadvisors.com)*](https://www.fiducientadvisors.com/blog/greenwashing-in-esg-dont-judge-a-book-by-its-cover)*, December 15, 2021* [↑](#footnote-ref-7)
8. *Pioneering Portfolio Management, David Swensen, January 6, 2009* [↑](#footnote-ref-8)