ESG Investing Trends for 2021
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As a fast-growing investing theme, ESG faces some challenges but has a lot of opportunity.

ESG investing, which includes three broad categories, environmental, social and corporate governance, allows you to invest in companies seeking solutions to the challenges we face in the world today that perform similar to traditional investments. This approach strives to achieve investment returns through ethical business practices.

There are certain elements of ESG that are relevant to all companies like diversity and inclusion or climate change, while there are other areas of ESG that differ by industry. Here's what you need to know about this popular investing theme to make sure your investments align with your values, but also meet ESG standard criteria:

- How to evaluate ESG investments.
- Risk and rewards of ESG investing.
- ESG market trends.

How to Evaluate ESG Investments

"There are many strategies out there that are labeling themselves ESG because it's growing very rapidly. Given this rapid growth, labeling yourself as ESG is an easy thing to do," says Theresa Gusman, chief investment officer at First Affirmative Financial Network in Colorado Springs, Colorado.

The practice of companies claiming they adopt ESG principles when in reality they don't have the data to support the claim is called "greenwashing." This results in some companies using the term ESG loosely to garner more investor appeal.

"Looking at whether the strategy truly integrates environmental, social and governance factors into their analysis and portfolio construction is critical," Gusman says.

Most of the information investors are looking for can also be found in the mutual fund fact sheets or prospectus. From a sustainability perspective, it's important to look further to assess the sustainability scores of the investment.

Gusman says the way to assess ESG components is by analyzing the Morningstar and MSCI sustainability ratings along with an investment's financial analysis to get a good idea of whether or not the securities in the fund strategy truly integrate ESG factors or not.

For those who are not well-versed in ESG investments or may have trouble properly analyzing ESG factors, Gusman says another option is to hire a financial advisor – that way you'll know you're getting what the advisor believes to be the best possible managed mutual fund solutions for custom portfolios.

Another key factor when assessing ESG investments is understanding what ESG issues are relevant to a given company when reviewing their performance.

ESG issues are specific across different companies, and not every company faces the same issues.

"As an investor, it's important to understand what are the ESG issues that are most relevant for that company when you're assessing how they're performing because that's going to be most connected to how that company will do over the long term," says Jade Huang, vice president and portfolio manager, Calvert Research and Management in the District of Columbia.

Identifying the ESG issues that are impactful for a particular company can help investors assess how well it will be able to navigate these ESG issues, which can lead to better risk management, and ultimately help you make better investment decisions.

Risk and Rewards of ESG Investing

A unique risk with ESG investing could be no exposure in a certain area that doesn't support the ESG framework or minimal exposure to a certain market segment.

"There may be a period where energy stocks were on a run and many ESG funds avoid fossil fuel companies with climate change in mind. So, if you have a certain segment of the market that is outperforming, you might not perform so well during that market cycle," Huang says.

Experts say another risk in ESG investing is the difficulty in measuring how well a company is doing with ESG issues. Because companies have different characteristics and given that there are many ESG features, it can be difficult to evaluate the impact of a company's diversity policies.

This stems from a lack of standard terminology and sustainability standards, resulting in some companies touting the ESG label when in reality they may or may not be making the cut.

One myth on rewards, it's a common misconception that investors have to sacrifice investment returns when thinking about incorporating their values into their portfolios. But experts say you do not have to compensate market returns for ESG investments.

Morgan Stanley's Institute for Sustainable Investing released a 2019 report, "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds," and found in its research on the performance of nearly 11,000 mutual funds from 2004 to 2018 that returns of sustainable funds were in line with traditional funds while simultaneously providing downside risk to investors.

Combining an ESG strategy with a corporate strategy can yield positive results on a company's overall performance in the long run, experts say.

ESG Market Trends

Susan Mac Cormac, corporate partner at Morrison & Foerster in San Francisco, says a positive trend for ESG will be seen from a disclosure perspective.

Standard setters for ESG disclosure like the Sustainability Accounting Standards Board, or SASB, along with other standard-setting institutions are involved in a joint effort to set standards on corporate reporting of sustainability standards and frameworks to better capture the performance of sustainability topics.

"Public and private companies and investors will be in alignment about which of the ESG factors are material to operations and which should therefore be included in reporting," Mac Cormac explains.

She is hopeful that we'll see an integrated standard for companies that want to focus on ESG, telling them how to report on that, whereas before everyone had their own standard.

Another trend Cormac notes is an increase in public benefit corporations (PBCs). PBCs are for-profit entities that include public benefits in their company's mission or statement of purpose. Mac Cormac says more companies are PBCs. These companies have to operate differently as they have a duty to certain ESG goals.

Many of the issues ESG investors are paying attention to are corporate and board diversity, climate policies, water issues, renewable energy and income inequality. Experts say these are popular themes people are connecting with and want to help address.

"More and more investors are focusing on what is the environmental and social impact of my portfolio; racial equity issues are more integrated into portfolios. All of these things should benefit ESG strategies going forward," Gusman explains.

Takeaway

ESG will continue to be an important topic as a growing number of investors are passionate about ESG considerations in their investments. This only adds to the pressure of more companies adopting ESG values.

"Companies that can communicate how they're helping to address these issues are going to be more effective in managing those risks and become a good investment," Huang says.

The risks ESG faces are being addressed, which may bring more confidence to investors and companies alike when making investment decisions around ESG. This positive trend can only help push forward ESG investing as demand continues.