Shareholders are getting serious about sustainability.
But many of them also believe that pursuing a sustainability agenda runs counter to the wishes of their shareholders. Sure, some heads of large investment firms say they care about sustainability, but in practice, investors, portfolio managers, and sell-side analysts rarely engage corporate executives on environmental, social, and governance (ESG) issues. The impression among business leaders is that ESG just hasn’t gone mainstream in the investment community.

“That perception is outdated. We recently interviewed 70 senior executives at 43 global institutional investing firms, including the world’s three biggest asset managers (BlackRock, Vanguard, and State Street) and giant asset owners such as the California Public Employees’ Retirement System (CalPERS), the California State Teachers’ Retirement System (CalSTRS), and the government pension funds of Japan, Sweden, and the Netherlands. We know of no other research effort that involved so many senior leaders at so many of the largest investment firms. We found that ESG was almost universally top of mind for these executives.

“ESG issues have become much more important for us as long-term investors,”
Cyrus Taraporevala, president and CEO of State Street Global Advisors, told us, expressing a view echoed in many of our interviews. “We seek to analyze material issues such as climate risk, board quality, or cybersecurity in terms of how they impact financial value in a positive or a negative way. That’s the integrative approach we are increasingly taking for all of our investments.”

The numbers back up the view that the capital markets are in the midst of a sea change. In 2006, when the UN-backed Principles for Responsible Investment (PRI) was launched, 63 investment companies (asset owners, asset managers, and service providers) with $6.5 trillion in assets under management (AUM) signed a commitment to incorporate ESG issues into their investment decisions. By April 2018, the number of signatories had grown to 1,715 and represented $81.7 trillion in AUM. According to a 2018 global survey by FTSE Russell, more than half of global asset owners are currently implementing or evaluating ESG considerations in their investment strategy.

Yet many corporate managers seem to be unaware of this new reality. In a recent survey by Bank of America Merrill Lynch, U.S. executives underestimated the percentage of their company’s shares held by firms employing sustainable investing strategies. The average estimate was 5%; the actual percentage is more like 25%.

The first step corporate leaders can take to prepare for this shift in focus is to recognize the forces driving it. Once they understand why investors now care so much about ESG issues, they can make changes within their organizations to maximize long-term value for shareholders.

What’s Driving the Change

OVER THE PAST FIVE YEARS OR SO, investors have become increasingly interested in ESG issues. Six factors are acting as tailwinds for this heightened focus.

THE SIZE OF INVESTMENT FIRMS. The investment industry is highly concentrated. The top five asset managers hold 22.7% of externally managed assets, and the top 10 hold 34%. Large investment firms are now so big that modern portfolio theory—which holds that investors can limit volatility and maximize returns in a portfolio by combining investments from asset classes with varying levels of risk—cannot be used to mitigate system-level risks. A small investment firm might be able to hedge against climate change and other system-level risks by investing in “doom” stocks, such as gold, or in shares of companies that build survival shelters, for example. But firms that have trillions of dollars under management have no hedge against the global economy; in short, they have become too big to let the planet fail. What’s more, large asset owners such as pension funds are forced to take a long-term view because

Sustainable investing is about materiality. A company that spends vast sums of money trying to address every conceivable environmental, social, and governance (ESG) issue will likely see its financial performance suffer; however, companies that focus on material issues tend to outperform those that don’t.

Materiality varies by industry. The Sustainability Accounting Standards Board (SASB) has identified the material ESG issues for all 77 industries in its classification system. For example, material issues for companies in food retail and distribution include greenhouse gas emissions, energy management, access and affordability, fair labor practices, and fair marketing and advertising. For internet and media services the list includes energy management, data security and customer privacy, diversity and inclusion, and competitive behavior.

A study by Mozaffar Khan, George Serafeim, and Aaron Yoon provides empirical evidence that good performance on material issues contributes to higher financial returns. Most tellingly, the researchers found that whereas firms with good ratings on material sustainability issues significantly outperform firms with poor ratings on those issues, firms with good ratings on immaterial issues do no better than firms with poor ratings on those issues.

Mainstream investors now look for evidence that their portfolio companies are focused on the material ESG issues that matter to financial performance, rather than on some ill-defined commitment to “sustainability.”
Firms that have trillions of dollars under management have no hedge against the global economy; they have become too big to let the planet fail.

they have long-term liabilities—they must plan to pay out retirements for the next 100 years. As Hiro Mizuno, the chief investment officer of Japan’s $1.6 trillion Government Pension Investment Fund, noted, “We are a classic universal owner with intergenerational responsibilities and thus have an inherently long-term view.”

FINANCIAL RETURNS. Many corporate managers still equate sustainable investing with its predecessor, socially responsible investing (SRI), and believe that adhering to its principles entails sacrificing some financial return in order to make the world a better place. That view is outdated. A study by Harvard Business School’s George Serafeim and colleagues (which included one of us, Eccles) found that companies that developed organizational processes to measure, manage, and communicate performance on ESG issues in the early 1990s outperformed a carefully matched control group over the next 18 years. In a different study, Serafeim and his colleagues demonstrated the positive relationship between high performance on relevant ESG issues and superior financial performance. Evidence from investors corroborates that: A 2017 study by Nordea Equity Research (the largest financial services group in the Nordic region) reported that from 2012 to 2015, the companies with the highest ESG ratings outperformed the lowest-rated firms by as much as 40%. In 2018, Bank of America Merrill Lynch found that firms with a better ESG record than their peers produced higher three-year returns, were more likely to become high-quality stocks, were less likely to have large price declines, and were less likely to go bankrupt. Also in 2018, Amundi Asset Management found that the relative importance of ESG factors varies by region. For European portfolios, governance is particularly important for determining outperformance. For North American portfolios, environmental factors are the most significant.

The key to the new generation of sustainable investing is that it focuses only on “material” ESG issues that impact a firm’s valuation—for example, greenhouse gas emissions are material for an electric utility company but not for a financial services firm; supply chain management is material for an apparel company using low-cost workers in developing countries but not for a pharmaceutical company. (See the sidebar “Materiality Matters.”)

GROWING DEMAND. Asset owners such as pension funds are increasingly demanding sustainable investing strategies from their asset managers. Mary Jane McQuillen, portfolio manager and head of the ESG investment program at ClearBridge Investments (an active manager with $145 billion in AUM), says that in recent years her firm has seen a marked increase in the number of new inquiries mentioning ESG. What’s driving this growing demand? Not only are sophisticated asset owners aware that sustainable investing improves returns, but many of them, including high-net-worth individuals, are also focused on the nonfinancial outcomes. “Our wealthiest clients want to know their investments are making a difference to make the world a better place,” noted Rina Kupferschmid-Rojas, head of sustainable finance at UBS Group, which has the largest wealth-management business in the world, at $2.4 trillion.

The demand for ESG investment options is so high that many asset management firms are rushing to pull together new offerings. Sustainable and impact investment at UBS Asset Management has more than tripled since December 2016, with $17 billion in AUM. “We have seen very strong asset growth in our Sustainable and Impact offering,” said Michael Baldinger, the unit’s head, “and client demand has simply accelerated over the past 24 months.”

Asset owners no longer have to be convinced that sustainable investing is important. “We used to have to put a lot of effort into explaining to our colleagues in the broad investment community why ESG is important,” noted Eva Halvarsson, the CEO of Swedish pension fund AP2. “Now the focus is on how we can most effectively capture value from ESG integration.”

AN EVOLVING VIEW OF FIDUCIARY DUTY. A corollary to the mistaken belief that sustainable investing means sacrificing some financial return is the belief that fiduciary duty means focusing only on returns—thereby ignoring ESG factors that can affect them, particularly over time. However, more recent legal opinions and regulatory guidelines make it clear that it is a violation of fiduciary duty not to consider such factors. Although adoption of this new understanding has been slow in the United States, other countries, such as Canada, the UK, and Sweden, are taking steps to redefine the fiduciary duty concept. On November 28, 2018, the Swedish
parliament approved major reforms requiring the four main national pension funds to become “exemplary” in the field of sustainable investment. As Will Martindale, head of policy at PRI, bluntly put it to shareholders, “Failing to integrate ESG issues is a failure of fiduciary duty.”

TRICKLE-DOWN WITHIN INVESTMENT FIRMS. It is one thing for the CEO or chief investment officer of a major investment firm to espouse sustainable investing and quite another for it to be practiced by the analysts and portfolio managers who make the day-to-day investment decisions. Historically, the ESG group at investment firms was separate from portfolio managers and sector analysts (on both the buy side and the sell side) in much the same way that corporate social responsibility groups were historically separate from business units. Now senior leaders are making sure that ESG analysis is being integrated into the fundamental financial activities carried out by analysts and portfolio managers. The big Dutch pension fund ABP, for example, has a program for full ESG integration across all asset classes. “Responsible investment is central to our investment philosophy,” said Claudia Kruse, the managing director of global responsible investment and governance for APG (ABP’s asset manager). “Portfolio managers are accountable for assessing every investment in the context of risk, return, costs, and ESG. This has been an internal cultural evolution.”

This shift will change the way investors engage with companies—and the way corporate executives view sustainability. The two key conversations—an investment team talking to a company’s CEO and CFO, and the investor’s ESG team members talking to their corporate counterparts—will be fused into one hardheaded conversation about material ESG issues. When it becomes clear that the people who decide whether to buy or sell a company’s stock have internalized ESG into their calculations, the business leaders will be forced to do the same within their companies.

The integration of ESG into financial analysis at BlackRock, the world’s largest asset manager, with $6.1 trillion under management, is illustrative. The firm’s CEO, Larry Fink, has promoted the importance of sustainable investing for several years—but full integration of ESG criteria into the firm’s investment strategies has not happened overnight. Tariq Fancy, the chief investment officer of sustainable investing at BlackRock, equates integrating ESG considerations into traditional financial analysis to an exercise in behavior change. “Some investors are naturally
inclined to do it. Others, depending on their asset class, geography, and investment style, take more time to see the investment value,” he says. Fancy’s background is as an investor—not someone from an environmental or social NGO—which gives him credibility in dealing with the investment teams. Given the size of BlackRock, changing investor behavior across the organization will require time and hard work. “But if we can do it at BlackRock, we can do it across capitalism,” he says.

Making the job of Fancy and other chief investment officers easier is the fact that the workforce is increasingly made up of Millennials, for whom ESG is central to any business analysis. Halvarsson told us that 20% of AP2’s employees are Millennials. “They expect us to integrate sustainability as a natural part of our daily work,” she said.

MORE ESG ACTIVISM BY INVESTORS. Shareholder activism is on the rise in financial markets—and ESG is increasingly becoming a focus of these interventions. Historically, equity and fixed-income investors have been hands-off, keeping the stock or bond when they like it and selling it when they don’t or when they think it’s reached its peak value. But active managers who intend to hold a stock for a long time and passive managers who hold a stock forever have an incentive to see that companies address the material ESG issues that will improve their financial performance. One form of active engagement is proxy resolutions and proxy voting, an aspect of the active ownership strategy for sustainable investing. According to the ESG research and advisory firm Institutional Shareholder Services, 476 environmental and social (E&S) shareholder resolutions had been filed in the United States as of August 10, 2018. The share of total resolutions focused on E&S has grown from around 33% in the 2006 to 2010 time period to around 45% from 2011 to 2016. By 2017, it stood at just over 50%. Leading topics for these resolutions include climate change and other environmental issues, human rights, human capital management, and diversity in the workforce and on corporate boards.

Even some activist hedge funds are moving into sustainable investing. For example, JANA Partners has launched its JANA Impact Capital Fund (JIC) and partnered with CalSTRS to encourage Apple to address the overuse of its iPhones by children and teenagers. (Disclosure: One of us, Eccles, is on JIC’s advisory board.) According to Charles Penner, a partner at JANA and the co–portfolio manager at JIC, the pressure has worked. “Apple quickly affirmed its commitment to the safety of its youngest customers the day after we raised our concerns, and it has since released new controls,” he said. Jeff Ubben, the CEO of ValueAct Capital, launched its ValueAct Spring Fund at the start of 2018 and took its first position in the global power company AES. Since Ubben joined the AES board, the company has accelerated its transition from coal to renewable energy sources and has become the first publicly traded U.S. power company to make its climate disclosures in accordance with the recommendations of the Task Force on Climate-related Financial Disclosures. As the company accelerates its carbon reduction goals, it is attracting European and Canadian ESG-oriented investors that had previously avoided it. Ubben told us, “Our goal is for each ValueAct Spring Fund portfolio company to earn a sustainability premium in its stock price for the long-term environmental and social value that is being generated.”

Investors that do not have the scale and resources of firms such as BlackRock or the activist orientation of JANA
Companies need to increase middle management’s involvement in identifying and managing material ESG issues.

While the world of ESG data still feels a bit like the Wild West, substantial progress in improving the quality and availability of information is being made through market forces, the efforts of NGOs, and, in some territories, regulation—such as an EU directive requiring all companies of a certain size to report nonfinancial information once a year. “The quality of ESG data is not perfect,” BlackRock’s Fancy said, “but it’s rapidly improving.”

Preparing for the New Era

Our research reveals five actions that companies can take to prepare for the new era of sustainable investing.

Articulate Your Purpose. Larry Fink, who writes an annual letter to CEOs, created quite a stir with his 2018 missive, titled “A Sense of Purpose.” He wrote, “To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.” He elaborated on this view in his 2019 letter, “Purpose & Profit,” stating that “purpose is not the sole pursuit of profits but the animating force for achieving them.” He further stated that “profits are in no way inconsistent with purpose—in fact, profits and purpose are inextricably linked.” According to Michelle Edkins, BlackRock’s global head of investment stewardship, “Some people think ‘purpose’ means diverting from profitability—but it doesn’t.” As Colin Mayer, a professor at the University of Oxford and an expert on corporate purpose, recently told us in an interview, “The purpose of a company is not just to produce profits, it is to produce solutions to problems of people and planet and in the process to produce profits.”

The easiest way for board members to communicate their company’s place in society is to publish a “Statement of Purpose.” In it, the board articulates the company’s reason for being, identifies the stakeholders most important to its continued prosperity, and lays out the time frames over which senior management’s decisions are evaluated and rewarded. It is essential that this statement come from the board since its role is to represent the intergenerational...
obligations of the corporation. Hermes EOS has launched an engagement campaign to encourage company boards to publish just such a statement. “Clarity about the corporate purpose is fundamental for board effectiveness,” explained Hermes EOS’s Hirt. “It’s a cornerstone of constructive engagement with investors and other stakeholders.”

**IMPROVE ENGAGEMENT WITH SHAREHOLDERS.** Investors, both active and passive and across asset classes, are seeking deeper levels of engagement with their portfolio companies. As “sustainable investing” becomes synonymous with “investing,” shareholders will want to be able to engage with the C-suite, including the CFO, and directly with the board. The “Statement of Purpose” provides a good foundation, but it should be part of a larger, integrated report for shareholders. As defined by the International Integrated Reporting Council, “an integrated report is a concise communication about how an organization’s strategy, governance, performance, and prospects, in the context of its external environment, lead to the creation of value.” In practice, this means that company reports should include a materiality analysis that identifies the ESG issues that affect financial performance. Such a report is an effective way to demonstrate to shareholders and other stakeholders that the company is practicing “integrated thinking” regarding its role in society. It is a way of changing the orientation from short-term financial results to long-term value creation.

The “Statement of Purpose” and an integrated report provide a good foundation for a company to start communicating its long-term plan. The Strategic Investor Initiative of CECP, a CEO-level coalition, has created a framework for executives to share the long-term strategic plans for their companies, and it hosts CEO Investor Forums in which to do so. Nearly two dozen heads of S&P 500 companies—including chief executives at 3M, Aetna, Becton Dickinson, GlaxoSmithKline, IBM, and Unilever—have presented their plans to institutional investors with some $25 trillion in assets under management.

Finally, companies should take charge of quarterly calls and not let them be driven by short-term sell-side analysts. A good start is to eliminate earnings guidance. Management can then use these calls to explain progress on ESG targets and how the targets are contributing to financial performance. This is already beginning to happen. According to a 2018 report by Goldman Sachs, nearly half of S&P companies addressed ESG topics in 4Q conference calls.

**INCREASE INVOLVEMENT BY MIDDLE MANAGEMENT.** As ESG considerations at major investment firms are trickling down from the CEO and CIO level to analysts and portfolio managers, companies need to respond by increasing their own middle management’s involvement in identifying and managing the material ESG issues. After all, middle managers are the ones who commit resources for achieving strategic

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**What Is Sustainable Investing?**

*Sustainable investing encompasses a menu of strategies that can be used in combination. Here are seven common ones:

- **Negative/exclusionary screening** (eliminating companies in industries or countries deemed objectionable)
- **Norms-based screening** (eliminating companies that violate some set of norms, such as the Ten Principles of the UN Global Compact)
- **Positive/best-in-class screening** (selecting companies with especially strong ESG performance)
- **Sustainability-themed investing** (such as in a fund focused on access to clean water or renewable energy)
- **ESG integration** (including ESG factors in fundamental analysis)
- **Active ownership** (engaging deeply with portfolio companies)
- **Impact investing** (looking for companies that make a positive impact on an ESG issue while still earning a market return)

A noteworthy example of sustainable investing is the strategy developed by Mats Andersson (a former CEO of AP4), Patrick Bolton (a professor at Columbia), and Frédéric Samama (a cohead of institutional clients coverage at Amundi Asset Management) that enables long-term passive investors to hedge climate risk without sacrificing returns. The strategy is based on building a portfolio of companies that have a carbon footprint 50% smaller than benchmarks and have 50% less exposure to “stranded assets” (such as fossil fuel assets that have become nonperforming or obsolete as a result of legislation, decreased demand, or other factors). This model, outlined in the *Financial Analysts Journal* article “Hedging Climate Risk,” has been used by AP4, CalSTRS, the New York State Common Retirement Fund, the New Zealand Superannuation Fund, and many others. Today some $50 billion in assets are being managed using this strategy.
for standards and better and more integrated IT systems) and concerns (increased liabilities, for example) in doing so. But these are surmountable problems that must be solved to accommodate the changing focus of investors.

**IMPROVE MEASUREMENT AND REPORTING.** Some ESG issues don’t affect a company’s bottom line but still impact society at large. A growing segment of the investment community is interested in those impacts—and willing to allocate capital to firms that actively work to benefit society. The challenge for companies wishing to attract these investors is that there is currently no agreed-upon way of measuring a firm’s “externalities”—the positive and negative effects of its products and services on society. As just one example of the challenge, consider geographical location. A windmill replacing coal in China has a greater positive impact than adding a similar windmill in Norway, where nearly all of the energy comes from hydropower.

The Impact Management Project is a network of organizations working to harmonize impact measurement and reporting initiatives. CEO Clara Barby calls it a “big tent” of people and organizations committed to creating standards that will be useful to companies and investors. Companies, like investors, are on the frontier of this effort and will be learning together. A good framework for thinking about impact is the United Nations Sustainable Development Goals (SDGs)—the 17 goals that the UN identified as necessary for a sustainable future, including eradicating poverty and hunger, ensuring responsible production and consumption, and promoting gender equality. A 2016 PwC study of sustainability reporting by 470 companies in 17 countries found that 62% mentioned the SDGs, although only 28% provided quantitative targets linked to societal impact.

**A SEA CHANGE** in the way investors evaluate companies is under way. Its exact timing can’t be predicted, but it is inevitable. Large corporations whose shares are owned by the big passive asset managers and pension funds will feel the change the soonest. But it won’t be long before mid-cap companies come under this new scrutiny as well. All companies, though, should seize the opportunity to partner with investors willing to reward them for creating long-term value for society as a whole.

**INVEST IN INTERNAL SYSTEMS FOR ESG PERFORMANCE INFORMATION.** Whereas every large company has a sophisticated and robust IT infrastructure for generating financial reports, few firms have reliable systems for measuring ESG performance. Instead, ESG information is typically generated through spreadsheets or various boutique software solutions focused on distinct topics, such as carbon emissions, supply chain, or customer retention. The result is untimely and poor-quality ESG data, which presents challenges not only to investors but to corporate managers themselves. Indeed, one of the main obstacles today for many companies wishing to produce an integrated report is that their ESG information is rarely available at the same time and in a comparable format as financial information. Developing standards for ESG information, as GRI and SASB are doing, will be helpful here. But corporate leaders can also play a vital role in speeding the pace of change in three ways.

First, they can put these standards into practice in their external reporting. Second, companies should challenge the software vendors that provide financial information to extend into ESG metrics. Some of the large software firms are already working on this—and they will work harder and faster if there is clear market demand. Third, businesses should press their audit firms to provide assurance on reported ESG performance, just as they do for financial performance. Yes, there are challenges (such as the need...