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Are ESG scores killing sustainable investing's potential?

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Public consciousness, financially engaged younger generations, and intergenerational wealth transfers have all contributed to ferocious demand for sustainable investment solutions.

Yet criticism of Environmental, Social, and Governance (ESG) investing has never been higher, with naysayers pointing to under-performance of funds in 2022 as evidence of a bubble bursting. ESG investing is failing, but it was never designed to succeed, and there is a ready-made replacement in **Impact Economics** available today.

When Elon Musk took to Twitter in May 2022 to call ESG a scam following the removal of Tesla from a leading ESG Index, it felt like a tipping point for a trend that Bloomberg had estimated in 2021 was on track to absorb over one third of global investment assets by 2025.

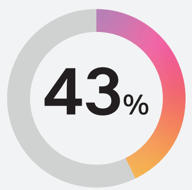
As Mr. Musk queried his company's exclusion from a list that has oil-major Exxon among its top ten most ESG-compliant companies, the irony was that it was governance concerns about overuse of social media that had triggered Tesla's downgrades.

The term ESG was originally coined in UNGC's landmark publication 'Who Cares Wins' (UN Global Compact, 2004). The goal was to increase awareness and understanding of company performance in governance and its impact on the environment and society. Clarity was provided at the time that the three metrics were not designed to be combined and treated as equal contributors to a company's overall impact.

In our opinion, a powerful ESG measurement narrative combined with human desire for simplicity resulted in the misdirected focus on achieving a single ESG rating. This has overwhelmed the original mission of sustainable investing.

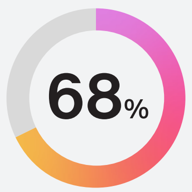
There is no longer common ground on what makes for a good ESG rating.

A growing appetite for sustainable investments



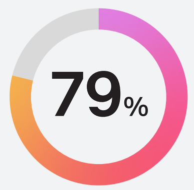
The number of global ESG funds rose **43%** in 2021.

Source: Morningstar Direct.



68% of global investors are interested in seeing environmental and societal impact of their investments.

Source: January 2020, Investec Planetary Pulse Survey commissioned by FNZ.



79% of individual investors and **99%** of millennial investors are interested in sustainable investing in the US.

Source: Morgan Stanley Institute for Sustainable Investing.

With over 150 providers and more than 600 scores, there are multiple methodologies with competing combinations of environmental, social & governance metrics and aggregation techniques.

It is hard to find a correlation between ESG and stock price performance partly because there is no standard measure of ESG. Any relationship between prices and ratings is most likely due to inflow of funds overall, or the slowdown thereof this year.

Lacking a standard definition and conflating inputs and outputs, it is little wonder ESG investing has failed to live up to the hype. This has led to well-publicized complaints of "greenwashing".

Impact economics provides a working alternative to ESG scores and measuring and managing a company's interactions with society. Impact economics separates the drivers of an outcome from its impact and places a monetary value on that impact. The use of a dollar number for positive and negative externalities means investors and stakeholders alike may determine what is material and compare sustainability-focused companies and funds accurately and with rigor.

While an Impact Framework enjoys consensus thanks to the work of organizations such as the Capitals Coalition, the credibility of Impact as Economics will only be enhanced by global standardization in disclosure, regulation and measurement.

We believe a combination of Impact Economics, trustworthy data, improved regulatory standards, and technology are needed to address the fledgling area of values-based investing. FNZ's integrated technology solution, IMPACT, combined with GIST's trusted data, are a step toward realizing the full potential of sustainable investing.

Impact economics values company performance by placing a monetary value on the company's most significant positive and negative impacts on society.

This involves quantifying externalities, and leads to a universal and comprehensive framework in which comparisons between companies and sectors may be made accurately and consistently. Whether this manifests in quantifying the social cost of carbon, summing the increase in wage-earning power through staff training, or calculating the value derived from local biodiversity, the final metric is expressed as a dollar value, making evidence-based comparisons across companies and sectors not only possible but scientifically rigorous and transparent.

Look out for our full Impact Economics white paper later this year.

About GIST

GIST is a pioneering data and analytics company that brings together world-renowned sustainability expertise with technology and big data to help investors and companies measure, value, and benchmark business impacts across all four capitals: Natural, Human, Social, and Produced. GIST's data and software solutions provide analytics and insights that make it easy for investors and companies to measure performance across all value dimensions, manage material risks, and make informed decisions.

gistimpact.com

About FNZ

FNZ provides a global, end-to-end platform to open up wealth, combining technology, infrastructure and investment operations in a single state-of-the-art platform. We partner with the financial institutions and wealth managers to make wealth management more accessible, helping people invest in the things they care the most about, on their own terms. This new approach makes wealth more transparent, sustainable and personal, empowering millions of people to grow their wealth the way they want.

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