How the Next Generation Can Add Value to ESG Investing

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Young investors – passionate about sustainability and business ethics – are exploring at the intersection of social impact and investing. You want the money that you invest in companies to not just make a profit, but also achieve a purpose. This includes everything from addressing the climate crisis, to supporting the careers of women and minorities in business.

An example of "Gen Z's unique way of reforming business is through investing," notes Raymond L., a high school student who participated this summer in our 2021 Comment & Win contest. "Investors will begin to shoulder the responsibility to solve social and environmental problems. As an impact investor, I will always be on the lookout to spot 'good' companies and find new ways to promote this type of investing through my generation."

Environmental, Social, Governance

ESG is one approach that investors are using to spot those good companies – and invest sustainably in financially strong prospects. Every year, it is a popular acronym and approach among the teams that participate in our Wharton Global High School Investment Competition.

ESG refers to the environmental, social and corporate governance practices of an investment. Looking at companies through an ESG lens, rating companies use data to score company performance around certain metrics, like a company's concern for the community, environmental impact, and how well its leadership performs. When selecting stocks, investors integrate ESG factors to improve their traditional financial analysis of potential investments and to identify risks and opportunities. It is part of the risk management that can be essential to sound investing.

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Different from socially responsible investing, where investors favor companies that are engaged in intentionally good acts like developing a technology that cleans plastic waste from the oceans, ESG screening rates all types of companies on how they measure up on various factors. And while there is an overlay of social consciousness, the main objective of ESG valuation remains financial performance – investments that will generate returns.

"The idea is to look at companies and to evaluate them on their ESG performance," says Katherine Klein, vice dean of the Wharton Social Impact Initiative. "What is their environmental performance? Are they polluting? Is there good diversity in gender and race on the board of directors? Governance has to do with how this company is governed by the board of directors. How many independent board members are there? How much control and oversight is there outside the company? The emerging evidence on ESG suggests that at least in some cases, it's a good way to evaluate risk."

Witold Henisz, Wharton professor of management, director of the Wharton Political Risk Lab, and the founder of the ESG Analytics Lab, notes that ESG investing takes different forms. "ESG investing incorporates or takes into account ESG factors in some manner. This could include screening out low-performing companies on ESG, tilting away from low and/or towards high-performing companies, or investing in companies that have been underperforming on ESG (and financial returns), but seem poised (or could be prodded) to improve."

Henisz believes ESG can generate value within companies, with big potential to deliver value to investors, the

environment and society. What’s been missing is solid research on the effectiveness of ESG measures.

Portfolios with Values and Value

Wharton started the ESG Analytics Lab in 2019 because “there is so much interest in harnessing the power of capital to ‘fix capitalism,’ but so little hard-edged data analysis of what works and why,” notes Henisz. ESG Analytics generates rigorous but practically relevant analysis on the financial importance of ESG factors. The latest research, due out this month, introduces a new metric for assessing a firm’s ESG performance that has a more rigorous academic theory behind it and stronger connections to stock market value as compared to other measures. Other recent analysis looks at how widely ESG impacts can differ across industries.

The buzz around ESG is driven in large part, Henisz observes, by younger generations wanting a portfolio whose “values appreciate as much as its value.” However, the cautionary tale for investors is that a lot of the ESG hubbub is still hype.

“Most of the ESG offerings are simple greenwash,” says Henisz, adding that certain index funds might be called ESG for marketing purposes as a way to take advantage of investor demand. “There is little evidence that any of this huge fund inflow is improving financial or societal returns to date. This is a huge risk. If we don’t demonstrate impact on returns…the entire boom could be followed by a bust,” which would waste precious time in advancing ESG investing to benefit society.

The world’s youth, already intrigued with Environmental, Social and Governance factors, have an opportunity to strengthen the impacts of and case for ESG by connecting that emerging “hard-edged data analysis” with ESG’s financial and societal goals. “At present, interest far surpasses rigor, which is an invitation to bright, young, interested minds to help reality catch up to the rhetoric,” says Professor Henisz of the ESG landscape. “Be that entrepreneur, not just because it will generate alpha [investment returns] or because it will address climate change, but because of both and how important it is to convince people that’s possible.”