Guest Editors' Introduction

Rethinking Environmental/Social/Governance Metrics for the Mainstream Investor

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Interest in *sustainable investing* has broadened and deepened in the past few years. No longer confined to a small niche of *socially responsible* (SRI) investors, the desire for metrics that gauge the environmental, social, and governance (ESG) performance of companies has expanded into the mainstream investment domain. Where the core focus of SRI investors centered on *negative screening*, which entailed the exclusion of disfavored industries – such as alcohol, tobacco, or gun making – or companies with bad track records on critical issues – such as pollution control or respect for labor rights – today's mainstream sustainability-minded investors are more diverse in their interests and therefore in their ESG data needs.

The sustainability interests of these investors, in fact, vary widely. Some have specific issues of concern in mind (such as climate change or a lack of diversity in the workforce) – and they want their portfolios to reflect these values. In this regard, a growing number of investors have asked their account managers to divest from companies with significant greenhouse gas emissions, but exactly how this should be done is often not clear. Likewise, those who care about diversity have signaled their desire not to own shares of companies that lack a significant female presence in their top management, but the data necessary to implement this preference too often are hard to come by.

Other investors wish to put their money into businesses that are helping to address societal challenges. Thus, some *impact* investors with a commitment to climate change action want to put their capital to work in corporations that are bringing renewable power or energy efficiency to the marketplace. How far these impact investors are willing to go in terms of accepting sub-par returns as the price for having their investments aligned with their values again varies widely. Some are willing to undertake significant risks to promote their values and commitment to social change. Others want to lean in the direction of their preferences but only to the extent that this tilt in their portfolio does not produce significantly diminished returns. Yet other investors believe that companies that are out in front on critical issues – such as the push toward a clean energy future or a more diverse workforce – will deliver superior returns from corporate valuation or improved diversification. But too often the ESG metrics available are risk-focused and not very helpful when it comes to identifying the companies that are delivering value by solving societal problems.

ESG analytics firms have grown with the rising demand from asset owners and asset managers. We have seen an explosion in coverage, metrics, and indices that seek to provide insight into ESG performance even through the recent consolidation in analytic firms. And yet, in our work in the sustainable investment arena, we hear time and time again a frustration with the current state of ESG metrics. Frustration from companies that must fill out questionnaire upon questionnaire asking for the same information, much of which is in the public domain. Frustration from asset managers who see discrepancies between ESG scores across the board – and justifiably retain skepticism as to whether the scores reflect any sort of reality. Frustration among asset owners that must sift through the soup of ESG metrics to find those that match their particular investment strategies. Frustration from society and policymakers who hope to see transformational shifts in capital toward sustainable investments that will improve both the bottom line and the world.

This special issue of the *Journal of Environmental Investing (JEI)* seeks to map the rise of sustainable investing with all of its various dimensions and investor preferences and to sharpen the focus on how ESG metrics must evolve to keep up with growing demand for guidance on what represents corporate sustainability leadership. The articles that follow reflect contributions from scholars and practitioners. Some of them offer frameworks for understanding who the new sustainability-minded investors are and what they want in the way of ESG data. Others put forward ideas about how improved ESG metrics might be constructed and explain ways that advanced data analytics might better highlight sustainability strategies that will have a material impact on financial performance. Yet other articles discuss new tools that can refine ESG analyses in the years ahead including machine learning and statistical techniques for better data normalization.

Yet, despite the wide range of perspectives, approaches, and techniques described in this issue of the JEI, some common themes emerge. First, despite the frustration with the existing ESG data, there exists a sense of optimism and confidence that the world is inexorably turning toward greater focus on sustainability. A focus on ESG factors must, therefore, be understood not as a fad but the new reality of investing. Thus, there is virtually no discussion in these articles of *whether* ESG metrics will become an integral part of investing decisions. Rather, these articles explore the *how* of this transition will unfold. Whether targeted at more integrated risk assessment, or valuation of intangibles, or identifying tomorrow's market leaders, the articles in this issue universally demonstrate pathways to more successful investment strategies using ESG metrics and analyses as a tool.

A second common theme is the acknowledgement that one size of ESG metrics will not fit all. ESG strategies are as diverse as investment strategies more generally. It is thus folly to suggest that a single set of metrics will meet the needs of the investor universe. That said, there are clear mechanisms emerging with which to assess those metrics that are meaningful and those that are not. Whether it is more robust materiality processes, better normalization techniques, the application of big data, or a more refined metrics menu, each paper offers a set of options for engaged investors.

As the guest editors of this special issue of the *Journal of Environmental Investing*, we are pleased with the array of articles that follow – and the contribution that they make, individually and collectively, toward strengthening the foundations for sustainable investing. In many ways, these pieces raise more questions than they answer – a hallmark of important analytic work in a significant new scholarly domain. These questions are also some of our key takeaways from the Issue: Who should drive the process of making ESG metrics more consistent, reliable, and informative? What is the most appropriate role for policymakers in the development of ESG metrics? What are the remaining hurdles to scaled-up sustainable investing? We invite your critique and comment on the articles and look forward to the debates that will follow.

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