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"ESG Investing: Coming into its Own—and Not a Moment Too Soon"
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Good morning and many thanks for inviting me to your annual conference. It is a great honor for me to be here. I'm also hoping that some of your investment skills will rub off on me. In return, I can offer you some thoughts about ESG investing and ways to make it an even more powerful force in moving financial markets.

There are several types and strategies of ESG investing, which together now account for nearly $31 trillion, or more than 25% of all assets under management worldwide. In Canada, the fraction is more than 50%. My focus this morning is on the integration of environmental, social and governance (ESG) criteria into financial analysis.

In the United States, we have seen two sharp spikes in ESG investing in recent years. The first occurred after the 2008 financial sector meltdown, reflecting eroding trust in mainstream finance. The second came in the wake of the 2016 presidential election—Morningstar called it the Trump Bump. Presumably it reflected the realization that the new administration was unlikely to advance the people and planet agenda. Indeed, just last week President Trump made a push to combat shareholder climate change advocacy, as part of his efforts to support fossil fuel use and development.

The global upward trend in ESG investing continues and is likely to be reinforced because millennial investors are expected to inherit some $30 trillion over the next decades, and they are believed to have stronger commitments to sustainability issues than their parents.

The underlying driver of the powerful growth of ESG investing is that it delivers. Several large meta-studies show, and the *Wall Street Journal* has grudgingly acknowledged, that ESG funds perform at least as well as conventional funds, and probably better over the medium term. They also offer greater transparency. Bloomberg reports that of 1,200 ESG funds it tracks only 34 held stock in PG&E. That's the California utility that triggered the wildfires destroying the town of Paradise, creating the first climate-related bankruptcy, but no doubt not the last. In a recent speech on the financial risks of climate change, Mark Carney, Governor of the Bank of England, describes ESG investing as "a new horizon."

In a similar vein, S-Ray, the AI data arm of Arabesque, the asset management firm on whose board I sit, had downgraded the ESG scores of multiple stocks well before the companies and their share price were hit by scandals. The companies included VW, Toshiba, Kobe Steel, Wells Fargo, Facebook, Nissan, Sun Edison, and, no surprise, SNC-Lavalin. Many of these cases involved weak corporate governance.

In short, the ESG investing community clearly is onto something fundamental. I want to build on this observation to address three issues this morning. The first is to remind ourselves just how critically important ESG investing is, not only for the opportunity to generate favorable returns, but also as a potential transformative agent in our extraordinarily turbulent and fragile economic world. The second is the urgent need to drive ESG investing further into the mainstream, aiming in particular to induce traditional mainstream investors, analysts, and the specialist financial press to look beyond their status quo comfort zones. And the third is to address the S in ESG, the weakest ESG component at this time, and to suggest ways it can be strengthened and thereby help improve the overall quality of, and confidence in, ESG data.

The Macro Picture

So, what does ESG mean in the big scheme of things? For nearly 50 years now, the doctrine of maximizing shareholder value has defined and even mesmerized Anglo-American capitalism. This no doubt has led to greater corporate profits and wealth for the people and countries positioned to take advantage of it. But it has also come at a cost that threatens the very system of corporate capitalism as we know it.

Together with government actions that enabled the doctrine to become standard practice, shareholder primacy has contributed to a generation of workers' income stagnation, political polarization, environmental degradation and an existential threat to the climate system, human rights violations in global supply chains, growing market concentration across the economy, greater frequency of financial crises, massive tax avoidance hollowing out public capacity, and even declining life expectancy in the world's wealthiest country. Under the shareholder primacy doctrine, these are all considered externalities that lie beyond any business responsibility. As Milton Friedman famously wrote in 1970, "The Social Responsibility of Business is to Increase its Profits."

Colin Mayer, former Dean of the Said School of Business at Oxford University, issues a powerful rejoinder in a new book. After fifty years of the shareholder primacy doctrine, he writes, by now we should be nearing a state of nirvana. Then he adds, poignantly: "Well let me tell you, if this is nirvana, I'm the Virgin Mary, which for a variety of reasons is unlikely."

Mayer and other farsighted business leaders such as BlackRock CEO Larry Fink and Bank of England Governor Mark Carney conclude that maximizing shareholder value is vastly insufficient if not destructive as a business paradigm for the 21st century. They stress that companies must serve a broader social purpose. As Fink said in his 2019 CEO letter: "Purpose is not a mere tagline or marketing campaign; it is a company's fundamental reason for being – what it does every day to create value for its stakeholders." Mayer adds that for a business to be sustainable, its purpose needs to reflect concern not only with financial capital, but also its impact on human capital, social capital, and natural capital. In short, the corporation needs to be reconceived as more of a social entity, not merely a nexus of contracts between the private parties to the firm.

This is where ESG investing comes in: by combining environmental, social, and governance criteria with sophisticated financial analytics, it aims to provide the real, not fake, profile and profit of a company: one that manages risk and creates shared value by being embedded in the social fabric and natural ecosystems around it. That is why the work that you do is so critical to creating the 21st century sustainable corporate form.

Widening

Having roughly 25% of global assets under management scrutinized on ESG grounds is good, but it isn’t good enough. We need to widen the circle. The targets of that effort must be tradition-bound financial analysts, investors who hang on their advice, and the specialized financial press that reports on the comings and goings of both. They are a brake on progress. And they also may well be missing opportunities to add alpha and lower risk. Let me take a couple of familiar examples.

Everyone here knows who Paul Polman is. Almost immediately upon becoming Unilever’s CEO, he stopped issuing quarterly earnings estimates. He had a bigger vision of corporate purpose. It included doubling the size of the business while halving its environmental footprint. Doubling the size of the business required a much larger consumer base, which could be found only in developing countries. But many of those potential consumers lacked the resources to be actual consumers. So Polman launched the Sustainable Living Plan. It now includes addressing wages and job security in its facilities, and enhancing agricultural livelihoods by investing in training small holder farmers so they can bring their products to the quality standards that enable Unilever to buy them. It includes raising public health awareness through handwashing campaigns; creating employment opportunities for women and addressing sexual harassment; going after forced labor in agricultural supply chains; reducing its water consumption, packaging and greenhouse emissions; and improving the nutritional content of its foods and refreshments. Progress reports with real numbers have been issued annually. Polman has been adamant that this is an integral part of Unilever's business model, not philanthropy or CSR.

The Sustainable Living Plan has generated great excitement among many stakeholders. But as Polman tells the story, mainstream analysts and investors were not among them. He reports that he was rarely if ever asked about it on analyst and investor calls; it might just as well not have existed. And yet when Kraft proposed a take-over, Polman dismissed it with the comment that "our corporate cultures will never merge." *Fortune* magazine described it as a clash between two models of capitalism: Unilever's social entity model, and Kraft's shareholder primacy model. The social entity model prevailed, and Unilever's share price has risen steadily since.

Such disinterest in ESG issues by traditional actors is not limited to the Unilever case. Alas, it remains the norm. You are all familiar with the recent merger between Barrick Gold and Randgold, and then Barrick's short-lived takeover bid of Newmont Mining. Amid the rapid fireworks, analysts raised no ESG issues that I could discern. And press reports told the reader far more about the "swashbuckling" CEO of Randgold, as they dubbed him, than they did about relevant ESG issues. And yet, with operations in the Democratic Republic of Congo, Mali and Côte d'Ivoire now brought into Barrick, one would have expected questions regarding the potential for added political risks, security risks, human rights risks, bribery and corruption risks, and other such matters that readily spring to mind based on the troubled history of mining in those countries.

This sort of myopia has to stop. There is no single silver bullet to fix what ails the world. But one thing is certain: one cannot fix any problem with the tools that created them. ESG investing is part of the solution. It is a welcome attempt to help transform a broken and unsustainable system. So, all of us need to redouble our efforts to make ESG the mainstream.

The S in ESG

Apart from Wall Street and Bay Street cocoons, another potential obstacle to the further rapid growth of ESG investing is the inconsistency of data and infrequency with which it is delivered. With the aim of achieving greater accuracy, data providers keep adding more indicators. But different providers are likely to be adding different indicators to their propriety scoring system, often reflecting the latest scandal or disaster they missed. This creates a potential comparability problem for the general investor because the data are unlikely to apply to all companies within a stock universe. It's less that we need more data; what we need is better data.

This is especially true of the S in ESG, which is the weakest pillar of the three. Elements of the E tend to be more self-evident and easier to measure. Governance criteria can be more readily discerned from general corporate governance principles and long experience. But for the S, a scatter plot of scores generated by different data providers resembles nothing so much as pigeon droppings in Venice's St. Mark's Square. The indicators are too diverse and fragmented because the way in which the S is conceived by different data providers lacks a common principled basis.

It doesn't have to be this way. Let's ask: what categories do we typically find under the S? Health and safety, employee relations, diversity and non-discrimination, human capital development, community relations, responsible marketing and R&D, indigenous peoples—***and*** the category of human rights. Now, that's really odd because ***all*** of the other issues are human rights issues. This conceptual confusion goes a long way to explaining the weak and even random correlations among S scores.

Put simply, the S is about people. Apart from shareholders, how many categories of people does a company impact? As I see it, three: workers, including in supply chains; customers; and people in affected communities. Where can you find an authoritative list of human rights? The Universal Declaration of Human Rights, adopted in 1948, is a good place to start; all international human rights standards build on it.

Where can you find an authoritative standard of what business responsibility is in relation to those human rights? In the UN Guiding Principles on Business and Human Rights, endorsed unanimously by the UN Human Rights Council in 2011, and which I had the honor to develop. The UNGPs are used by various international standard setting bodies, governments, businesses, workers and civil society organizations. Even FIFA, the global governing body of football—or what some people call soccer—now uses them as a bidding requirement for the World Cup. Elements of the UNGPs have been incorporated into national law, most prominently in anti-slavery legislation. France has a mandatory "due vigilance" requirement for business impacts on people and the environment. And just two weeks ago, Canada appointment the first Ombudsperson, anywhere, for Responsible Business Enterprise, with a mandate focused on human rights and drawing on the UNGPs.

The Guiding Principles even come with a simple reporting framework, developed by the non-profit Shift, founded by members of my former UN team, and which I chair. Under the Guiding Principles, here is what a company is expected to do:

1. Have public commitment to respect human rights that is embedded in its institutional culture;
2. Have an ongoing process of human rights due diligence through which the company should
    - assess its risks to human rights, prioritizing the most acute;
    - integrate the findings into its decision-making and actions in order to mitigate such risks;
    - track the effectiveness of these measures;
    - communicate its efforts and results internally and externally;
3. Enable or contribute to remedy for those harmed by the company's conduct or through it business relationships.

By focusing on the quality of companies' policies, processes, and above all their practices, analysts, data providers, raters and investors can obtain a richer profile of how well a company has internalized its responsibility to respect human rights than is currently available. Actual practices are key, because they directly affect outcomes for people, which in turn can play back into value creation, value protection, or value destruction for the business.

A pilot project conducted by the Shift, employing manual coding of publicly available information on nearly 150 companies, demonstrated that it is entirely feasible to develop ordinal scales for these qualitative assessments. Shift is now collaborating with S-Ray, the Arabesque sustainability data firm, to automate the analysis using AI and big data on more than 7,000 companies, updated daily.

In sum, for the S in ESG, internationally authoritative standards and high-level guidance exist. They don't need to be reinvented. They have been endorsed and are used by governments as well as leading businesses and other stakeholders. The intellectual and practical challenge for us all is to assist the traditional investment community in seeing connections it might not have imagined before: that human rights are the core of the S, and that the S is the core of the social sustainability of business itself.

Conclusion

We live in truly turbulent times. The people and planet agenda are at great risk. No single actor or sector in society alone can provide the fix. ESG investing is part of the solution. But it needs to make further inroads to become an even greater force in transforming markets. It needs to become a strong voice for the social entity conception of the corporation. It needs to get conventional financial players to move beyond their comfort zones. And it needs to improve the quality and timeliness of ESG data, beginning with the S.

Finally, if you're having a bad day at the office, remind yourself of the historic journey you are on: the most recent in a long series of episodes when corporate capitalism had to be saved from its own excesses. Godspeed! And thank you.

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