Alternatives to ESG

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With the 13th of the UN Sustainable Development Goals aiming to take urgent action to combat climate change, many countries turned their attention to the reduction of emission to achieve net- zero by 2025. As a result, investments in low-carbon solutions are increasingly gaining importance and it poses the question of the role of the financial industry in the sustainability debate. Sustainable finance is a current buzzword in the financial sector, but extensive regulations and the effective coordination of initiatives are still missing to this day. The financial industry plays a powerful role in the possibility to transform economies and societies in a sustainable way when valuable tools are applied and used. By allocating capital, lending, investing and finding optimal insurance solutions, it can not only aid in the positive development of low-carbon solutions but more generally the financial sector can have an essential impact in the environmental-, social-, and governance sectors. By taking into account the impact of an investment decision, capital can be mobilised in order to have a serious impact on society and its development in the future. Using environmental, social and governance (ESG) measures, investors nowadays not only assess the economic performance of a company but also evaluate non-financial determinants to distinguish material risks and growth opportunities. This analysis includes the environmental footprint of a company, the working standards for employees and finally, how the company is administrated. Considering non-financial factors presents an important part of investment decision making in order to increase returns and minimise risks.

A critical view on ESG

Even though ESG measures provide investors with a score for each company, this framework is often criticised as an inadequate representation of the business influence on society and too general to fit specific industries. From a corporate viewpoint, many leaders use ESG factors to increase reputations and appeal to socially responsible investors. On the other side, investors are missing chances of improving returns by successfully investing in corporations, which make advancement in social progress. This is also partly due to the neglection of financial materiality when making investment decisions based on ESG rankings. Investing carries an important opportunity to shape the social purpose of the economy by allocating capital to businesses that positively sustainably contribute to society's needs. Because of the issues connected to ESG rankings, other models have emerged, presenting considerable alternatives to support the relationship between social purpose and investing.

Shared value creation

Aside from ESG measures, companies have multiple possibilities to focus on societal issues that improve their competitive edge and profitability by engaging in so-called shared value creation. Shared value creation can refer to an environmental impact, such as reduction of carbon dioxide footprint, resource waste or energy use. But it also refers to the productivity of employees, and the overall understanding of the needs, advantages and consequences companies' products have on society. This presents investment opportunities, which show growth potential, while at the same time minimising risks. For instance, the London-based Generation Investment Management has shown that it is profitable to include a sustainability analysis in its fundamental valuation criteria and thus, to invests in companies with competitive business plans based on their environmental influence. Shared value creation is not necessarily tight to ESG criteria but rather focuses specifically on industry evaluations of societal impact.

Impact Investing

Critics claim further that by merely evaluating ESG criteria, a real impact is not necessarily achieved. . Moreover, it also does not help to improve the performance of a business. For example, even though many worldwide funds are labelled "sustainable", their impact is close to zero. Hence, the concept of impact investing has emerged, which refers to an investment or financial action in general that leads to a real – and most importantly - measurable change. With this, it can be ensured that a positive effect on society and the planet is achieved, while at the same time generating profit. The inclusion of the profit-generating goal distinguishes this concept of impact investing from other sustainable investments. Companies have multiple possibilities to focus on societal issues that improve their competitive edge and profitability by engaging in so-called shared value creation. Shared value creation can refer to an environmental impact, such as reduction of energy use, carbon dioxide footprint or resource waste. But it also refers to employee productivity, and the overall understanding of the needs, advantages and consequences companies' products have on society. In this way, every company and industry create societal value on an individual level with the influence of the investor.

Outlook

The UN Sustainable Development Goals are not unachievable goals by 2030, but society and economy are required to work together to make these goals come true. As ESG has been criticised in the past, new ideas such as impact investing or shared value creation in enterprises have emerged. This enables enterprises to reconnect with the consumer base, develop a competitive advantage, improve profitability while at the same time giving back to the community. Through the pressure of socially responsible shareholders, capital is allocated to companies that translate the thought of shared value creation. Moreover, this, in turn, improves sustainable development in the overall society. Despite the tremendous growth of sustainable finance in the last years, it still has not reached its full potential. An approach could be to nudge investors in the right direction by providing concrete regulations, as it would provide an incentive to change society from within and might allow us to live more sustainable and responsible towards ourselves and the planet.