What does ESG mean? Two business scholars explain what environmental, social and governance standards and principles are

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Environmental, social and governance business standards and principles, often referred to as ESG, are becoming both more commonplace and controversial.

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But what does "ESG" really mean?

It's shorthand for the way that many corporations operate in accordance with the belief that their long-term survival and their ability to generate profits require accounting for the impact their decisions and actions have on the environment, society as a whole and their own workforce.

These practices grew out of long-standing efforts to make businesses more socially and environmentally responsible.

ESG investing, sometimes called sustainable investment, also takes these considerations into account.

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Zeroing in on the E, S and G

ESG priorities vary widely, but there are some common themes.

These priorities usually emphasise environmental sustainability – the E in ESG – with a focus on contributing to efforts to slow the pace of climate change.

There's also an effort to uphold high ethical standards through corporate operations. These social concerns – the S – can include, for example, ensuring that a company doesn't buy goods and services from exploitative suppliers, or treats its employees well. Or it might entail taking care to hire and retain a diverse workforce and taking steps to reduce social injustices in the communities where a corporation operates.

Companies embracing ESG principles should also have high-quality governance – the G. Governance includes oversight, handled by a competent and qualified board of directors, regarding the hiring and firing of top corporate leaders, executive compensation and any dividends paid to shareholders.

Governance also pertains to whether a company's leadership operates fairly and responsibly, with transparency and accountability.

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Why ESG matters

By 2026, the total amount invested globally according to these principles will nearly double to $34tn from $18.4tn in 2021, the accounting firm PwC estimates. However, increasing scrutiny of which investments really qualify as ESG could mean it takes longer to reach that volume.

This corporate concept is becoming a political touchstone in the US because some states, like Florida and Kentucky, arguing that these practices divert from the focus on maximising profits and can be detrimental to investors by making other considerations a priority, have barred their pension funds from using ESG principles as part of their investment considerations. Some very large asset managers, including BlackRock, aren't allowed to work with those pension funds anymore.

Many of the arguments against embracing these principles hold that they reduce profits by taking other factors into account. But how do ESG practices affect financial performance?

A team of New York University scholars looked at the results of 1,000 different studies that had sought to answer this question. It found mixed results: Some of the studies found that ESG principles increased returns, others found that they weakened performance, and a third group determined that these principles made no difference at all.

It's possible that the disparities among results could be due largely to the lack of clarity regarding what counts and does not count as ESG, which has been a long-standing discussion and makes it hard to assess how ESG investments perform.

The NYU scholars also found two consistent results regarding ESG strategies. First, they help protect investors against risks such as losses resulting from the failure of a supply chain due to environmental or geopolitical issues, and they can protect companies from volatility during periods of economic instability and downturns. Second, investors and companies benefit more from ESG strategies in the long term than in the short term.

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