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SPOTLIGHT ON...

ESG refers to the three key factors: environmental, social and governance, when measuring the sustainability and ethical impact of an investment in a business or company. Why are they important? These factors help to evaluate the behaviour of companies, as well as determining their future financial performance.

'E' or environmental is probably the most widely understood given the global focus towards transforming to a low-carbon economy. It considers a company's consumption of natural resources and the effect of their operations on the environment, both directly and across their supply chains.

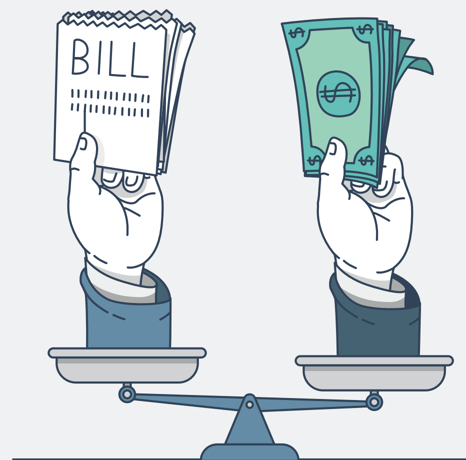
'S' or social, on the other hand, focuses on employee relations, working conditions, and interactions with the community. And it is closely linked with governance. As to deliver on the social side, you have to have a strong governance structure.

'G' or governance, for the most part deals with board structure and diversity, tax strategy, executive remuneration, political lobbying, and corruption and bribery. The tie in with social is that if you don't have an efficient and functioning board, then you won't be able to achieve good social outcomes.

DON'T FORGET THE 'G'

When analysing environmental, social, and governance factors, the 'G' element is less discussed in headlines. With considerations over climate risk, societal implications and other 'E' and 'S' risks and opportunities taking the spotlight. However, corporate governance is vitally important because it creates a system of rules and practices that determines how a company operates and how it aligns the interests of all its stakeholders. And it's well recognised that good corporate governance leads to ethical business practices, which leads to financial viability.

THE SHAREHOLDER VERSUS STAKEHOLDER DEBATE



Arguably, the role of corporations is no longer to act solely in the interests of shareholders. Instead moving to a model where top executive compensation and incentives are aligned with the well-being of all stakeholders, including employees and consumers. Poor corporate governance has highlighted the need for more transparency and more dialogue-driven decisions, for companies to communicate with all their stakeholders — not just shareholders.

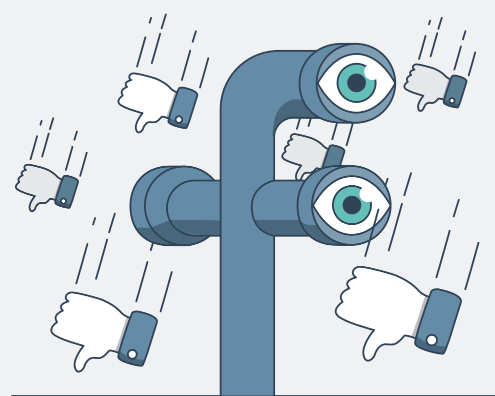
RESEARCH BACKS THIS UP

S&P research on governance factors has shown that companies that rank well below average on good governance characteristics are particularly prone to mismanagement and risk their ability to capitalise on business opportunities over time. While companies that invest in their employees, protect the environment, and deal fairly with their suppliers have been shown to perform better.

INVESTORS RECOGNISE THE FACTS

With this in mind, it is sensible for all investors to consider governance factors, whether they think of themselves as socially responsible or not. And indeed, research undertaken by Architas confirms this. Notably, in an Architas ESG Investor study covering 11,000 global investors across 11 countries, we asked questions on what their motivations were for investing in ESG and what the important factors were. Overwhelmingly, investors picked a governance factor as their top response. With environmental factors starting to come through in second place in Europe and social in second place in Asia.

SCANDALS AND OTHER MISDEMEANOURS



Understanding governance risks and opportunities in decision-making is critical, as poor corporate governance practices have stood at the core of some of the biggest corporate scandals. Volkswagen's emissions tests fraud, Facebook's misuse of data, and Wirecard's accounting scandal and many other incidents have all raised fresh questions and thrust corporate governance into the spotlight. One common thread in many high-profile business scandals is a focus on short-term profits over the long-term health of the company.

A RENEWED FOCUS

- ✓ The past few years have seen a significant uptick in interest around ESG products, but with a much heavier focus on ethical and environmental issues.
- ✓ Factors such as the Covid-19 emergency, existing firms' disputes and a renewed focus on best practice have highlighted how much effective corporate governance can make a difference in a company's destiny.
- ✓ In fact, of the E, S and G factors governance is often the most significant to returns as it determines the overall direction of company policy and how key risks are addressed.
- ✓ ESG integration provides additional tools for investors to select companies and build portfolios with the aim of generating long-term returns for 2021 and beyond.

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