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Part 3: How are SRI/ESG strategies implemented?

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Evaluating companies based on environmental, social and corporate governance (ESG) factors is not a binary exercise. It's not an either/or, yes/no proposition to analyze how a company is performing or should be scored based on responsible investing criteria.

There is a mix of art and science and any two investors could have different preferences that they want to express via their investment choices.

There are several ratings services that provide sustainability scores or other ESG-focused grades for global stocks and bonds. A statistical review can create the impression that the process is more scientific than it may actually be and, as with any form of investing, there is no guarantee that the investment performance outcome will follow any grade or rating assigned to a stock or bond.

There are also inconsistencies from one ESG rating to another because each ratings firm uses its own proprietary evaluation points and grading criteria. This means SRI/ESG investors often have to do even more evaluation of data and factors than an investor without any preference for identifying responsible investments.

When considering mutual funds or exchange-traded funds and the money managers who direct the buying and selling of investments, there are three primary ways that SRI/ESG considerations are woven into the process. ESG integration – In addition to traditional forms of financial analysis (e.g., discounted cash flows, earnings growth, profitability, dividend yield, competitive advantages, management quality) the most common way to apply an SRI/ESG perspective is to consider how the company performs on the many categories of ESG focus. The multiple topics in the graphic below are integrated by analysts either quantitatively or qualitatively, providing a broader viewpoint on a company’s current practices and projections for future growth that goes beyond financial statistics.

- Negative screen – Some investment funds operate from a model that evaluates companies in order to apply an exclusionary screen. If a company is involved in a certain line of business, it is excluded as a potential investment in the portfolio. This would most commonly apply to "sin stocks" (e.g., alcohol, tobacco, weapons, gambling, pornography) or, of more recent prominence, fossil fuels. Conflicts can arise using strict exclusionary screens. Some companies may be mostly attractive as investments but could still draw a small portion of their revenue from an objectionable category. For instance, Warren Buffett's Berkshire Hathaway has a tremendous history of generating returns for shareholders. The company is a conglomerate, owning dozens of companies across a variety of industries. Berkshire Hathaway owns companies in the energy sector. It does generate energy from renewables but also has some remaining energy generated by coal. This would eliminate Berkshire Hathaway as an investment option for a strict no-fossil fuels screen but might leave it eligible if the negative screen was only triggered if a company generates more than 10% of its revenue from otherwise undesirable sources.
- Positive/Best in Class – Similar to the Berkshire example, best-in-class screens evaluate companies for SRI/ESG preferences but don't fully eliminate sectors or industries. There may still be exposure to fossil fuels for example but only to the company or companies in the sector that receive the best SRI/ESG scores. These companies might be considered the least bad of their peers or the "cleanest dirty shirt." For example, some SRI/ESG mutual funds do not own Chevron, Exxon or BP but do own Conocco Phillips and Marathon Oil.

In addition to steering investment dollars where they feel their personal values and preferences are best represented, investors can also take a more proactive role in expressing their values via shareholder activism.

According to the U.S. Forum on Sustainable Investing: "The purpose of shareholder activism is to improve a portfolio company's behavior related to specific ESG issues, thereby benefiting the company, its shareholders and society."

Active ownership includes proxy voting, filing shareholder resolutions, participating in awareness building campaigns and possibly meeting with company executives. Often, shareholder activism can be successful even without bringing an issue to a vote of shareholders. Simply filing a shareholder resolution can encourage a company to communicate and listen to shareholder preferences. The company may negotiate a satisfactory change in its practices that causes shareholders to pull back their resolution.