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Fundamentals of ESG Materiality

An Overview for Investors

Acknowledgments

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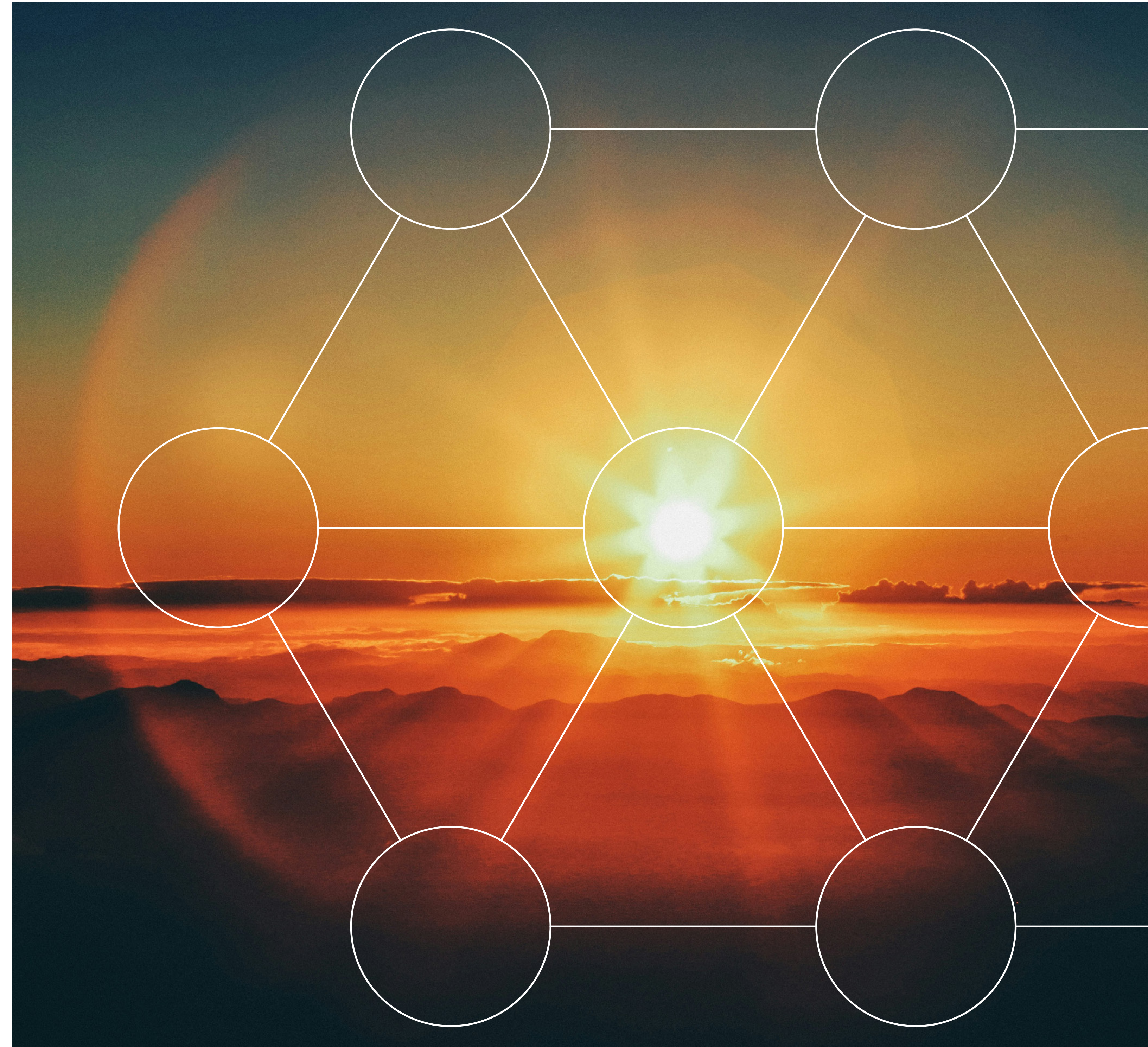
The Purpose of This Overview

Incorporating environmental, social, and corporate governance (ESG) considerations into modern investment strategies gives financial market participants a more holistic view of the risks and opportunities that their investments are exposed to. Analyzing businesses' exposure to ESG issues and how they manage them can be a window into their potential for long-term value.[1] This overview will explore the materiality of ESG factors, why investors and companies should pay attention to them, and how market participants can find and employ reliable, timely, and complete ESG data for their various investment strategies.

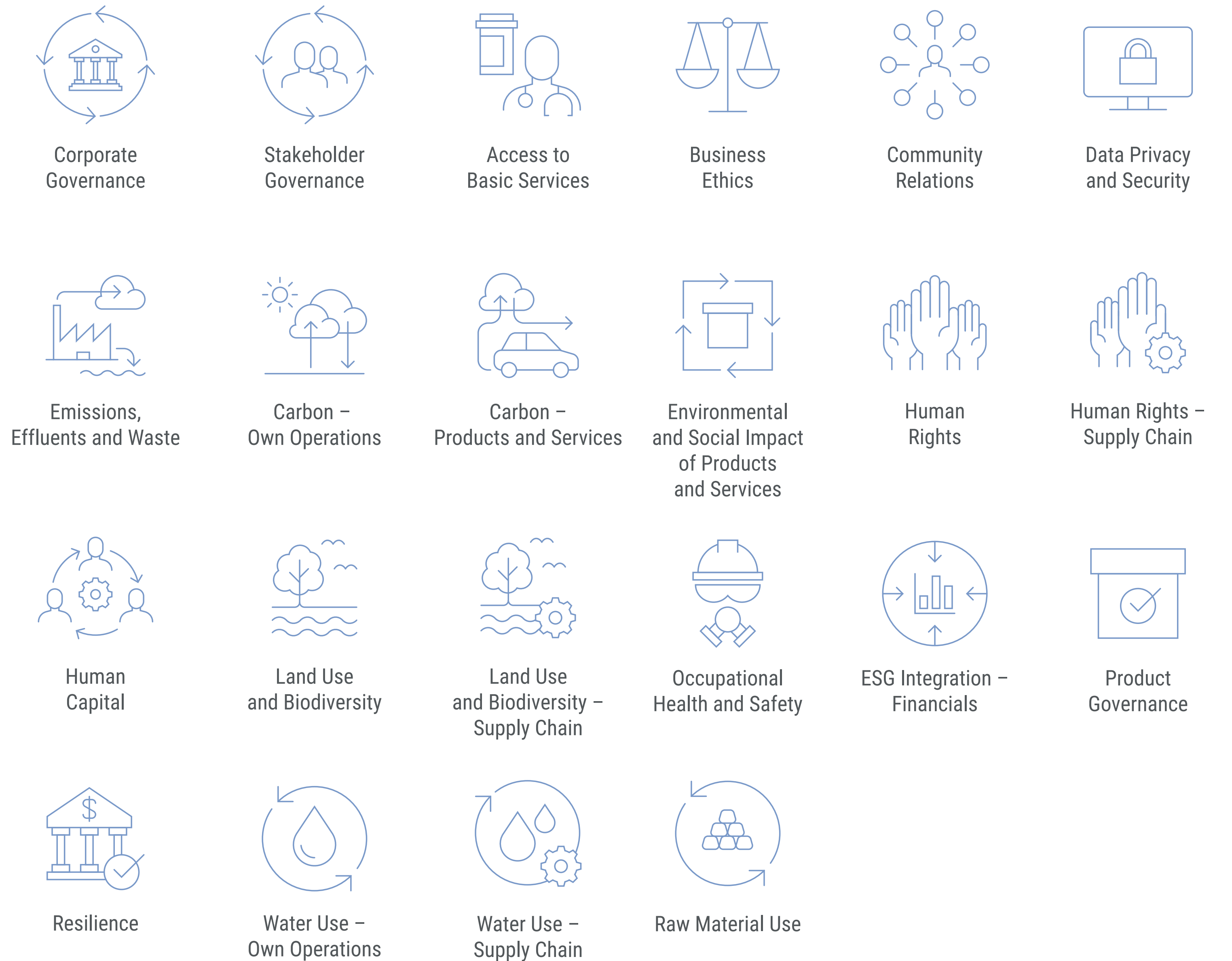


What Makes an ESG Issue Material?

In auditing and accounting, information that would likely affect share price or that a reasonable investor would want to know before making an investment decision is considered material.[2] Many financial market participants have realized that for most companies, ESG factors also have an impact on company value and should be considered in their decision making. For example, if a significant portion of a company's real estate assets are at risk of damage from wildfires or flooding, this could affect the decisions of a reasonable investor.

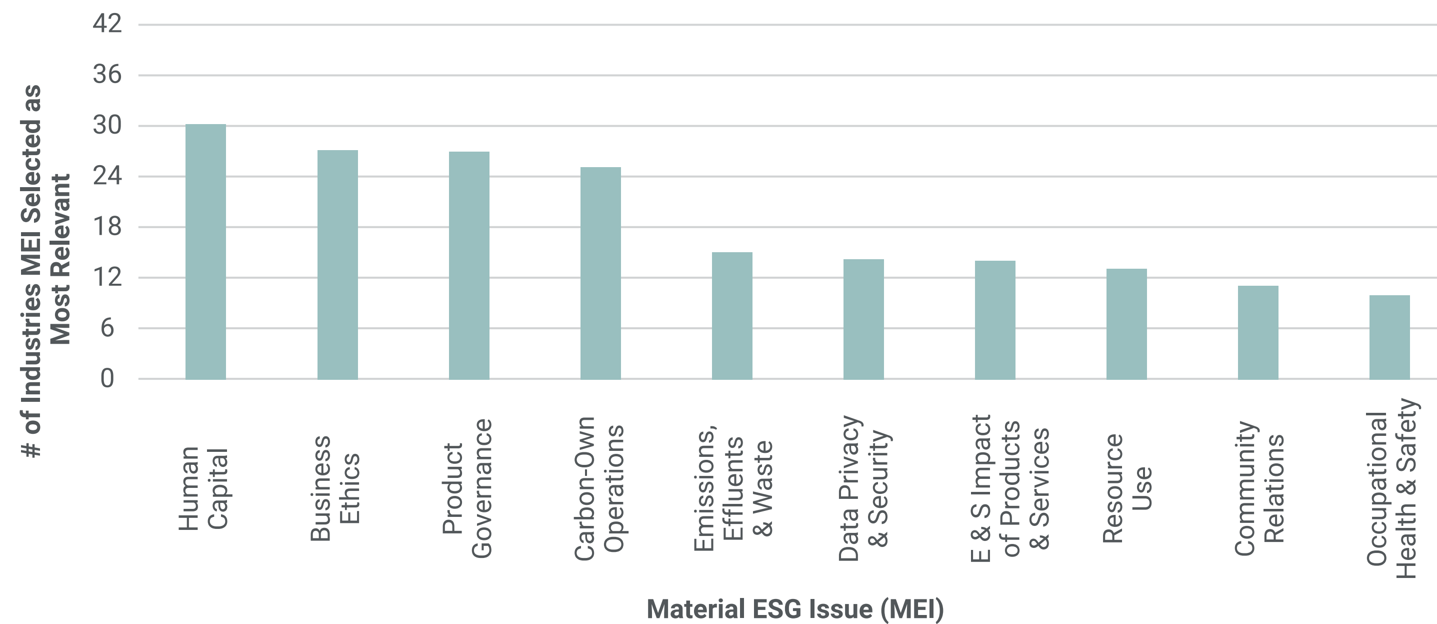
Physical climate risks, changing regulations, data privacy concerns, cybersecurity risks, and supply chain human rights abuses are all examples of ESG issues that may be material depending on a company's business model or industry. Given the demonstrated and potential future impact these risks can have on financial performance, investors are increasingly demanding that companies provide details on the ESG issues they're exposed to. Regulations will also continue to increasingly mandate that companies disclose their material ESG risks and their processes for managing them.

Figure 1. Complete List of Material ESG Issues



Source: Morningstar Sustainalytics.

Figure 2. 10 Most Relevant Material ESG Issues in Morningstar Sustainalytics ESG Universe



Source: Morningstar Sustainalytics. For informational purposes only.

Investors can assess a company's ESG risk by understanding the material ESG issues (MEIs) affecting its industry, and then analyzing how the company manages its exposure to those risks. Leveraging resources such as the SASB Materiality Map or partnering with ESG research and data providers can help investors in these efforts. Poor management of material issues often carries legal, operational, regulatory, and reputational risks, potentially damaging credibility with consumers, investors, and other stakeholders as well as affecting long-term value.

ESG risk and ESG Risk Ratings, however, do not measure the impact that a company has on the environment or society. Investors increasingly view a responsible investment strategy as one that considers the environmental and social impacts of their portfolio, alongside their risk exposure to ESG factors.[3] Asset managers who want to understand the impact of their investments can complement ESG risk data with ESG impact data.

Double materiality assessments capture both the material ESG risks that a company is exposed to and the impacts that the company's activities have on the environment and society. These assessments are where impact data and ESG risk ratings meet to provide investors with a holistic view of portfolio companies' financial and societal impact. Double materiality assessments are also an important component in key pieces of ESG disclosure regulations such as the European Union's Corporate Sustainability Reporting Directive (CSRD).

Three Key Reasons Why Investors Are Evaluating ESG Risk

Material ESG issues present real financial risks to businesses. Financial institutions and other market participants face many of the same customer, reputational, and regulatory pressures that companies experience with regard to ESG risk management.

Institutional investors are being asked, and mandated in some regions like the U.K., EU, and New Zealand, to reduce their financed emissions, investigate supply chain human rights issues, adhere to robust ESG management strategies, and report on their progress in all ESG areas.

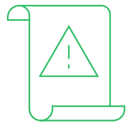
Investing time and resources to evaluate ESG-related investment risks carries benefits that go beyond mere compliance. Asset managers who integrate ESG considerations across their investment portfolios often benefit from reduced portfolio risk, as well as greater alignment with changing consumer preferences.

Morningstar Sustainalytics' research found that low ESG risk portfolios outperform high ESG risk portfolios and that low ESG risk portfolios are better able to withstand financial crises.[4] Echoing those findings, a report showed that 58% of studies found a positive relationship between good material ESG issue management and strong financial performance, with 34% of studies showing neutral or mixed results.[5]

Whether focused on risk, impact, or both, a growing number of asset managers globally are integrating ESG factors across their investment portfolios for the following reasons.

1. Portfolio Risk Mitigation

Businesses and investment portfolios are exposed to diverse ESG-related risks. From fines for effluent spills, cybersecurity issues and supply chain factors, to longer term issues like the impacts of physical climate change – these risks compound the material ESG issues that businesses face. Other risks stemming from cybersecurity issues, supply chain factors, and regulatory changes compound the material ESG issues that businesses face. Assessing how portfolio companies manage their exposure to material ESG issues helps investors better understand these risks when making investment decisions, potentially reducing the overall risk profile of their investment portfolios.

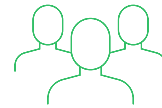


2. Regulatory Risks and Penalties

The rules that govern global commerce continue to change as climate and ESG-focused regulations are implemented worldwide. These affect both companies and investors. Regulations like the CSRD in Europe or the growing number of nations adopting the International Sustainability Standards Board's sustainability and climate disclosure frameworks add significant obligations for businesses and investors.

Firms are being tasked with adopting more sustainable practices and more comprehensive reporting requirements. For instance, the U.S. Securities and Exchange Commission modernized its Names Rule to ensure that a fund's portfolio aligns with its name — a move that will crack down on greenwashing and other misleading or deceptive marketing practices. Institutional investors, depending on their region, will have to demonstrate the steps taken to manage their exposure to ESG risks and develop a plan to reach net zero in their investment portfolios.

Asset managers not only have to manage their own regulatory risks, but they also have to assess how portfolio companies are responding to the incoming regulatory challenges.



3. Changing Investor and Consumer Preferences

Sustainable investing continues to shape global capital markets. The Global Sustainable Investment Alliance's biennial report found that in non-U.S. markets, sustainable investment assets under management increased 20% between 2020 and 2022.[6] Despite a slowdown over the last year, investors continue to invest in sustainability-focused funds[7] and are managing their investments using ESG-focused approaches.

Many consumers are also changing their purchasing behaviors to support more sustainability-focused businesses and products. A McKinsey study found that products making ESG-related claims averaged 28% cumulative growth over a five-year period, compared to 20% for products that did not make such claims.[8]

With investors increasingly concerned about ESG risk and the impact of their investments, demonstrating effective management of material ESG issues will be critical for companies. Also, the growing number of ESG and climate regulatory requirements for both investors and issuers means material ESG issues cannot be ignored.

Double Materiality: Where Risk and Impact Converge

Double materiality considers not just the risks that material ESG issues pose to a business, but also the impact that business activities have on the environment and society.

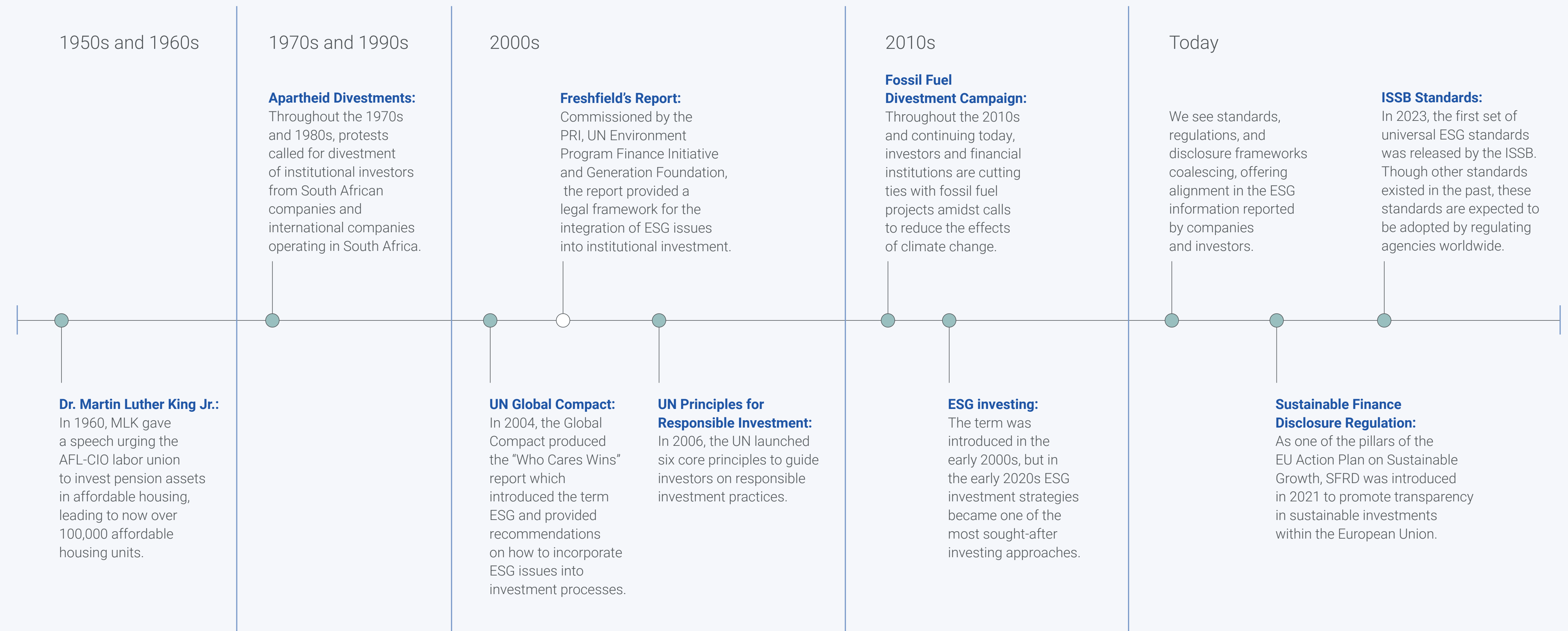
Public perception, brand reputation, and regulatory implications are factors to consider for investors who finance high-impact businesses. For instance, public opposition to the potential negative social and environmental impact of TC Energy Corp.'s XL Keystone pipeline project contributed to its cancellation in 2021.[9] The company's history of spills and leaks, along with the negative impacts of its operations made it a prime target for public and investor scrutiny.

Incoming European regulations, such as the CSRD, will require double materiality assessments from companies that meet the reporting threshold. Especially for impact investors, double materiality assessments are key to informing responsible investment decisions.

Figure 3. The Evolution of ESG Timeline

The Evolution of ESG

Sustainable investing has gone by many names, but the concept has been around for decades. What started as an approach by religious groups to avoid investing in business activities that went against their values has expanded in scope and method. Investment approaches have broadened from focusing solely on the outcomes of company activities on the environment and society, to also include the risks that mismanagement of those issues pose to companies' financial performance and long-term value. Today's ESG investment landscape includes various combinations of values-based, risk-focused and impact-focused approaches. The timeline in Figure 3 gives a brief overview of how investors have considered ESG factors throughout the decades.



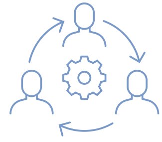
Sources: Morningstar.com, "ESG Investing Comes of Age"; PRI, "Building on Fiduciary Duty in the 21st Century: A Legal Framework for Impact."

Understanding How Mismanagement of MEIs Affects Business

Every industry experiences risk from a variety of ESG factors. Some industries are more exposed to issues around carbon emissions, while others are more susceptible to matters related to business ethics or human capital.

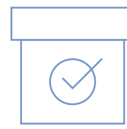
The first step for investors exploring a company's exposure to a particular ESG risk is to understand which material ESG issues affect its specific industry as a whole. From there, company-specific risks can be identified and explored.

Sustainalytics's analysis shows that four ESG issues emerged as material for more than half of all industries in its research universe. Human capital, business ethics, product governance, and direct carbon emissions are material for most businesses.[10]



Human capital concerns employee well-being and fair treatment. Indicators like the prevalence of discrimination policies, diversity programs, and the employee turnover rate demonstrate how companies manage their human capital risks. Indonesian food company PT Indofood Sukses Makmur Tbk has been linked to labor issues at oil palm plantations through its agribusiness operations. The Roundtable on Sustainable Palm Oil (RSPO) noted 10 violations of local labor laws by Indofood. This led many of Indofood's buyers and partners to cut ties with it, which posed a risk to the company revenues. Following the company's removal from the RSPO due to human rights abuses, Citigroup cancelled its USD 140 million credit facility to Indofood.[11]

Business ethics analyzes corporate governance issues like bribery and corruption policies, whistleblower programs, and political involvement policies. Mining giant Glencore was investigated and pleaded guilty to bribing foreign officials, in efforts to gain business and avoid audits. A U.S. judge ordered Glencore to pay a USD 700 million penalty in 2023.[12]



Product governance measures attributes that ensure the quality and safety of business products like responsible marketing policies, product safety programs, and quality management system certifications. Major controversies have surrounded Boeing recently over the safety and quality of its commercial airplanes, leading to hundreds of millions of dollars in regulatory penalties[13] and a decline in trust for the airline among flyers and business travelers.[14] Boeing's share price lost roughly one-third of its value from January through April 2024.

Direct carbon emissions, or emissions from a company's own operations also known as scope 1, are a risk area for many industries. Companies face regulatory requirements and demands from investors for relevant emissions data. With the transition to a low carbon economy, companies may also need to prepare for carbon pricing across jurisdictions. Setting greenhouse gas emissions reduction targets was found to be a common practice among companies in industries with the best Low Carbon Transition Rating (LCTR) management scores.[15] Looking at the entire LCTR universe, however, only about 20% of companies have set emission reduction targets.

Each industry experiences the above material ESG issues to a different degree and has exposure to other, more industry-specific ESG issues. Poor management of material ESG issues has potentially serious negative consequences for businesses and their investors. From regulatory penalties and reputational damage to increased portfolio risk and environmental harm, the negative outcomes of mismanaging material ESG issues can be detrimental. The opportunities afforded by incorporating ESG considerations into portfolio management, coupled with the drawbacks of poorly managed material ESG issues, make it a necessary practice for today's investor.

Using Material ESG Data to Support Your Investment Approach

Incorporating the consideration of material ESG issues into conventional investment strategies has become standard practice for many. One of the challenges encountered when doing so, however, is finding reliable data.

The data challenge has restricted investors' ability to implement their desired sustainable portfolios.[16] Regulations are imminent in many regions and mandatory disclosures should bring more ESG data to the surface; but until then, investors may struggle to secure accurate data.

Depending on the chosen approach to incorporating material ESG issues into the investment process, there are different strategies and resources to overcome the data barrier.

ESG Investment Approaches[17]

Screening:
Screening is a process of filtering out investments based on certain qualitative or quantitative data. Negative screening excludes companies that have characteristics an investor may want to avoid, and positive screening includes companies that meet the performance threshold for a specific quality or metric.

ESG Integration:
ESG integration is the process of incorporating ESG risk analysis into investment decisions. ESG integration requires finding ESG data, analyzing the material risk posed to issuers, and integrating the information into investment analysis.

Thematic Investing:
Thematic investing chooses assets that are expected to have exposure to some identified medium or long-term trend. Regarding ESG issues, this includes clean energy, energy-efficient buildings and sustainable agriculture.

Stewardship:
Investors have rights they can exercise with investees like serving on a company's board, filing shareholder resolutions, and proxy voting. Through stewardship activities, investors can exercise influence over company decision-making.

Impact Investing:
Impact investing focuses on creating a positive social or environmental impact while generating a positive financial return as well. Impact investing has positive impact as the focal point of the strategy, providing funding to realize those benefits.

Screening
Those who use a screening technique for investments, whether driven from an investment thesis or values alignment, rely on the availability of uniform data across a wide range of companies. No matter the focus, accurate and reliable data are critical for effective screening.

Investors using this approach will typically focus on a few key issues and apply their screen across sectors. For instance, a health-focused portfolio may screen out companies involved in the production or sale of tobacco products. They may also assess companies' overall ESG Risk Rating or their management score on a particular ESG issue to compare and screen across all sectors.

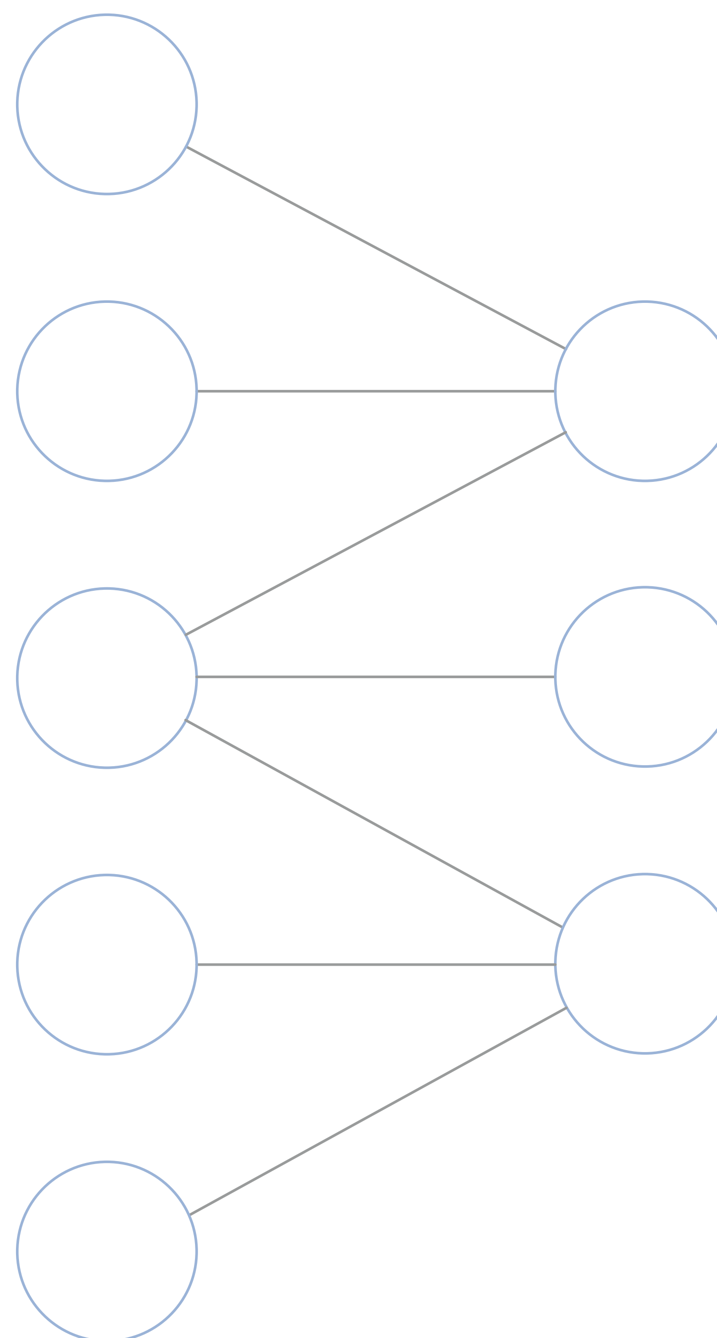
Country risk ratings and controversy analysis may also be employed to complement evaluations and better understand ESG risk exposure.

ESG Integration
Generally, asset prices reflect a company's exposure to risk, but ESG integration takes the approach that an issuer's exposure to material ESG issues may not be accurately reflected in equity valuations.[18] There are two main reasons for the undervaluation of ESG risks: incomplete data and the short-term nature of capital markets. Integrating ESG factors into a standard financial analysis requires a more thorough look at company-specific ESG issues.

ESG integration may see asset managers systematically consider environmental, social and governance factors in any number of ways, including asset allocation and portfolio construction, equity or fixed income security analysis, and real asset analysis. It is common to employ a combination of screening and integration in investment strategies.[19]

Selecting the material issues to investigate can be done using a variety of resources, but it typically begins with an understanding of the most relevant ESG risks to an issuer's industry and an analysis of how the issuer is managing those risks. ESG Risk Ratings provide insight into an issuer's management of a wide range of material ESG issues.

Controversies related to a particular ESG issue or set of issues can also be a strong indicator of the quality of a company's systems and policies in place to manage a given issue. Controversy reports provide investors with a company's historical controversy assessment, offering insight into how the company has addressed ESG-related incidents over time.



Thematic Investing
Incorporating a thematic investing approach entails targeting companies with exposure to long-term ESG trends like renewable energy, circular economy, or biodiversity. Portfolio managers can identify structural trends that are deemed to have long-term relevance and construct portfolios of issuers that are exposed to that trend.

For example, if a portfolio manager identified biodiversity as a theme of interest, they could use a combination of impact metrics and ESG risk ratings to identify companies that are not only reducing or making a positive impact on biodiversity issues, but are also adequately managing their exposure to risks related to biodiversity loss. Likewise, if an investor wanted to identify tech companies that performed strongly on issues of cybersecurity or data privacy, they could use those resources to align their portfolio, with the expectation that companies that perform well on those issues are also expected to perform well financially. Portfolio managers may choose to combine multiple themes to diversify their investment strategy.

Stewardship
Asset managers also manage their exposure to material ESG issues through investment stewardship and engagement with portfolio companies. Stewardship can be a useful approach to protect long-term value and ensure that issuers are responsibly managing their ESG issues.

For example, by identifying companies with especially high ESG risk and analyzing their management of material ESG issues, investors can proactively engage with those companies to help them understand and better manage those risks. Not only can stewardship and engagement potentially protect long-term company value, it may also lead to reducing negative company impacts and/or increasing positive ones.

Proxy voting is also an aspect of stewardship where investors can assert their influence. Using an ESG voting policy overlay can help investors identify relevant ESG-focused shareholder resolutions and topics and guide them on the best course of action to take during proxy season.

Asset managers may also use controversy scores to identify issuers that require attention. Using their rights as investors, they can mitigate their portfolio risk and enhance long-term value by employing stewardship techniques.

Impact Investing
Although not directly tied to companies' material ESG issues, having accurate impact data is paramount for impact investors. Data not only measures to what extent impacts are being made, but also demonstrates to clients and regulators that investments are indeed driving positive social or environmental change.

Inaccurate or incomplete impact data poses regulatory and reputation risks for asset managers marketing impact funds. As well, unreliable data can lead to missed opportunities, diminished impact results, and increased risk.

As mandatory ESG disclosure regulations evolve worldwide, reliable impact data should become easier for investors to access and compare between issuers. While the world waits for disclosure rules to take effect, impact metrics are available to compare investment opportunities and assess the positive social and environmental impacts that companies generate.

ESG Risk is Enterprise Risk

While incorporating ESG analysis into portfolio management may have been a nice feature to have in the past, today's top institutional investors recognize that managing ESG risk factors is critical to a business' long-term viability and overall business outlook.

Failure to analyze companies' management of material ESG issues can expose investment portfolios to heightened risk, reduce the long-term viability of investments, and bring regulatory and legal complications for asset managers.

Incorporating ESG factors into investment decision-making requires accurate, timely, and complete ESG data – something that can be difficult to find. Depending on the investment approach, there are a few resources that portfolio managers can use to find reliable data. Sustainalytics has a suite of ESG data solutions that allows investors to analyze an issuer's management of material ESG issues, reducing portfolio risk exposure and driving long-term value.

Incorporating ESG materiality into investment decisions is not only about supporting a sustainable future, but also about building financial success.

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About Morningstar Sustainalytics

Morningstar Sustainalytics is a leading ESG data, research, and ratings firm that supports investors around the world with the development and implementation of responsible investment strategies. For more than 30 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Morningstar Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG information and assessments into their investment processes. The firm also works with hundreds of companies and their financial intermediaries to help them consider material sustainability factors in policies, practices, and capital projects. Morningstar Sustainalytics has analysts around the world with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit **www.sustainalytics.com**.

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