



Amplifying the “S” in ESG: Investor Myth Buster

ESG

Amplifying the S

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ESG Working Group: who are we?

We are a new partnership that has been formed with the aim of emphasising the importance of the 'social' criteria within Environmental, Social and Governance (ESG) investing.

The Thomson Reuters Foundation, Refinitiv, International Sustainable Finance Centre (ISFC), White & Case, Eco-Age, The Mekong Club, and the Principles for Responsible Investment (PRI) – an observer participant – have created the ESG Working Group ('the Group'), as a pro bono partnership that brings together civil society, experts and private sector.

All Group partners believe in amplifying the work around social performance and indicators as an important consideration when making investment decisions, and agree that there is a need for a broader and speedier action globally.

The Group hopes that this ongoing work will help further the momentum for both improving the "S" indicators and expanding their use among the investor community.

The partners view this white paper as the start of a broad dialogue to promote a better understanding, and wider adoption, of social criteria in investment strategies. We plan to carry on with this work by engaging with more stakeholders, as well as organising events and training sessions to build greater capacity.

The white paper reflects the vision of the Group, and not that of the individual organisations involved in its work.

If you would like to find out more, stay updated or get actively involved in this work, please contact: swhitepaper@thomsonreuters.com.



Amplifying the “S” in ESG: Investor Myth Buster

Executive Summary



Impact of COVID-19: this needs to change everything

In 2021, investors are under renewed pressure to consider the “S” (social) performance component in their investments. Yet in the world of Environmental, Social and Governance (ESG) investing, the integration of social performance assessment has seen insufficient progress. It is plagued by many challenges, and by what this white paper calls ‘myths’: misperceptions about why social indicators – such as a company’s labour practices or community relations – matter, and how or whether they can be integrated into investment analysis. For all investors, it is important to proactively address these questions because, as the Working Group found, social issues can create key risks; they are salient and will be increasingly relevant in the future.



Social performance assessments: how and why?

The objective of this group is to demonstrate to investors how it is possible, and why it is necessary, to have and drive forward more sophisticated social performance assessments. We do not aim to provide definitive answers, nor to be prescriptive about solutions.

Instead, we address the most common misperceptions, or myths, that have emerged because of the real challenges that investors face now, and have faced in the past, when trying to integrate social performance indicators into their analytical metrics. The Group highlights the existing gaps and challenges, while also looking at the positive steps investors can take. It is hoped that this white paper will be a springboard for a wider discussion about both improving the “S” indicators and strengthening them as a tool for the investor community.

Our analysis used the rights outlined in the Universal Declaration of Human Rights and the International Bill of Human Rights (including its component treaties and conventions) to inform the way we thought about social indicators, and how we organised our four overarching themes:



High-risk labour and land issues



Socio-economic inequality



Diversity and inclusion



Digital rights



The tools already exist to start taking action

More indicators are available to investors, for measuring both the efforts (policies and processes) and effects of companies' performance than are routinely being integrated into investment analysis today.

This is illustrated by a mapping and consultation exercise undertaken by the Group (See [Annex I](#)). Our analysis uses the rights outlined in the Universal Declaration of Human Rights and the International Bill of Human Rights (including its component treaties and conventions) to inform the way we thought about social indicators, and how we organised our four overarching themes. As a starting point, we leveraged Refinitiv's social indicators that capture data from over ten thousand and three hundred companies globally and examined a wide range of industry approaches to identify thematic indicators that were linked to *effects*. We then cross-mapped these thematic indicators across the frameworks of two leading standard-setting organisations, the [Sustainability Accounting Standards Board \(SASB\)](#) and [Global Reporting Initiative \(GRI\)](#), along with data collected by [Refinitiv](#) and [RepRisk](#). We assessed how these indicators corresponded to the targets of the [UN Sustainable Development Goals \(SDGs\)](#) and consulted with approximately 100 industry stakeholders, including investors, subject matter experts, lawyers, data providers and civil society, for input and feedback.

This mapping exercise is by no means exhaustive; it was not designed to be. The purpose was to offer an initial overview of indicators linked to *effects*, compare key themes and identify existing data sets as a starting point. While our analysis shows that there are still significant data gaps due to the lack of standardised reporting requirements - in particular, for global supply chains - many quantifiable social indicators are available for investors to include as part of their investment analysis.

Many quantifiable social indicators on the effects of companies' actions are already available for investors to take action and use as part of their investment analysis.





Demanding more data improves investment resilience

The link between business and human rights is well established. Regulation is fast increasing. The current state of disclosure requirements by governments and stock exchanges is illustrated in [Annex II](#). A decade after the adoption of the UN Guiding Principles on Business and Human Rights (UNGPs), there's a growing consensus that voluntary commitments and compliance are not enough. There are also many resources for improving the understanding of social risks and performance, some of which are available in this white paper and in [Annex III](#).

Firstly, investors can, and should, demand more data from both companies and data providers that is focused on the effects of companies' policies and impacts, while paying closer attention to supply chains. This is key, because emerging evidence shows that the integration of ESG criteria in investment analysis leads to improved returns, less volatility and lower downside risk. Better integration of social indicators in particular can help to identify more resilient and profitable investment opportunities that are already aligned with established and anticipated regulation.

More effective and consistent integration of social criteria in investment processes can also help de-risk investments and fulfil fiduciary duty, the understanding of which itself is changing. **It is key for investors to develop a strategy for their total portfolio – public and private markets, equity and debt – covering engagement, advocacy and integration.** Lessons learnt from the work of compliance professionals show that voluntary policies and procedural 'tick-box' exercises are not a remedy for avoiding enforcement actions or investment risks.



A proactive, mixed approach pays off

A more proactive effort is needed to better understand and address social issues appearing within supply chains, which form a substantial part of companies' social performance.

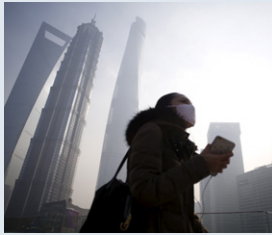
In the quest for better approaches to ESG criteria integration, qualitative approaches can be enriched by data-driven elements, and vice versa. A combination of the two for the purposes of due diligence and engagement can improve outcomes and help generate alpha.

It is important to note that technology is, and will keep on, changing the availability and type of data investors can use, a development that will increase the volume and granularity of available data. It will also allow for more information that is not based on self-disclosure.

The direction of travel is clear. Now is the time for the investment community to be proactive and engage fully in the development of increasingly robust approaches to assessing social performance and integrating social criteria, in order to play its part in creating more resilient and equitable economies.

Lessons learnt from the work of compliance professionals show that voluntary policies and procedural 'tick-box' exercises are not a remedy for avoiding enforcement actions or investment risks. A decade after the adoption of the UNGPs, there's a growing consensus that voluntary commitments and compliance are not enough.

Investor myths about “S” indicators



Financial materiality

Social performance is less financially material than environmental performance

Reality

Social issues are key risks to all investors and their beneficiaries

Action

Diminish risk and fulfil fiduciary duty



Starting point

It is too difficult to know how and where to start assessing social performance

Reality

The link between business and human rights is well established

Action

Use existing resources to improve your understanding of social performance assessment



Data

The “S” indicators are too hard to measure; there is no reliable and comparable data

Reality

It is possible and necessary to start using social indicators more

Action

Identify the most useful indicators; use and demand more data



Integration process

Qualitative surveys or questionnaires are the best method for tackling social issues and analysing the social aspects of performance

Reality

Qualitative approaches can be enriched by data-driven elements

Action

Use a combination of data-driven input and qualitative analysis for due diligence and engagement



Relevance to investors

Integrating “S” indicators is only relevant for impact investors

Reality

“S” indicator integration can help to identify more resilient and profitable investment opportunities

Action

Tailor your approach to social indicators to avoid missed risks and opportunities



Introduction: Investor myths about “S” indicators

Our social indicators themes



High-risk labour and land issues



Socio-economic inequality



Diversity and inclusion



Digital rights

Over the last decade, investors’ understanding of both environmental and governance indicators and their materiality has improved, and investors have moved to integrate those indicators into risk analysis and screening.

However, social performance considerations have often been dismissed as either immaterial or a lesser priority, because of the perception that they present a lower risk to revenue streams or are less likely to be subject to regulatory action or punitive measures.

Quantifying the implications of social considerations has not been considered easily measurable and, therefore, other than in the case of a few targeted investors, the link to investor returns has been under-explored. Many companies adopt a public position that their only obligation is to comply and that social issues are the responsibility of governments, rather than private actors or investors.

This perspective is wrong and needs to be challenged.



REUTERS/Marko Djurica

The Universal Declaration of Human Rights, the International Bill of Human Rights and its component treaties and conventions, together articulate the many individual rights that may be material to assessing the social risks of a company's operations and supply chain. Our work has used the rights outlined in these instruments, alongside the UNGPs, to create four themes to inform the way we organised both our thinking about social indicators and the four indicator themes for this white paper.

The responsibilities outlined in the UNGPs imply that investors assessing the social performance of a company's operations and supply chain should:

Ensure businesses have in place adequate human rights policies and due diligence processes, as well as grievance and remedy mechanisms

Assess whether these policies are functioning properly

Monitor company performance over time and against its competitors

Provide access to remedy

At present, there is an enormous gap between this ideal and actual practice.

Most social assessment focuses on indicators that measure effort (policies and processes) rather than the effects of corporate performance. There are many gaps in publicly available data and engaging with companies is time and resource-intensive. To add to this complexity, analysis of a company's impacts on society and the environment, as well as the financial risks posed to the company by social and environmental issues (the concept of 'double materiality'), should be conducted not only for a company's operations but also for its contractors and supply chain – in the same way environmental indicators look at direct and indirect greenhouse gas emissions (GHG) by using scope 1, scope 2 and scope 3.

As part of our consultation process, the Group spoke with many stakeholders from the world of ESG and responsible investing to better understand why the "S" lags behind. While there is no question that significant challenges must be overcome to properly assess social performance, our findings suggest that some of the lack of progress is based on misperceptions, or myths, influencing investor behaviour.

These myths prevent more resources being allocated to improving the quality of the current approaches to assessing social performance.



REUTERS/Aly Song

MYTH

1

Financial materiality: Social performance is less financially material than environmental performance

Much less attention has been paid to the materiality of social indicators than to environmental indicators. A company's social credentials – for example, its labour practices or community relations – have long been regarded as a lesser risk to financial performance.

The environmental performance of a company has been regarded as more material because of the tangible environmental risk that factors such as climate change pose to business operations,

and through risks arising from environmental law and policy. In contrast, the scope of social indicators goes beyond directly regulated issues, including themes such as diversity and inclusion, health, and individual freedoms. Some of these themes are seen as political.

Many investors perceive a limited interplay between environmental and social outcomes, ignoring the many ways in which indicators interconnect and influence each other.



Reality: Social issues are key risks to all investors and their beneficiaries

The prevailing investor application of materiality has had a narrow focus that stems from its historical roots. Originally, materiality¹ was a legal concept oriented toward identifying risks that require disclosure, as their concealment would prevent proper evaluation of the issue at hand. It gives rise to short-term, static financial materiality, which fails to properly recognise that it can be dynamic; social events and performance can become material to investors, beneficiaries, and stakeholders.

Such an approach disregards the much-improved understanding of risks that arise from secular trends such as climate change, technological advances, and changes in demography – all of which change the operational backdrop for companies. These risks are fluid, as they change in nature and intensity over time. They also create pressures for regulatory change, making ESG criteria, including the social dimension, crucial for risk management. As suggested in a comprehensive report by the OECD in 2020, market stakeholders should pay more attention to the types of non-financial reporting that can help investors make decisions about longer-term financial materiality.

Investing in companies with low scores on “S” indicators, or no available data, has risks. The recent example of Boohoo is a case in point. The company scored poorly on most industry transparency measures and lost £2bn of its market value in August 2020, after poor labour practices and low pay were exposed in its supply chain. Boohoo has suffered reputational damage and at the end of 2020 the company's share price was still a quarter down from its summer peak.

¹ The International Accounting Standards Board defines materiality as follows: “Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.”
From: www.ifrs.org/news-and-events/2018/10/iasb-clarifies-its-definition-of-material/

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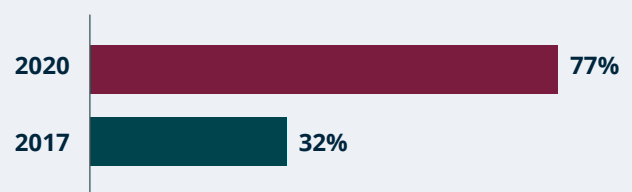
Boohoo might now face a US export ban, after US Customs and Border Protection launched an investigation into the company as a result of petitions from lawyers running the Liberty Shared campaign against modern slavery.

Notably, research by the Business & Human Rights Resource Centre has shown that companies that might score highly on environmental issues (such as renewable energy companies) can have serious social issues, related to human rights, in their supply chains. Regulations, such as the Global Magnitsky Act, sanction entities and individuals engaging in severe human rights violations. Its adoption is an example of a step in the right direction towards signalling the importance of human rights.

As the recent pandemic has highlighted, sudden changes in government policies or regulation, or in their application of them, can create costly supply chain disruptions.

The US Proxy season in 2020 demonstrated that environmental and social issues will be of great interest to shareholders, with more attention to be paid to companies' labour relations, human capital, employee health and safety, and diversity indicators.

Proxy disclosures that highlighted company initiatives and commitments regarding human capital (% Fortune 100)



Source: EY (2020), Four ESG highlights from the 2020 proxy season

Both regulation and legislation are catching up, too. **Regulators around the world are paying more attention to sustainability risks,** alongside other financial risks, and are **requiring companies to disclose their impact on society as well as the environment.** The European Union's (EU) Non-Financial Reporting Directive (NFRD) introduced the concept of double materiality, stipulating that companies should disclose both information necessary for understanding their impacts on society and the environment, and the financial risks posed to the company by social and environmental issues.

The EU's financial supervisors have also called for a "social taxonomy" in addition to the green taxonomy that is focused on environmental sustainability. The EU has heeded the call and created a working group on social taxonomy, making new regulation extremely likely. Regulation on mandatory human rights due diligence is also changing. The EU's proposed legislative changes will alter the disclosure and due diligence demands on companies. It will increase reporting requirements, which is likely to negatively impact underperforming companies and their investors.

These developments will also have repercussions for companies registered outside the EU but operating within the EU, and those who do business with corporations headquartered in the EU.

Changes to the UK's Stewardship Code in early 2020 now require the integration of ESG considerations into decision-making, stating that "signatories must systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities".

Failure to consider the social dimension of supply chains can present a very real risk in the context of this rapidly evolving regulatory landscape, even when a company might perform well environmentally. Spotting problems hidden in supply chains or sub-contracting is crucial because supply chains account for up to 40% of corporate ESG impacts, according to a recent study of 1,600 MSCI World Index companies. Demanding greater company disclosure on suppliers and contractors may be able to drive competition for the provision of improved information from data vendors and industry groups.



Action: Diminish risk and fulfil fiduciary duty



To begin with, social indicators should be treated as material.



Investors need to identify the specific social issues that are material to the geography or jurisdiction in which an investee company operates, and then by each sector or industry. Issues may become material with time, such as poor labour practices within supply chains. More granular information will help form an understanding of the most salient social issues, revealing hidden risks that can affect long-term value creation.

Investors can educate themselves on the “S” issues facing companies, their stakeholders and communities globally by referring to resources on responsible business conduct, some of which we have listed in [Annex III](#).



For improved outcomes, adequate resources and time need to be allocated to the evaluation of companies’ social performance. Developing in-house capacity on ESG topics is a crucial step for creating competitive advantage in an increasingly competitive market. **Building in-house capacity to better understand social indicators** will improve the ability to interpret and use ESG data for risk management and capital allocation. ESG investing metrics and frameworks would also benefit from using more input from the stakeholders they are designed to evaluate, as pointed out by a [recent release](#) from the First Nations Major Projects Coalition (FNMPC). This would help rectify the issue raised by a 2017 New York University (NYU) Stern School of Business [report](#), which called for investors to make an effort to measure what is most meaningful, not just what is most convenient. This means a greater focus on companies’ real-world effects, not just their efforts, and a greater involvement of impacted stakeholders, which will require both more capacity and more expertise. The involvement can include grievance mechanisms and opportunities for direct engagement, including structuring diverse boards and leadership with representation from stakeholder groups like workers and communities.



When looking at a company, investors and analysts should first determine if it is transparent in its reporting and next, if any essential information on social performance is missing. It may seem counterintuitive, but there may be a need to appraise whether there is an excessive focus on positive performance aspects that are of little importance, or are less material, such as philanthropic activities. Excessive emphasis on a few positive elements could indicate that the company in question has not assessed its social performance adequately, or that it has not provided full disclosure of some information because of inferior performance.

One significant aspect of the “S” is the responsibility to respect human rights, and the requirement to provide remedy is universal and independent from government [responsibility to protect human rights](#). Every company should carry out human rights-related due diligence in order to assess materiality, consistent with the UNGPs. Requiring companies to perform human rights due diligence and disclose relevant information enables investors to fulfill their own responsibility to respect human rights.

An overview of current disclosure requirements by governments and stock exchanges, prepared by White & Case, one of the partner organisations, is available in [Annex II](#). This shows that governments are paying more attention to social issues and performance, and that regulation and standards in this space are changing.

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REUTERS/Fatih Saribas

MYTH

2

Starting point: It is too difficult to know how and where to start assessing social performance

Within the investment community, there is a belief that identifying social indicators is not as straightforward as other financial analysis. There is some truth in this perception, because 'social issues' cover a broad range of topics, including healthcare, diversity, product safety and labour relations. The fact that the materiality of social risks differs between industries and countries adds a layer of complexity. For example, in the USA, provision of healthcare benefits and diversity are particularly important issues, whilst in other countries forced labour and corruption issues receive more attention.

This has led to a perception that it is impossible to delineate the scope of the "S", making it very difficult for investors to know what exactly falls within the remit of the indicators. Any effort to tackle the "S" in ESG is thus seen as time-consuming and a constraint on the available investment universe.



Reality: The link between business and human rights is well established

It is true that social indicators are many-fold. However, the UNGPs provide an easily accessible roadmap for building an understanding of social issues that investors should consider. There is also consensus that social indicators are about stakeholders' rights: a company's responsible behaviour regarding its human capital, customers, suppliers and wider society.

To explore these topics more closely, there are numerous meaningful indicators and metrics that are geared to help understand a company's performance. Data providers already have sub-segments of social indicators, helping to reduce complexity.

In 2020, five of the world's leading framework and standard-setting institutions for sustainability and integrated reporting – Carbon Disclosure Project (CDP), Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB) – announced a shared vision for a comprehensive corporate reporting system. In addition, the World Economic Forum published a recent report geared towards common metrics and consistent reporting of sustainable value creation. Efforts to harmonise standards will continue, exerting pressure on companies to disclose non-financial information.

Globally, there are dozens of initiatives that offer tools and indicators to assess companies' performance, which can help develop a much more comprehensive understanding of both risks and opportunities. The challenge for investors is in choosing the right frameworks that help them track the most consequential issues related to companies' performance. Pinning down decision-useful indicators and data, and making sense of it all, takes time. But the potential benefits to be gained from making more robust and resilient investment choices, and the potential to generate alpha, all make this effort worthwhile.

The UNGPs provide an easily accessible roadmap for building an understanding of social issues that investors should consider. There is also consensus that social indicators are about stakeholders' rights: a company's responsible behaviour regarding its human capital, customers, suppliers and wider society.



Action: Use existing resources to improve your understanding of social performance assessment

Plenty of useful resources exist for familiarising oneself with social performance and themes. As a starting point, **consider exploring these frameworks and resources:**

- ✓ The [UN Guiding Principles on Business and Human Rights](#) is the starting point to implementing the UN's 'Protect, Respect and Remedy' framework, which delineates the state responsibility to protect human rights from a corporation's responsibility to respect human rights in its operations and supply chain, as well as the shared government and corporate responsibility to provide effective remedy for abuses.
- ✓ The Organisation for Economic Co-operation and Development's (OECD) [Guidelines for Multinational Enterprises](#), offer internationally recognised principles and recommendations on responsible business practices in a global context, along with the supporting [Due Diligence Guidance for Responsible Business Conduct](#), which provides practical steps on the implementation of these principles.
- ✓ The ILO [Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy](#) offers concrete guidelines for designing responsible social policy for businesses, governments and workers' organisations, in areas such as employee training, conditions of work and life, industrial relations and more.
- ✓ The Robert F Kennedy Human Rights organisation has created a useful [resource](#) for investors to learn about unjust systems and practices, providing an investor [action plan](#) that can help move beyond diversity and inclusion towards the creation of a more equitable and just society.
- ✓ [Shift Project](#) offers practical advice and a tool for assessing and measuring whether companies' human rights programmes, policies and interventions are, in fact, successful – focusing on the outcomes instead of inputs.
- ✓ The UN Environment Programme Finance Initiative (UNEP FI) [impact analysis tool](#) provides details of country-level associated impacts in a holistic way. They also provide social indicators across impact areas and assist by grouping sustainability topics by sector. Multiple social indicators are available and can be selected as fit for purpose.
- ✓ The World Bank has published the [Atlas of Sustainable Development](#), with detailed social indicators included.

To identify the most salient social issues, and what information is most useful for tackling companies' social performance, it is key to **form a good understanding of the "S" in ESG**. Often, finding more localised and geography-specific information is very useful for more granular analysis. For example, it is important to understand why race is a salient issue in the USA, and how it is linked to social and economic inequality. For example, the [Change to Win](#) group files shareowner proposals calling

for racial equity audits to be conducted at US companies. [Just Capital](#) tracks corporate performance on a range of social, pay and diversity issues, offering easy to use data and insights.

In [Annex I](#), we have identified overarching themes and sub-themes relevant to the intersection of business and human rights, as explained in the first section of this white paper, which can be used as a starting point.



REUTERS/Kai Pfaffenbach

MYTH

3

Data: The “S” indicators are too hard to measure; there is no reliable and comparable data

A lack of standardisation for the “S” in ESG has led to the widespread perception among investors that it is impossible to measure the social performance of companies, and that existing data is not reliable or comparable. This belief has been reinforced by numerous papers confirming the lack of standardisation and divergence of ESG ratings, in some cases calling the situation an “[alphabet soup](#)” or “[aggregate confusion](#)”.

Several recent investor [surveys](#) also indicate that some of the greatest impediments to ESG integration are data-related challenges, such as data gaps and inadequate consistency, comparability, and scalability.

Because of these challenges, many investors believe that data on social performance has not reached a state that is sufficient for investment analysis, and that it is best to wait for standardisation, as well as improved data and measurement, before starting more serious work on social indicator integration.



REUTERS/Mark Blinch



Reality: It is possible and necessary to start using social indicators more

While it is true that there are issues around lack of standardisation, it is still possible to integrate social performance in investment analysis more rigorously than most investors do now. Over the last decade, much has changed in data collection and in our understanding of social indicators and their measurement. For example, developments in EU regulation already have an impact on disclosures and data availability. New technologies and capacity have enabled data providers to identify additional data points, paving the way for the accumulation of actionable information, while a range of initiatives have helped identify key elements that allow for the evaluation of social performance.

The main issue is still the relative shortage of company disclosures on social topics. Historically, companies have been reluctant to disclose, for example, policies on avoiding human rights abuses in supply chains, unless prompted to do so by regulatory requirements or serious pressure from investors. While there is no doubt that measuring social impact has been challenging, the common belief that social matters are overly abstract is not entirely accurate. It should not prevent investors from starting to integrate them into investment decisions.

The main issue is still the relative shortage of company disclosures on social topics. Historically, companies have been reluctant to disclose, for example, policies on avoiding human rights abuses in supply chains, unless prompted to do so by regulatory requirements or serious pressure from investors.

Data providers and rating agencies have been progressively improving the quality and variety of the data they offer. This has been driven by an increasingly competitive market for data provision. The data points for the “S” themes have been steadily improving, with even more focus on social indicators in 2020 due to the COVID-19 crisis and Black Lives Matter movement. Major ESG data providers have reviewed their own indicators and expanded them in a more applicable and measurable way, with new metrics being added regularly. These now also include data points that are not self-reported by companies, for example, controversy data from external news sources.

Investors should utilise various data sources for their analysis since data vendors differ in their scope and focus. This will mostly depend on the focus of an investor's portfolio. When investing in emerging markets, for example, it may be more appropriate to leverage data from local specialists.

In addition, significant technological developments and the ability to easily collect, store and analyse large amounts of data have created new opportunities for innovative approaches to measuring and monitoring the "S" factors. These have included the use of earth-observing satellite imagery, blockchain technology, and artificial intelligence (AI) by data vendors, to give investors greater insights into "S" factors.

How technology is changing social performance measurement

The increased resolution quality and frequency of satellite images have been used for monitoring the use of illegal labour by detecting and tracking time spent in fields, construction sites, quarries, mines or forests.

Blockchain has been increasingly used for assessing the integrity of multinational companies' supply chains. It allows for improved authentication processes, and visibility and compliance over outsourced suppliers and vendors, and further enforces better labour practices.

Advances in AI have revolutionised how large volumes of complex data are processed. One of the innovative methods, which has been gradually used in ESG investing, is sentiment analysis algorithms – also known as 'opinion mining' – which can be trained to analyse the tone of certain conversations, including social media, and gauge brand perception.

Going forward, these and other new technological developments will provide valuable complementary data which is not self-reported. Indicators based on such data will offer more granular information about a company's performance.

Once analysts proactively dig deeper beyond the obvious metrics, a range of innovative methods to address the complexity of measuring the "S" data opens up. Analysis should focus on information that may not be obvious at first, but which can provide measurable data to evaluate the effectiveness of processes and policies. The challenge for investors is to drill down and analyse the available data, to determine what the most relevant information is for their investment strategy and due diligence process. The challenge for investors is to drill down and analyse the available data, to determine what the most relevant information is for their investment strategy and due diligence process.

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Action: Identify the most useful indicators for evaluating effects; use and demand more data

In order to find the relevant indicators for the needs of the due diligence process, investors should **review the dominant and well-recognised standard providers** such as the GRI and SASB, which offer a starting point for the integration of social factors. Both are now collaborating on how their frameworks can be used concurrently.

While no single framework is perfect, they do offer a starting point for familiarising oneself with a company's social performance.

To help investors start working on social indicators, we have also mapped a series of thematic indicators across existing frameworks in Annex I.

Beyond this, **investors should also dig deeper** – a more comprehensive and nuanced understanding of social issues and the salience of different indicators according to sector, geography and jurisdiction can create a competitive edge and avoid unpleasant surprises about company supply chains or sub-contractors.

Additionally, **continue monitoring resources on an ongoing basis**, as new resources can emerge and existing ones are often updated with new data and findings. Along with the indicators, improving tools and approaches for measuring and managing impact have also been a focus of innovation. Various resources are available and easily accessible for investors when designing their processes and looking for data:



For a broad scope of gender metrics, Equileap has the largest up-to-date database on gender equality and it assesses and ranks thousands of companies globally on gender equality. Its gender diversity index, launched with Morningstar, was recently adopted as a benchmark to invest by Japan's Government Pension Investment Fund (GPIF).



RepRisk leverages advanced machine learning, together with highly trained analysts, to provide a dataset that allows for more accurate and effective identification of ESG risks. For example, their recent work on lobbying and how it intersects with other ESG issues showed how it is often linked to a range of both environmental and social issues.



Refinitiv and Fortune have recently partnered on the Measure Up initiative to address the lack of racial and ethnic diversity in the workplace. The initiative encourages, and provides a way for, corporates to report race metrics, allowing them and their investors to obtain better insight into the demographics of workforces and benchmarks to aim for.



WikiRate, an open data platform, brings together free, comparable and easily accessible corporate ESG data. It is also working on supply chain transparency, tying together disparate datasets.



The [Impact Management Project \(IMP\)](#) provides a forum for building global consensus on how to measure, manage and report impacts on sustainability, in other words, the effects. Since 2016 it has convened a community of more than 2,000 practitioners to share best practices, delve into technical issues and identify areas where further consensus is required in impact measurement and management. The IMP also facilitates a structured network of 16 standard-setting organisations that are coordinating efforts to provide complete standards for measurement, management and reporting of impacts on sustainability.



The [Workforce Disclosure Initiative](#) aims to improve corporate transparency and accountability on workforce issues, providing companies and investors with comprehensive and comparable data and helping increase the number of good jobs worldwide.



An alliance of leading NGOs who are experts in supply chains recently focused on supply chain data and put together a [useful list](#) of key performance indicators (KPIs), examining how companies should be reporting on their supply chains.



The [Global Impact Investing Network \(GIIN\)](#) provides a range of useful free publications about the latest developments in impact investing and also offers the free of charge [IRIS+ system](#) that enables impact investors to measure, manage and optimise impact.

Data availability will keep improving due to technological and policy changes. **Many investors can also help influence data availability and quality by creating a demand for different and additional data points from the ESG data providers and for improved disclosures from companies.** Investors can be agents of change, influencing developments in the data and disclosure space to ensure human rights are protected, especially in supply chain disclosure. Improving transparency is a key element for better risk management.

There are also changes in the accounting industry, and a push for a rethink. Harvard University is working on an innovative approach called [Impact-weighted Accounts](#), which measures environmental and social impact in monetary terms. It provides decision-makers with new information on the costs and benefits of their actions, allowing for a better understanding of a company's societal and environmental effects, which are often hidden because of the mainstream accounting approaches. Changes in reporting can help generate more useful data on company effects, which will help improve data landscape.

Importantly, **more serious effort needs to be made to evaluate companies' social performance in supply chains and sub-contracting arrangements.** The negative social impacts that result from current business models and arrangements contribute to growing inequality and erosion of economic resilience.

A more thorough rethinking of how to address systematic risks arising from inequality is needed. [The Taskforce on Inequality-related Financial Disclosures \(TIFD\)](#), inspired by the [Taskforce on Climate-related Financial Disclosures \(TCFD\)](#), is a nascent but welcome development. Recognising inequality as one of the most pressing problems facing economic systems and societies, TIFD is aimed at creating a mechanism for improved and increased reporting on inequality-related socio-economic issues. This would help financial markets to better price risks related to social performance.

Investors can be agents of change, influencing developments in the data and disclosure space to ensure human rights are respected, especially in supply chain disclosure.



REUTERS/Erik De Castro

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Integration process: Qualitative surveys or questionnaires are the best method for tackling social issues and analysing the social aspects of performance

Many investors already use surveys or specially designed questionnaires to assess the social performance of companies, based on the belief that this approach offers sufficient information for contextualisation and interpretation.

The premise of this is that a qualitative approach alone is enough for rigorous analysis of social risks and performance. This approach is driven by an assumption that survey responses allow investors to contextualise the information and make an informed judgement, without the need for very much quantitative data.



Reality: Qualitative approaches can be enriched by data-driven elements

Currently, many investors use this qualitative approach based on questionnaires that are often designed in-house. In many cases, no experts with in-depth expertise on human rights or social indicators are involved in the design process.

This approach results in companies often receiving many different questionnaires and having to spend considerable time on investor engagement. It also leads to basic, box-ticking questions with little value for investment decision-making. In most cases, almost all social performance issues can be explained away with elaborate and contextualised answers. Binary questionnaires have their place, as they are less complex and less time-consuming.

Also, they can target issues that need a 'yes' or 'no' answer. However, they tend to focus on corporate efforts and input (policies) instead of the actual impact.

In contrast, **data-driven elements can help flag potential issues**, offering scale for investors with large portfolios and allowing the monitoring of companies that disclose comparable data on social issues. Rather than viewing data points as static, their use over time can help evaluate whether a company is making progress to achieve its targets. The data can be contextualised to account for changing market conditions or improved practices. In addition, using data that is not self-reported by companies can add valuable insights into potential risks and performance.

While data might be insufficient on its own, combined with qualitative analysis, social indicators can shed additional light on whether the policies adopted by a company are working or where there are 'red flags' – potential performance issues. Use of indicators can improve the due diligence process and lead to more effective engagement with the company, flagging potential problems for further consideration. The indicators we have listed in [Annex I](#) offer a good starting point for the use of data on social issues.





REUTERS/Marcos Brindicci



Action: Use a combination of data-driven input and qualitative analysis for due diligence and engagement

Data-driven input can be extremely useful for both the analysis before the investment is made, as part of the due diligence process, and after the investment, as part of any ESG or impact-monitoring process.

It is important that investors do not rely solely on questionnaires or on data-driven ESG ratings alone. **To strengthen due diligence, use data-driven input to help you spot potential issues or 'red flags'.**

Engage with the NGO and expert community, who can efficiently pinpoint the social risks a business might face and provide additional data. Often, poor labour practices are well-documented by the NGO sector, while investors are not fully aware of the problems and risks. Additional insight can inform the drafting of targeted questions to build a more complete picture of the situation. Some of these organisations and initiatives can be found in [Annex III](#).

When there is no data available, query why that is the case. Investors can take on a more active role by requiring, or recommending, that companies obtain or report some of the missing data.

Engage with the business – this is one of the most powerful tools at an investor's disposal for managing risks and shaping better outcomes. Engagement offers a unique opportunity for an investor to better clarify and **communicate ESG expectations** to companies, helping to avoid misunderstandings about metrics and data. It can also be useful for identifying any potential future risks and new growth opportunities. To improve engagement practice, useful resources can be accessed on the [PRI website](#).

Using indices or benchmarks to assess companies is becoming a more frequently adopted practice, which also enables investors to influence corporate behaviour on a larger scale. These benchmarks include:



The World Benchmarking Alliance (WBA), which now includes the Corporate Human Rights Benchmark, itself a multi-stakeholder initiative between investors and civil society organisations. The WBA has outlined a framework that helps to assess companies' performance against a common set of core social indicators, providing a minimum benchmark for human rights performance that businesses should meet.



KnowTheChain, a collaborative partnership between the Business & Human Rights Resource Centre, Humanity United, Sustainalytics, and Verité, has a resource for companies and investors to understand and address forced labour risks within their global supply chains. KnowTheChain uses benchmarks that measure companies' disclosures on their policies and practices to mitigate the risk of forced labour and human trafficking in their supply chains.



Ranking Digital Rights, which provides an easy-to-use accountability index that evaluates and ranks information and communications technology (ICT) sector companies on relevant commitments and policies, based on international human rights standards.

To stay ahead of the curve and better manage risks, one of the approaches investors can take is to **actively help companies structure more diverse boards that include representation from affected stakeholders, such as workers and communities.**

Engagement enables a more efficient exchange of information between investors and companies on an ongoing basis to monitor improvements and progress on relevant indicators and KPIs. It can enable companies to explain issues such as scandals or negative reports in the media, and to ensure that companies establish appropriate processes to provide effective and timely remedy to rights-holders if a negative impact materialises. It also allows investors to **act on information and exert influence.** This can involve voting against the company directors or take the form of shareholder resolutions.

With greater public scrutiny of investor behaviour and decisions, those investors with active and effective engagement policies and practices will stand to benefit from a positive reputation and will be able to proactively manage their portfolios. It is a convenient opportunity that also delivers another goal: more resilient investments.

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REUTERS/Chaiwat Subprasom

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5

Relevance to investors: Integrating “S” indicators is only relevant for impact investors

The Group’s interviews revealed a misperception that the proper integration of social indicators is only relevant to funds that focus on impact first. Many mainstream investors believe that they should remain ‘returns first’ and, therefore, putting additional effort into understanding the relevance or importance of social indicators is not necessary.

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Some investors and companies worry that integrating measurements of social impact could unfairly penalise otherwise well-performing companies that represent sound investment opportunities.

There is also a perception that a greater focus on the “S” indicators risks creating another layer of complexity for investment professionals whose work to seek out profitable investments is already difficult enough, with little added value from looking at social performance as part of the investment analysis or decision-making process.

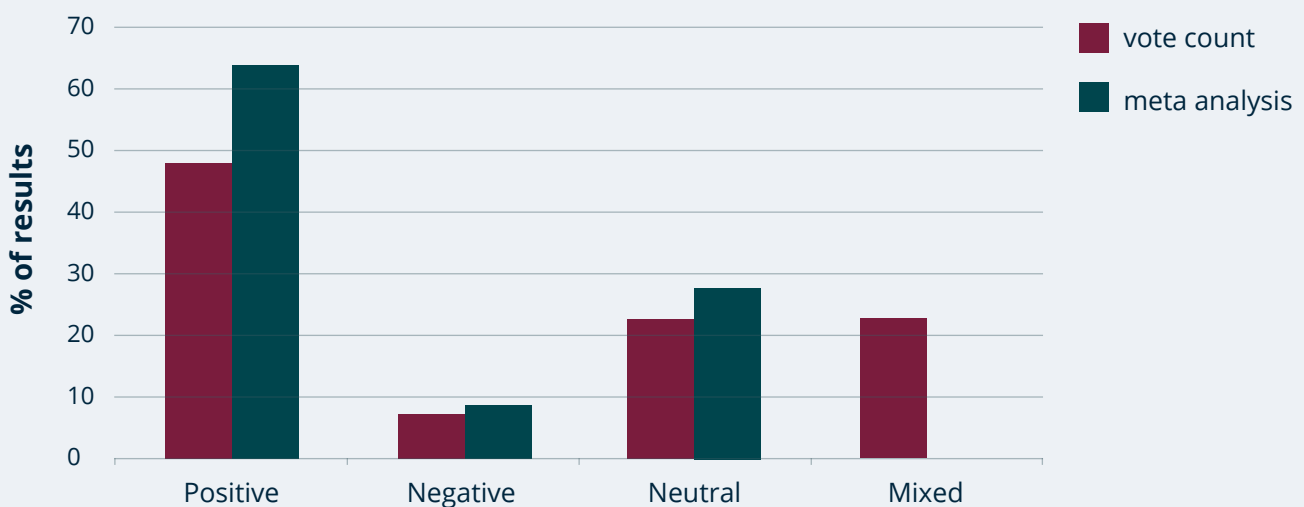


Reality: “S” indicator integration can help to identify more resilient and profitable investment opportunities

There is no evidence to show that greater focus on social indicators leads to diminished returns. On the contrary, the business case for ESG investing is well-founded. Analysis of ESG fund performance over the last decade has shown that ESG funds show greater resilience during times of crisis.

ESG and Corporate Financial Performance Study Findings

Aggregate evidence from more than 2,000 empirical studies



Source: Friede, Busch, Bassen, ESG and financial performance: aggregate evidence from more than 2,000 empirical studies, Dec, 15, 2015. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

For example, according to Amundi Asset Management, the MSCI World index shed 14.5% in March 2020, while 62% of large cap ESG funds outperformed the index.

Similar trends were also observed with ESG-focused exchange traded funds (ETFs) listed on US markets during both the upheaval of the sub-prime crisis and the COVID-19 pandemic, when the average growth rate for outstanding units of ETFs listed on US markets was, on average, 1.7 times higher for equity ESG funds than for conventional equity funds. During the COVID-19 crisis, the daily growth rate was 4.6 times higher for ESG funds, compared with 1.3 times higher over the period between the two crises.

For long-term profitability, the “S” in ESG will only become more important, making ESG data analysis crucial. A recent study (which used both calendar-time portfolio stock return regressions and company-level panel regressions) found that companies with good ratings on material sustainability issues significantly outperformed ones with poor ratings on the same issues. One example is Unilever, which launched its Sustainable Living Plan strategy in 2010 and focused on long-term shareholder value accretion with a multi-stakeholder approach, and on competitive advantage through sustainability. It was able to deliver a 190% return to its shareholders between 2010 and 2017.

There is also evidence that demonstrates companies with better scores on the environmental and social dimensions of their business trade at a premium in comparison with their peers. For example, in the last few years, businesses within the purpose-driven B Corp movement have experienced an average year-on-year growth rate of 14%, which is 28 times higher than the national average.

The relationship is becoming clearer between a company's culture, social and business practices, its place in society, and its ability to achieve sustained positive financial results. As a recent study by FCLT found, there is systematic evidence that a long-term approach can lead to superior performance for revenue and earnings (with less volatility), investment, market capitalisation, and job creation.

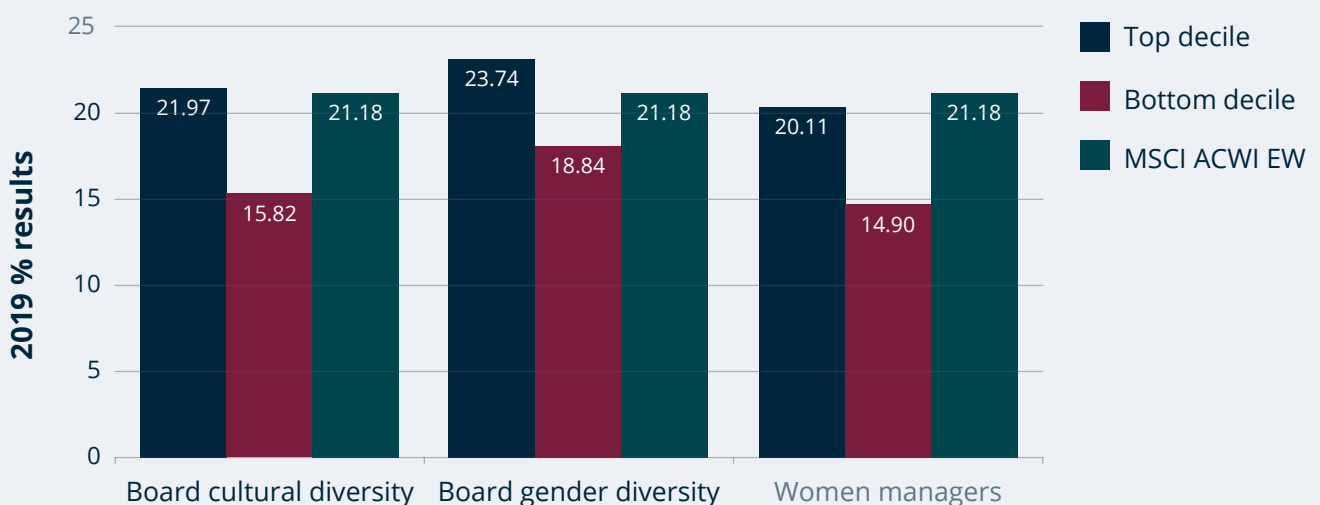
With more data collection and research, there is also **growing evidence that more diverse and inclusive companies tend to outperform their competitors**. A 2019 International Finance Corporation study found that portfolio companies in emerging markets with gender-balanced leadership teams outperformed in valuation increases by as much as 25%, compared with non-diverse teams.

As a study by McKinsey & Company found, there is systematic **evidence that a long-term approach can lead to superior performance for revenue and earnings (with less volatility), investment, market capitalisation, and job creation**.

The Refinitiv D&I study, 'Key factors driving diverse and inclusive workplaces', found there was outperformance in a number of portfolios that took diversity of employees or boards into account.

There is also evidence that demonstrates companies with better scores on the environmental and social dimensions of their business trade at a premium in comparison with their peers. For example, in the last few years, businesses within the purpose-driven B Corp movement have experienced an average year-on-year growth rate of 14%, which is 28 times higher than the national average.

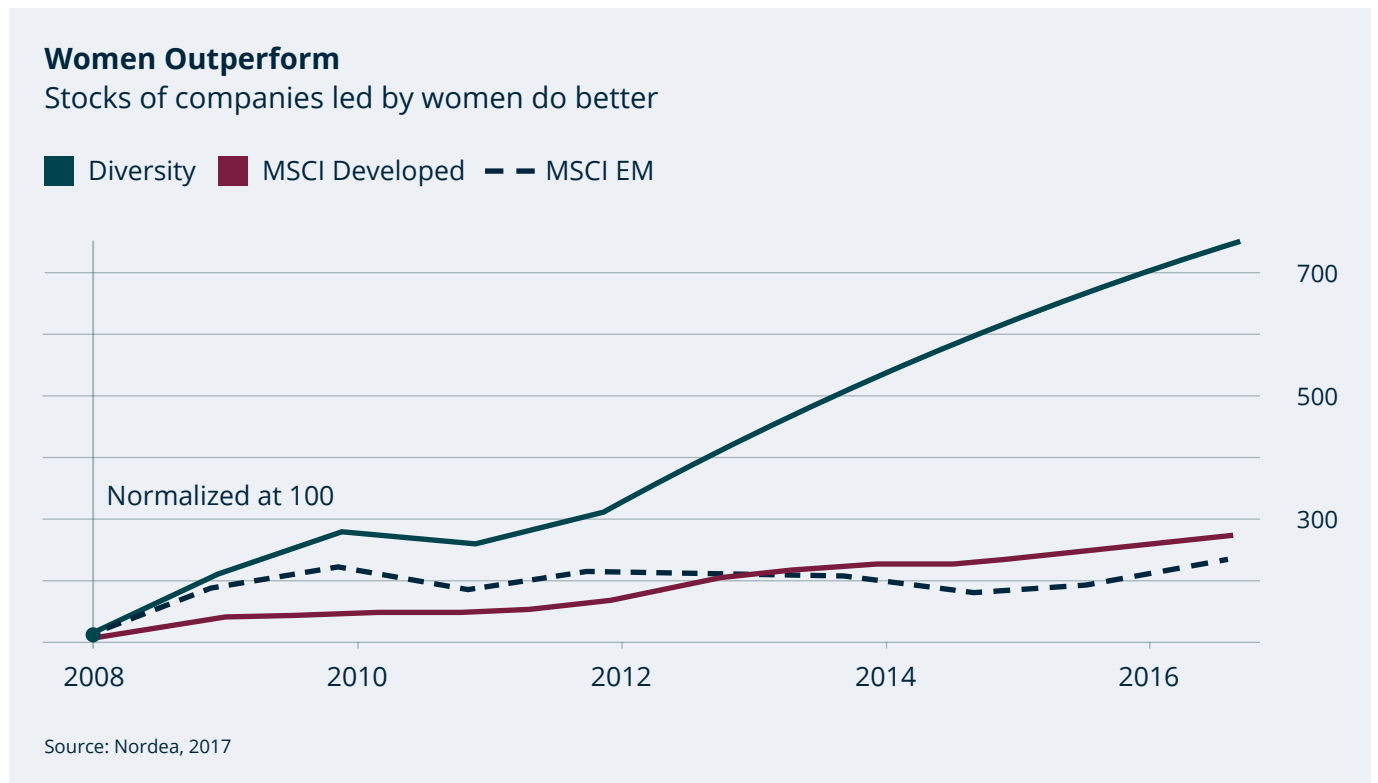
2019 average performance for top and bottom decile portfolios alongside MSCI All Country World Index (equal weighted)



Source: Refinitiv, Key factors driving diverse and inclusive workplaces, 2020



Nordea Bank's analysis of 11,000 publicly-traded companies found that, since 2009, companies run by women exceeded the benchmark index in all but one year. These companies also had a 25% annualised return over that time, more than double the 11% the MSCI World Index delivered based on equal weightings.



At a time of low interest rates and low yields, spotting opportunities for improved returns can make a significant difference. In addition, socially responsible companies are better able to attract and retain talent, something that is of growing importance for future competitiveness.



Action: Tailor your approach to social indicators to avoid missed risks and opportunities

As more businesses and financial institutions accept responsible investing as a new normal, understanding ESG analysis and the opportunities this can unleash is increasingly critical to creating a competitive edge.

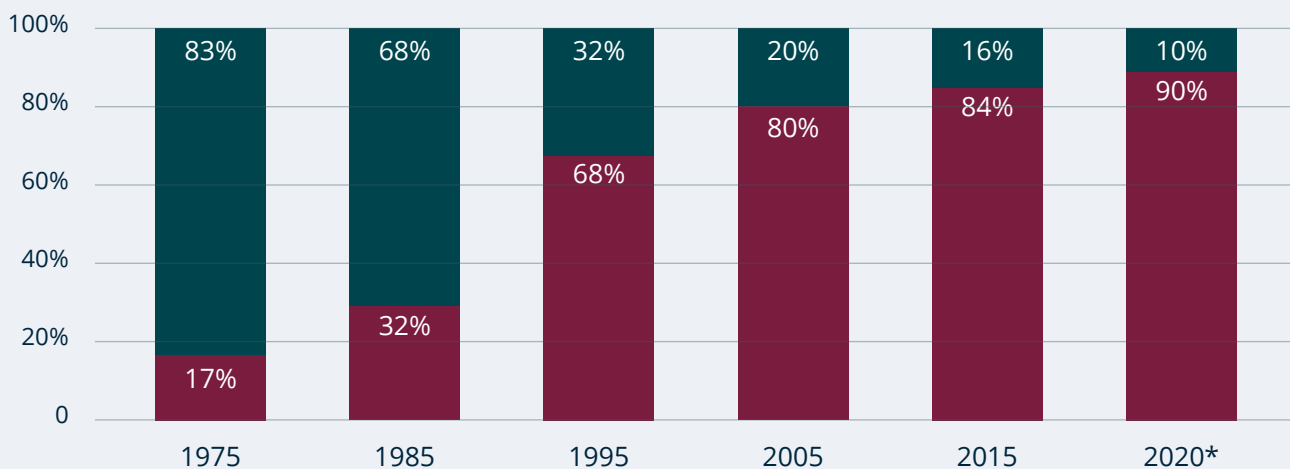
First of all, the lack of standardisation or data harmonisation provides an opportunity for an enhanced approach to ESG investing, and to social indicators in particular. Since a lot of ESG performance is not yet captured by the markets, a more in-depth understanding of material ESG issues and indicators can help identify under-priced but long-term profitable opportunities. The use of data and contextual information can then be tailored to pursue an investment strategy that fits with one's risk budget.

It is also key to **exploit the advantages that superior capacity in ESG analysis can offer for improved competitiveness**. In a competitive and growing sustainable investing market, it is possible to use ESG expertise, and especially more in-depth knowledge on the "S" in ESG, to attract new business. In the US alone, the number of ESG-focused ETFs launched in the first six weeks of 2021 is double those launched in 2020. This shows the growing appetite for more ESG investment options, a market that is only likely to grow due to a range of regulatory, policy and climate pressures. In addition, estimates show that the rise of millennial and female investors in the next decades will create additional pressures on the investment industry to incorporate ESG criteria.

Moreover, talent and innovation are key value drivers for companies. According to a recent study, between 1995 and 2015 the share of intangible asset market value increased from 68% to 84%. Human capital plays a critical role in determining the future value of a business.

Components of S&P 500 market value

■ Tangible Assets ■ Intangible Assets



Source: [Ocean Tomo, LLC Intangible Asset Market Value Study, 2020](#) (Interim study update as of 7/1/2020)

Advanced ESG integration can be used as a lever to attract and retain top talent, which will help improve staff productivity and performance. Demonstrating a serious effort to integrate all the ESG criteria and incorporate it into business purpose will be increasingly critical in attracting millennial talent, for whom, according to numerous studies, social purpose plays an important role. Shortage of talent with key skills is already a rising risk for the financial industry. Going forward, recruiting leading ESG talent will be crucial for competitiveness. Importantly, **investors themselves need to consider the need to improve diversity and inclusion**, since a 2020 study showed a lack of diversity amongst investment groups – only 11% were Asian and less than 1% were black.

Investors also should consider involvement in initiatives tackling social issues that have investor and civil society participation. This can help improve their understanding of the subject matter and allow them to drive the agenda at the same time. For example, consider joining the Investor Alliance for Human Rights, an alliance of 160 institutional investors looking at how to put investor responsibility to protect human rights into practice. The Human Capital Management Coalition (HCMC), launched in the wake of the Rana Plaza tragedy in Bangladesh, addresses a wide range of concerns faced by key sectors,

from worker health and safety, to a living wage and diversity and inclusion. It proactively tried to tackle the lack of standardised reporting by developing a petition to the US Securities and Exchange Commission (SEC) and prompting the SEC's Investor Advisory Committee to issue recommendations for a new framework. Active involvement in such initiatives enables investors to help shape the agenda, while also improving approaches to social performance.

Investors should exercise their power to push for positive change at companies whose practices are lagging, while searching for businesses that have forward-looking, long-term focused business strategy and practices that drive value creation. With a more proactive approach, investors can influence the availability of data and improve their own ability to comprehensively analyse investments.

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Conclusion

Investors navigate great **complexity**, journeying through many new and changing trends. Yet two key trends are reshaping the world as we know it **and bringing ESG issues to the fore: climate change and inequality.**

Apple, one of the world's largest tech companies, is linking executive bonuses to ESG performance. Similarly, restaurant chain Chipotle is tying executive compensation to annual targets aimed at improving the

company's internal diversity and sustainability. In its 2021 letter to CEOs, BlackRock, the world's largest asset manager, stated that stakeholder connections drive returns.

The more that a company can link its purpose and strategy to delivering value to stakeholders – customers, employees, and communities – the more it will produce long-term, durable profits for shareholders.

Key takeaways

- ✓ Social issues are salient to all investors and their beneficiaries, and they will be increasingly material going forward.
- ✓ Emerging empirical evidence shows that the integration of ESG criteria leads to improved returns, less volatility and lower downside risk.
- ✓ Proper integration of social criteria in the investment process can help diminish investment risk and fulfil fiduciary duty, the understanding of which itself is changing.
- ✓ The link between business and human rights is well established; there are many resources to grow understanding of the “S” in ESG, and working closely with experts is key.
- ✓ It is possible and necessary to start using social indicators more for improving investment analysis.
- ✓ Qualitative approaches can be enriched by data-driven elements, and a combination of the two for due diligence and engagement can improve outcomes and help generate alpha.
- ✓ Technology is changing the availability and type of data investors can use, a development that will increase the volume of available data, and allow for information that is not based on self-disclosure.
- ✓ The integration of social indicators can help to identify more resilient and profitable investment opportunities.
- ✓ It is key for investors to develop a strategy for their total portfolio – public and private markets, equity and debt – covering engagement, advocacy and integration.
- ✓ More proactive effort is needed to better understand and address social issues appearing within supply chains, which form a substantial part of companies’ social performance.
- ✓ The ESG approach and a balanced choice of social indicators and data can be tailored to suit individual investment philosophy and strategy.

The direction of travel is clear. Now it is time for the investment community to be proactive and engage fully in the development of increasingly robust approaches to assessing social performance and integrating social criteria, in order to play its part in creating more resilient and equitable economies.

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List of abbreviations

AI	Artificial intelligence
CDP	Carbon Disclosure Project
CDSB	Climate Disclosure Standards Board
EBIT	Earnings before interest and taxes
ESG	Environmental, social and governance
ETFs	Exchange-traded funds
EU	European Union
FNMPCC	First Nations Major Projects Coalition
FCLT	Focusing Capital on the Long Term
GHG	Greenhouse gas
GPIF	Government Pension Investment Fund
GRI	Global Reporting Initiative
HCMC	Human Capital Management Coalition
IAC	Investor Advisory Committee
ICT	Information and communications technology
IFC	International Finance Corporation
IIRC	International Integrated Reporting Council
ILO	International Labour Organisation
MP	Impact Management Project
ISFC	International Sustainable Finance Centre
KPIs	Key Performance Indicators
MSCI	Morgan Stanley Capital International
NFRD	Non-Financial Reporting Directive
NGO	Non-governmental organisation
NYU	New York University
OECD	Organisation for Economic Co-operation and Development
PRI	Principles for Responsible Investment
SASB	Sustainability Accounting Standards Board
SDGs	Sustainable Development Goals
SEC	Security and Exchange Commission
TCFD	Taskforce on Climate-related Financial Disclosures
TIFD	Taskforce on Inequality-related Financial Disclosures
UK	United Kingdom
UN	United Nations
UNEP FI	United Nations Environment Programme Finance Initiative
UNGPs	United Nations Guiding Principles on Business and Human Rights
USA	United States of America
WBA	World Benchmarking Alliance

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