

Environmental, Social, and Governance (ESG) Principles and Criteria

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Updated May 28, 2022

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What Are Environmental, Social, and Governance (ESG) Criteria?

Environmental, social, and governance (ESG) criteria are a set of standards for a company's behavior used by socially conscious investors to screen potential investments. Environmental criteria consider how a company safeguards the environment, including corporate policies addressing climate change, for example. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.

KEY TAKEAWAYS

- Environmental, social, and governance (ESG) criteria are used to screen investments based on corporate policies and to encourage companies to act responsibly.
- Many mutual funds, brokerage firms, and robo-advisors now offer investment products that employ ESG criteria.
- ESG criteria can also help investors avoid investment losses when companies engaged in risky or unethical practices are held accountable.
- The rapid growth of ESG investment funds in recent years has led to claims that companies have been insincere or misleading in touting their ESG accomplishments.

How Environmental, Social and Governance (ESG) Criteria Work

Investors have, in recent years, shown interest in putting their money where their values are.

As a result, brokerage firms and mutual fund companies have started offering exchange-traded funds (ETFs) and other financial products that follow ESG criteria. Roboadvisors including Betterment and Wealthfront have promoted these ESG-themed offerings to younger investors.

ESG criteria are also increasingly informing the investment choices of large institutional investors such as public pension funds. According to the most recent report from US

SIF Foundation, investors held \$17.1 trillion in assets chosen according to ESG criteria at the end of 2019, up from \$12 trillion just two years earlier.

ESG investing is sometimes referred to as sustainable investing, responsible investing, impact investing, or socially responsible investing (SRI). To assess a company based on ESG criteria, investors look at a broad range of behaviors and policies.

58%

The share of respondents to a survey by Investopedia and Treehugger who indicated increased interest in ESG investments in 2020. 19% reported using ESG considerations in selecting investments.

Types of Environmental, Social, and Governance (ESG) Criteria

ESG investors seek to ensure the companies they fund are responsible stewards of the environment, good corporate citizens and are led by accountable managers.

Environmental

Environmental criteria may include corporate climate policies, energy use, waste, pollution, natural resource conservation, and treatment of animals. The criteria can also help evaluate any environmental risks a company might face and how the company is managing those risks.

Considerations may include direct and indirect greenhouse gas emissions, management of toxic waste, and compliance with environmental regulations.

Human influence is unequivocally to blame for the warming of the planet and some forms of climate disruption are now locked in for centuries, according to a report from the U.N. Intergovernmental Panel on Climate Change. "This report must sound a death knell for coal and fossil fuels before they destroy our planet," said United Nations Secretary-General António Guterres.

Social

Social criteria look at the company's relationships with stakeholders.

Does it hold suppliers to its own ESG standards? Does the company donate a percentage of its profits to the local community or encourage employees to perform volunteer work there?

Do workplace conditions reflect high regard for employees' health and safety? Or does the company take unethical advantage of its customers?

Governance

ESG governance standards ensure a company uses accurate and transparent accounting methods, pursues integrity and diversity in selecting its leadership, and is accountable to shareholders.

ESG investors may require assurances that companies avoid conflicts of interest in their choice of board members and senior executives, don't use political contributions to obtain preferential treatment, or engage in illegal conduct.

Special Considerations

Investment firms following ESG criteria often set their own priorities. For example, Boston-based Trillium Asset Management, with \$5.6 billion under management as of December 2021, uses a variety of ESG factors to help identify companies positioned for strong long-term performance.⁶

The criteria are set by analysts who identify the relevant issues facing specific sectors, industries, and companies. Trillium's ESG criteria preclude investments in the following:

- Companies that operate in higher-risk areas or have exposure to coal or hard rock mining, nuclear or coal power, private prisons, agricultural biotechnology, tobacco, tar sands, or weapons and firearms.
- Companies involved in major or recent controversies over human rights, animal welfare, environmental concerns, governance issues, or product safety.

In contrast, Trillium looks for investments meeting the following ESG criteria:

Environment

- Publishes a carbon or sustainability report
- Limits harmful pollutants and chemicals
- Seeks to lower greenhouse gas emissions
- Uses renewable energy sources

Social

- Operates an ethical supply chain
- Supports LGBTQ rights and encourages diversity
- Has policies to protect against sexual misconduct
- Pays fair wages

Governance

- Embraces diversity on board of directors

- Embraces corporate transparency
- Someone other than the CEO is chair of the board

Pros and Cons of Environmental, Social, and Governance (ESG) Criteria

In years past, the socially responsible investor was assumed to be sacrificing self-interest to some degree by avoiding some investments based on non-financial criteria. After all, tobacco and defense, two industries avoided by many ESG investors, have historically produced well-above-average market returns.

More recently, some have argued that, in addition to their social value, ESG criteria can help investors avoid the blowups that occur when companies operating in a risky or unethical manner are ultimately held accountable for its consequences. Examples include BP's (BP) 2010 Gulf of Mexico oil spill and Volkswagen's emissions scandal, which rocked the companies' stock prices and cost them billions of dollars.

As ESG-minded business practices gain more traction, investment firms are increasingly tracking their performance. Financial services companies such as JPMorgan Chase (JPM), Wells Fargo (WFC), and Goldman Sachs (GS) have published annual reports that extensively review their ESG approaches and the bottom-line results.

The ultimate value of ESG criteria will depend on whether they encourage companies to drive real change for the common good, or merely check boxes and publish reports.¹⁰ That, in turn, will depend on whether the investment flows follow ESG criteria that are realistic, measurable, and actionable.

Source: Investopedia