

This key element of ESG investing could drive real change at companies and boost returns



With the importance of socially responsible investing strategies increasingly ubiquitous, advocates are turning their attention to an area they see as less understood.

The social pillar of the environmental, social and corporate governance investing framework — known as ESG in short — has been dubbed the “[middle child](#)” largely due to data challenges. As ESG has reached new heights in terms of broad awareness on Wall Street and Main Street, those in the space now see an opportunity to better define and quantify the “S” pillar.

“There’s been quite a bit of growth,” said Michael Young, director of education and outreach at the Sustainable Investment Forum. “But amongst the three, it’s definitely sort of the latest to be included in an investment process. And not everybody will use it the same way.”

For years, the social pillar has been considered relatively nebulous and hard to quantify. BNP Paribas [found in 2021](#) that more than half of the 350 institutional investors around the globe surveyed believed the “S” was the most difficult to analyze and integrate.

At the same time, the climate and corporate leadership themes have garnered growing interest. That came in part as climate change and racial justice have gained more awareness in recent years, pushing investors and company leadership to pay more attention to how corporations perform in these categories. And it comes despite the fact that the ESG investing framework has found itself in [hot water politically](#).

Now, investors are left trying to understand what the “S” means to them and how best to analyze corporate efforts in the space.

Defining and quantifying the ‘S’

The elevator-pitch definition for the social pillar usually goes something like this: It’s how companies interact with their communities, both in terms of their work forces and the locations their business operates in.

While data around human capital and diversity has improved over the past several years, investing professionals still see a lack of standardized information that can make social themes harder to integrate. The patchwork of data can also make apples-to-apples comparisons between competing companies more difficult.

Looking ahead, Young said a potential human capital [disclosure rule](#) from the Securities and Exchange Commission is being [watched by advocates](#). They're hoping the rule will lead to a database of information from companies given to the Equal Employment Opportunity Commission made publicly available.

“That would be a huge catalyst,” he said. “It would be the very first ‘S’ disclosure rule in the United States.”

In the absence of enough standardized data, some have gotten creative.

Marian Macindoe, head of ESG stewardship at Parnassus Investments, said data on the share of part-time versus full-time workers, benefits for contract workers and evidence of hiring best-practices are all things to consider. She said Parnassus will often ask for engagement data from companies, while admitting it is an imperfect way to measure performance.

When looking for information, her team will check for publicly available fines or lawsuits against a company. Even reviews on Glassdoor or memes posted to social media platforms that touch on common themes can offer user insights, she said.

The firm wants companies to know: “This stuff matters – and you should be held accountable for it,” she said.

Harbor Capital and Irrational Capital partnered to build exchange-traded funds centered thematically on employee satisfaction: They include the [Harbor Human Capital Factor US Large Cap ETF](#) and the [Harbor Corporate Culture Small Cap ETF](#).

Fittingly, the funds trade under a variety of tickers — like [HAPI](#) and [HAPS](#) — that use the same first three letters as the word “happy.”

The funds use survey data collected by Irrational from more than 15 million employees across several thousand companies. That's useful because the firm believes that strong employer-employee relationships can drive better business performance and, thus, boost shares.

Big technology names such as [Microsoft](#) ⁺, [Apple](#) ⁺, [Alphabet](#) ⁺ and [Meta](#) ⁺ were some of the biggest positions in the large-cap fund as of mid November. Meanwhile, [Insperity](#) ⁺, [H.B. Fuller](#) ⁺, [Apple Hospitality](#) ⁺ and [Evercore](#) ⁺ are among the biggest holdings in the small-cap version.

Elsewhere, socially responsible investors see companies' roles in the communities they operate in as part of the "S." Macindoe said companies can sometimes mistake this for just doing charity work rather than being active members of the community.

"Charitable contributions and philanthropy are really great, but that's not the 'S' of ESG," she said. "The 'S' in ESG is about taking care of the people that rely on you and that you rely on when you plan your business strategy and operations."

There can also be overlap between environment and social themes that can sometimes drive confusion, according to Yijia Chen, vice president at Calvert Research and Management, a firm that was an early proponent of socially responsible investing. In these cases, she said the social pillar comes into play in ensuring a carbon transition is equitable and just.

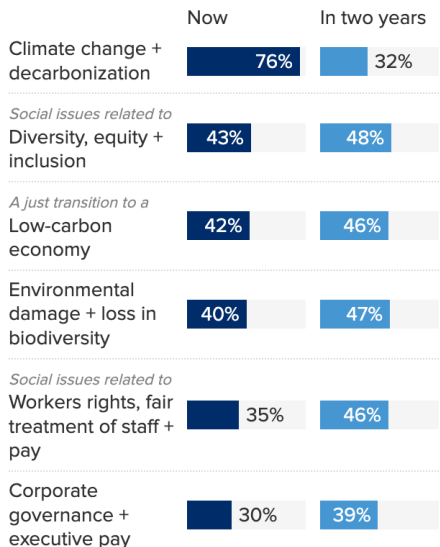
A fraught environment

Globally, it appears social themes will become more clear and important to investors over time.

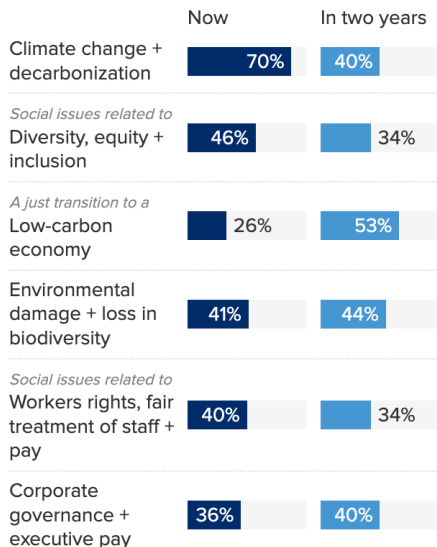
Current and near-future investor priorities

On topics of voting, engagement and possible investment changes, like exclusion and divestment

GLOBAL



NORTH AMERICA



Graphic: Gabriel Cortes / CNBC

Source: BNP Paribas [ESG Global Survey 2023](#)



This year, BNP Paribas found investors around the globe said that a company's commitment to workers' issues would become [more of a priority](#) when proxy voting or making investment decisions in the next two years. (BNP Paribas specifically gauged topics like fair pay and equal treatment. The firm also asked about how investors view the importance of a company uplifting of diversity, equity and inclusion efforts, known in short as DEI, in the workplace.)

But North American investors showed a reverse trend, with the survey finding these issues will lose priority over the next two years. That comes as ESG and DEI have become politically divisive and spurred debate among lawmakers over the past year.

Meanwhile, backlash toward [Target](#)'s [Pride collection](#) and [Anheuser-Busch](#)'s [Bud Light campaign with a transgender influencer](#) have become symbols of how these so-called culture wars have bled into corporate America. RBC Capital Markets found that U.S. corporations have increasingly [turned to terms like sustainability](#) rather than ESG when discussing social responsibility on earnings calls.

While the ESG landscape has grown politically fraught, some investors caution against reactionary moves like divestment when they don't see a company living up to socially responsible values.

Instead, they argue they can make a better impact by using their power as active investors to advocate for better policies. Many point to materiality and risk reduction as recurring reasons they bring up to companies for why they should care about ESG issues.

Han Yik, a senior advisor for the New York State Teachers' Retirement System pension, told attendees of an ESG conference last month to think about the decision to divest like how to handle trash in a backyard. The trash can be moved to a neighbor's yard, or can be dealt with for the betterment of all.

"We're not a fan of divestment," Yik said. "We think that we can have more influence as owners of the companies than if we were to sell them to someone else."

Though ESG experts contend with data challenges and broader confusion around the social pillar, they say its importance shouldn't be a particularly hard sell.

"If you're a business and you don't take care of the natural human capital in which your business relies, you will not be successful in the long term," Macindoe said. "It's just about scanning your landscape and making sure that you're going to thrive in it for the long term."