Investors get serious about ESG's link to long-term corporate performance

Board perspectives

In recent months, a number of major institutional investors—including BlackRock and State Street—have emphasized the importance of environmental, social, and governance (ESG) issues in long-term corporate strategy and have offered guidance to boards regarding how they should focus on these issues. Indeed, we see ESG issues as being fundamental to a company's long-term performance, requiring serious attention in the boardroom. How a company manages environmental and social issues—and connects these activities with strategy—are important signals to investors of how well the company is run and its long-term financial sustainability.

Whatever stage your company is on the ESG journey, a review of this guidance from some of the world's largest asset managers—which we have highlighted below—can provide a deeper understanding of why these issues are front-and-center for investors and why they are increasingly important to bottom line performance.

BlackRock on climate change and the long view

In announcing its five engagement priorities for 2017–2018, BlackRock stated that "[w]e hope that highlighting our priorities will help company boards and management prepare for engagement with us." In addition to perennial governance issues—board composition, the board's role in strategy, executive compensation, and talent—BlackRock identified "climate risk disclosures" as one of its five engagement priorities for the coming year. The investor also highlighted the importance of board diversity and other environmental, social, and governance issues (ESG).

BlackRock acknowledges the complexity companies and investors face in understanding the impact of climate change on their business models and operations over time: As a result, "[w]e believe that enhanced, meaningful disclosures are an important step towards building understanding of the impact on individual companies, sectors, and investment strategies." BlackRock went on to say that, because climate risk is a systemic issue, disclosure standards should be developed that are applicable to listed companies across each market and, ideally, globally. As a member of the Financial Stability Board Task Force on Climate-related Financial Disclosure, BlackRock suggested that the recommendations of the task force are a good road map for companies to follow in developing their climate disclosures.

On the concept of the "climate competent board," BlackRock noted that, for directors of companies that are significantly exposed to climate risk, the investor expects "the whole board to have demonstrable fluency in how climate risk affects the business and management's approach to adapting and mitigating the risk."

More generally, BlackRock reaffirmed its view that ESG factors relevant to a company's business can provide essential insights into management's effectiveness and the company's long-term prospects.

State Street links sustainability and long-term strategy

In its January letter to directors, State Street emphasizes the importance of sustainability in long-term corporate strategy: "In 2017 we will be increasingly focused on board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent management, some or all of which may impact long-term value." The State Street letter includes a framework to help boards focus on ESG issues, providing a list of questions that boards can use as a starting point to begin work with management to add a sustainability lens to its long-term strategy, including:

— Has the company identified the sustainability issues material to the business?

— Has the company analyzed and incorporated sustainability issues, where relevant, into long-term strategy?

— Does the company consider long-term sustainability trends in capital allocation decisions?

— Is the board equipped to adequately evaluate and oversee the sustainability aspects of the company's long-term strategy?

— Is the board incorporating key sustainability drivers into performance evaluation and compensation programs?

— Does the company's reporting clearly articulate the influence of sustainability issues on strategy?

Vanguard's new voting policy on environmental and social proposals

Even Vanguard, often more reserved when it comes to making across-the-board pronouncements regarding its proxy voting guidelines, has stated that its funds will now evaluate each environmental and social shareholder proposal on its merits and "may support those where [Vanguard believes] there is a logically demonstrable linkage between the specific proposal and long-term shareholder value of the company." Among the key factors Vanguard will be looking at: the materiality of the issue, the quality of current disclosures/business practices, and any progress by the company toward the adoption of best practices and/or industry norms. Vanguard's previous policy position was typically to abstain from voting on these proposals absent a compelling impact on shareholder value.

The boardroom conversation

No doubt, ESG issues will continue to rise on investor agendas—and, indeed, may become an even greater priority in an era of relaxed government regulation. Boards need to understand the ESG issues that are material to the business, have a good discussion with management around those issues, and demonstrate that they have the right processes in place to oversee management and help embed ESG initiatives into the long-term strategy. We view the recommendations—and clear policy positions—of BlackRock, State Street, Vanguard, and other institutional investors as providing boards with valuable insights and guidance to help their companies align ESG issues, strategy, and long-term performance.

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