BCG Consulting about ESG

Evidence is mounting that company performance regarding environmental, social, and governance (ESG) factors contributes to business success, and the speed at which those factors become material to any given business is increasing. Consider, for example, how quickly the COVID-19 crisis translated from a health crisis into one of the worst economic crises in recent history.

[](https://www.linkedin.com/pulse/what-covid-19-tells-us-materiality-esg-factors-veronica-chau/?trackingId=40GVpAZ9xePxQY8ujuahdA%3D%3D)

A number of drivers lie behind this increase in speed. They include greater availability of data and the related demands for transparency, society’s changing expectations as public awareness of social and environmental challenges increases, and the growing influence of investors as they integrate ESG factors into mainstream investment processes.

Because not every ESG factor will be material to all businesses and sectors, it is essential for both companies and investors to be able to identify and manage those that are. That said, what is financially material will change over time—and with rapidly increasing speed. This requires the ability to understand what makes ESG issues become financially material over time and to adapt to the changes. In a new age of materiality, investors must proactively work to to understand ESG factors and incorporate these trends into investment decision making in a more agile way.

**DYNAMIC MATERIALITY DEMANDS FORESIGHT**

Pressure for disclosure is mounting, and among those calling for ESG disclosure is the world’s largest fund manager. In his annual letter to CEOs in January 2020, BlackRock CEO Larry Fink said that the firm would be expecting disclosures in line with guidelines set by the Sustainability Accounting Standards Board and the Task Force on Climate-Related Financial Disclosures. Meanwhile, work is underway to streamline the reporting demands placed on companies. For example, the World Economic Forum’s International Business Council is developing a methodology for ESG principles—including approaches to target and track climate emissions—that will complement standard financial metrics. The launch of such initiatives does not mean that companies need to report less. If anything, the amount of data they need to disclose will increase, particularly as technological advances—such as satellite imaging that provides asset-level carbon emissions data—yield more and more information about the operations and impact of business. As a result, investors must enhance their research and analytical capabilities so that they can sift through the rapidly growing volume of data to identify the key trends influencing financial materiality.

The amount of data companies need to disclose will increase as technological advance yield more and more information about operations and impact of business. Intensifying the pressure for transparency are such stakeholders as nongovernmental organizations (NGOs), activists, and civil society groups, which are increasingly targeting investors as a strategy for achieving broad-based change. These groups are now better equipped to track companies’ social and environmental impact and, through the actions they take in response, influence corporate behavior. At a time when information is disseminated widely and immediately, movements such as #MeToo can achieve scale rapidly, creating legal, branding, recruiting, and other challenges for companies whose practices fail to meet stakeholder expectations. Investors need to anticipate these challenges and identify how they will affect a business and its performance.

Investors are factoring company performance on material environmental and societal factors into their value-creation plans and investor stewardship. The next step for investors is to engage with management teams on initiatives that can improve performance with regard to the ESG factors that are likely to become material in the future.

### FOUR TRENDS DRIVING ESG MATERIALITY

While the time frame in which individual ESG factors become financially material varies, they all do so with a dynamism that is driven by four trends: hypertransparency, stakeholder activism, societal expectations, and investor emphasis on ESG.

**Hypertransparency.** Mounting scientific evidence is driving the speed at which ESG issues become material to business. In several European countries, for example, studies on the damage to health caused by air pollution have provoked public and regulatory debates on whether to ban internal combustion vehicles. Similarly, academic research linking gender-diverse boards to improved financial performance is prompting debate on workforce gender diversity among policymakers and investors. Meanwhile, such technologies as artificial intelligence, blockchain, and virtual reality are creating unprecedented levels of transparency, enabling investors and other stakeholders to look beyond publicly reported ESG data.

**Stakeholder Activism.** Key influencers—such as the media, public figures, or NGOs—can increase the materiality of a sustainability issue to business when they disseminate evidence and create narratives that change societal expectations or prompt action by regulators or investors. Social media greatly magnifies these voices, as seen by activist Greta Thunberg’s ability to create the #FridaysForFuture youth movement on climate change, which led to global protests that attracted more than 6 million participants in September 2019.

Campaigns are becoming increasingly sophisticated. For example, within 20 days of the 2019 UN climate change conference in Madrid, the Polluters Out campaign had established a website, issued a video and a press release in multiple languages, and delivered a list of demands. Active in more than 40 countries, the group uses such online tools as Slack, Zoom, and Google Drive to organize collective action and engage others, including climate scientists. Large funders and the public are increasing their support to such groups. For example, the European Climate Foundation is financing several environmental NGOs and initiatives and contributing to the financial support of foundations. Investors must pay more attention to these efforts because, in the long term, they could lead to regulatory shifts that have sector-level impacts on asset values.

**Societal Expectations.** The evolution of materiality also comes through the influence of key decision makers. Whether they are policymakers shaping legislation, consumers making purchasing choices, or employees deciding to work for certain companies, these influencers can have a direct impact on a company’s profitability. And we see an uptick in the responsiveness of these three groups.

Policymakers are increasingly ready to take action. In Germany, for example, the government recently decided to phase out coal power by 2038. And in China, where public pressure to tackle air pollution is intense, the government has adopted a three-year action plan that includes ambitious targets for clean air and emissions in 2020.

Consumer attitudes are also shifting: demand for sustainable products and services is on the rise. According to a recent BCG analysis, 72% of consumers in Europe prefer products in environmentally friendly packaging, and 46% of consumers worldwide say that they would choose ecofriendly products over a preferred brand. In the consumer packaged goods industry, for example, a recent survey by the Corporate Eco Forum found that sustainable products were responsible for 50% of market growth from 2013 to 2018 and accounted for a dollar market share of 16.6% during that period.

We also see a shift in behavior among employees. [BCG research](https://www.bcg.com/publications/2019/organizing-future-tech-talent-purpose.aspx)revealed that 67% of millennials expect the companies they work for to be purpose-driven and their jobs to have societal impact. Employees are also more willing to publicly criticize their employers’ climate policies, and many are forming advocacy groups or submitting shareholder proposals.

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**Investor Emphasis on ESG.** Investors can influence the process by which issues become material. For example, they can evaluate companies from an ESG perspective and use the results to inform portfolio construction. And an influential investor that raises public awareness of a certain issue can cause management teams to pay attention.

This is something activist investor JANA Partners has done through its impact fund. Citing research on the psychological risks that excessive screen time poses for children, the firm pressured Apple to develop solutions. At the time, no major regulatory or societal pressure to curb youth screen time existed. But JANA Partners’ pressure on a key market player made screen time for children financially material.

Investors also shape the market by pushing for greater

transparency. Following the Brumadinho dam disaster, for example, the Investor Mining and Tailings Safety Initiative (investors representing $13 trillion in assets) called on more than 700 extractive companies to disclose information on their tailings storage facilities, prompting the creation of the first global database of tailings dams.

We are seeing more of this kind of ESG investor activism. In the US, shareholder resolutions that focused on environmental and social issues—as varied as climate change, diversity, and human rights—made up half the total in 2017, up from 33% from 2006 to 2010.

### IMPLICATIONS FOR INVESTORS

To thrive in this new age, investors need to complement their sustainable investing capabilities with the ability to foresee and transparency. Following the Brumadinho dam disaster, for example, the Investor Mining and Tailings Safety Initiative (investors representing $13 trillion in assets) called on more than 700 extractive companies to disclose information on their tailings storage facilities, prompting the creation of the first global database of tailings dams.

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### IMPLICATIONS FOR INVESTORS

* To thrive in this new age, investors need to complement their sustainable investing capabilities with the ability to foresee and improving performance on future material issues
* Contributing to broader efforts to understand the dynamism of materiality through transparent reporting and disclosure about portfolios

### A WIN FOR ALL STAKEHOLDERS

Strong performance with regard to such ESG factors as carbon reduction and greater gender equality can unlock significant positive impact for investors, companies, and society. Similarly, integrating forward-looking ESG considerations into strategy and practice can lead to long-term corporate resilience and improved allocation of capital.

Consumers, activists, and employees all play a role in determining which ESG issues become material to business, but companies and investors can also become key influencers of the materiality process. Adopting an always-on approach to materiality allows investors to gain competitive advantage by optimizing performance with regard to current and future material ESG issues.