

What Are ESG Funds?



ESG investing has grown in popularity in recent years as investors have become increasingly aware of sustainability's importance in the long-term success of companies. Because of this, some mutual fund and exchange-traded fund companies have introduced ESG funds to investors. Here is everything you need to know about ESG funds and how to decide if you should invest in them.

Key Takeaways

- ESG investing is investing in companies that promote positive environmental, social, and governance fundamentals.
- ESG investing is not without controversy, as some see it as a money grab.
- ESG investing is very similar to socially responsible investing (SRI), and people often interchange the two terms.

What are ESG Funds?

ESG is short for Environmental, Social, and Governance. The acronym identifies companies engaging in business practices that align with the fundamentals of an ESG stock pick.

ESG funds are portfolios of securities and bonds from companies that have included environmental, social, and governmental factors in their investment process. A company with a strong history and outlook in these areas qualifies for inclusion in such an investment portfolio. In contrast, a fund may not consider a company with a poor track record in these areas for inclusion in its portfolio.

Some fund managers intentionally focus on companies they believe have room for improvement when addressing ESG risks and opportunities. Increased exposure may encourage a company to align its operations further with ESG standards.

The rationale behind ESG funds is straightforward. Improving sustainability and the quality of life for the population are noble causes. Studies have shown that entities incorporating ESG into their investment decisions perform better than those who don't.

For example, a company that decides to stay ahead of government regulations by installing clean air equipment or finding ways to reduce energy consumption may receive good press. Hearing about the company's responsible risk management, investors may extrapolate that the company is generally efficient and stands by sound principles.

ESG funds are also a way for investors to get involved with ecological and sociological issues that improve life on the planet, all while getting a return on their investment.

Why the Push for ESG?

ESG as a concept is controversial in many ways. On one side, investors who want to help shape a better future for the planet look for companies demonstrating these principles. On the other hand, many industry names are ideologically opposed to the concept.

ESG has snowballed as a concept, and investors have embraced it as a way to make sustainability profitable by encouraging companies to engage in green practices. However, investors need to understand it's still relatively new compared to other investment vehicles.

Arguments for ESG

Many investors, from individuals to major-name brokerages, have enthusiastically turned to ESG investing. A small-time investor can rest easy knowing their hard-earned money is going toward a company with responsible operations.

Meanwhile, brokerages can offer a new portfolio product that combines savvy investing principles with stocks from companies committing themselves to improve the world. Investing in these companies encourages them to stay the course and use their financial strengths to achieve as much good as possible.

Criticisms of ESG

The arguments against ESG usually focus on the lack of definition around the concept and concerns about "greenwashing."

Some critics argue there need to be more standards for using ESG as a label and that many operations use the acronym to attract investors who won't look deeper to determine if the companies are as socially responsible as an ESG rating makes them seem.

Some conservative critics have argued ESG funds don't focus on getting investors the best return possible but are instead efforts from funds to seem more "woke." Because of this, ESG has inadvertently become part of a recent culture war.

Both former vice-president Mike Pence and Florida governor Ron DeSantis publicly opposed ESG investing. Some proponents of ESG investing have criticized the backlash from Republicans as a form of climate denialism.

ESG has a lot of promise as a way of combining investing with activism. It satisfies many global concerns about our world and encourages companies to create a brighter future for tomorrow's children.

Questions remain, however, about the label's standards and whether ratings accurately reflect a company's ethics. Sustainability can mean different things to different people. So while a business might think it's ahead of the pack in its commitment to specific environmental issues, experts might disagree.

ESG vs. Socially Responsible Investing vs. Corporate Social Responsibility

Many investors use ESG, socially responsible investing (SRI), and corporate social responsibility (CSR) interchangeably. However, there are some slight differences between them.

ESG investing considers environmental, social, and governance factors when deciding where to put money. SRI is broader and can include anything an investor finds important. This could be environmentalism, faith-based principles, or supporting companies with good customer service. CSR is what a company does to give back. It includes things like sustainability programs, community involvement, and charitable giving.

Most of the time, you'll see ESG and SRI used together. This is because they involve a lot of the same principles. Some would argue that SRI is a type of ESG investing. The critical difference is that SRI can be more flexible in what it considers. ESG has specific environmental, social, and governance factors that it focuses on.

How does a Company Get an ESG Rating?

No single entity reviews companies and assigns the most ethical an ESG rating. Instead, various investment firms, consulting groups, NGOs, and even government bodies can use their own scoring systems for rating companies.

For example, the Institutional Shareholder Service (ISS) is an advisory service that provides various scores and ratings for companies, including a carbon risk rating. A group can evaluate a company by communicating directly with its employees about its sustainability efforts or by reviewing publicly available information.

Any of the following factors could be involved in a group's evaluation of a company:

- Air and water pollution
- Deforestation
- Waste management
- Labor standards
- Gender diversity
- Board composition
- Allegations of bribery

In the future, if groups apply a more universal rubric to ESG ratings, the investing practice may become more popular among skeptics. Because there is no unified SEC rating of "score" for ESG, the label can risk seeming inconsistent or arbitrary.

Why should we believe a company upholds ESG values if it receives the label from one group but not another?

Examples of ESG Funds

Currently, over 580 sustainable ESG funds and ETFs are available for investing. Here are five of the most popular funds. This does not represent an investment recommendation on our part. We want to give you the names of certain funds so you can research them further and better understand ESG funds.

Vanguard FTSE Social Index Fund Admiral (VFTAX)

Vanguard's VFTAX fund holds Apple, Microsoft, Amazon, and Alphabet. It's classified as an aggressive fund, and its return tends to be volatile. However, despite this, the holdings in the fund are solid.

The Vanguard website says the fund excludes stocks "of companies that do not meet certain labor, human rights, environmental, and anti-corruption standards as defined by the UN Global Compact Principles."

Shelton Green Alpha Fund (NEXTX)

Shelton Green Alpha Fund focuses on identifying green economy companies with solid growth potential. It invests in companies focused on products and services that mitigate environmental and economic systemic risks.

Parnassus Core Equity Fund (PRBLX)

This fund's managers focus on finding stocks that engage in ESG and exclude ones that get most of their revenue from fossil fuels, tobacco, nuclear power, gambling, and alcohol. They use ESG screeners to refine their search and identify companies with competitive advantages and ethical practices.

iShares Global Clean Energy ETF (ICLN)

iShares ICLN ETF is an example of how fund managers try to create ESG funds and keep them balanced while adhering to ESG principles. In April 2022, the fund underwent methodology changes to rebalance its holdings. ICLN contains securities, including companies producing solar, wind, and other forms of renewable energy.

1919 Socially Responsive Balanced Fund (SSIAX)

1919 Fund's SSIAX fund focuses on a high return from a socially responsible portfolio. It identifies undervalued securities and determines if the issuing companies are operating in a socially responsive fashion. SSIAX seeks to hold 70% of its assets in U.S. stocks and 30% in investment-grade U.S. debt.

The Bottom line

ESG funds incorporate environmental, social, and governance issues into their selection processes. They allow investors to invest in companies with ethical practices. Critics of ESG are only sometimes arguing in good faith. No central organization decides which companies to include in ESG funds, so it's always good to research different funds' selection processes.

Investing in ESG funds comes down to the individual investor and their beliefs about environmental, social, and government change. Investing in these types of funds is not required to have a diversified portfolio. Investors usually invest in these funds to support businesses that positively impact the world. But other investors not interested in investing in these businesses can still invest with success.

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