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The Materiality of The "S" In ESG

July 07, 2020

Katherine Kroll

Environmental, social, and governance (ESG) research among institutional investors has historically focused mostly on the “E” and the “G,” leaving social issues as somewhat of a forgotten middle child. Investors have concentrated on quantifiable environmental targets such as carbon emissions, and on best governance practices for compensation and board composition; meanwhile, social investment risks—especially risks related to racism and racial injustice—have often taken a back seat.

There are several factors that may have led institutional investors to deemphasize social issues in their research. Social matters have been viewed as abstract in nature, and they are often broadly intertwined with our societal fabric, which makes it very difficult to develop a quantitative model for understanding how these matters impact corporate performance. Additionally, there is an undeniable disconnect between the demographics of typical institutional investors versus the populations that are most directly impacted by the negative externalities of such investments.

We believe that a company’s positive and negative social attributes are material and salient investment factors. Not only do these attributes represent meaningful risks and opportunities on their own, they are often inextricable from the environmental and governance matters that have captured the lion’s share of attention from ESG investors. We have seen this intersectionality play out very clearly in 2020; the evolution of the COVID-19 pandemic and the powerful reaction of society against police violence have developed in a highly interrelated matter. This has forced international attention on linkages in social and environmental justice that the Black community in the U.S. and other marginalized populations have long understood. It is just one of many examples that demonstrate why we believe that “E,” “S” and “G” issues need to be evaluated in concert with each other, and not in isolation.

INVESTMENT AND JUSTICE

As humanity’s technological and industrial footprint has expanded, our impact on the world has intensified, and our actions in one place can have meaningful impact in other places. This is the basis of environmental justice, a concept that can play out both globally and locally.

On a global scale, the U.S. is the second-largest carbon-emitter in the world, next to China. The U.S. plays a meaningful role in determining the fate of many low-lying island nations—these countries generally have miniscule carbon footprints, yet their very existence above water is threatened by climate change. We believe an investment approach that seeks to avoid the destruction of nations is wise from a moral perspective, as well as from a financial perspective given the interrelatedness of the global economy. This is one of the reasons we seek to largely avoid investments in the world’s biggest corporate emitters. Simply put, we think there are better investments on the table.

Domestically, we can look at the community of Port Arthur, Texas for a stark example of environmental injustice. The city is home to the largest oil refinery in the U.S., and the surrounding area has been referred to as “the Cancer Belt” since the 1980s. Serious health conditions, including cancer, respiratory conditions and many other illnesses run rampant in Port Arthur. The communities closest to the refinery are predominantly populated by people of color, and those communities and their health are disproportionately affected. Texas Cancer Registry data from 2017 reported that Black people in Jefferson County, which includes Port Arthur, had cancer rates 15% higher than average Texans, and cancer mortality rates nearly 40% higher than the state average.¹

Notably, preexisting respiratory conditions are a common result of living near facilities such as refineries or hazardous waste facilities, and those circumstances are also a key indicator of survival rate for those infected with COVID-19. This is all part of a broader mosaic in the U.S. that systemically harms people of color; Black people in the U.S. are 4x more likely to die from COVID-19², 2.5x more likely to die from police brutality³ and 3x more likely to die from air pollution than white people.⁴

These concepts can come into play in our investment decisions. Our fixed income team recently passed on investing in bonds issued by a large city’s municipal water utility, for example; the reasoning was not just because of concern over water quality, but also because the team was concerned that the people at greatest risk of having contaminated water would be people of color.

PUBLIC OPINION IS SHIFTING, AND IT MATTERS

Issues perceived as “too political” can be divisive, and difficult to navigate. Climate change, the COVID-19 pandemic and racially-driven police violence—these issues all have highly polarized stakeholders and progress is slow as a result.

As long-term investors, we need to expect that highly divisive issues may evolve into consensus viewpoints in the not-so-distant future. Climate change stands out as an example of this concept. In 2010, the materiality of climate change risk was still widely debated in political and corporate circles; yet today, the corporate world has largely come to agree that climate risk is dangerous and that it is good business to try and mitigate that risk. We believe this

was driven at least in part by ESG research practices that consistently looked at climate risks through an investment lens, looked at the cost/benefit of

climate resilience measures being considered by companies and governments, and importantly, identified companies poised to expand existing businesses or create entirely new ones based on the growing customer demand for solutions to reduce energy, water and other resource usage. To a meaningful extent, company and issuer action on climate change has become the expectation, not the exception.

Climate change and racism are not identical issues. Rising sea levels are scary, but they do not force us to look in the mirror and confront our society's prejudices and systemic biases. But climate change is increasingly understood as a risk to investments, health, and justice, and we view social issues like racism in the same manner.

We think one clear factor investors need to consider is the racial diversity and progressiveness of Generation Z, which accounts for 40% of consumers as of 2020.⁵ The rising generation has high expectations for companies with regard to sustainability and social responsibility. They want to work for businesses and buy products that reflect their diversity and inclusiveness, and companies are going to need to meet this generation's expectations to attract their talent and purchasing dollars. Approximately 90% of Generation Z supports Black Lives Matter, and brands that do not clearly articulate anti-racism efforts risk losing this cohort as customers or colleagues.⁶

WHAT WE ARE DOING AS INVESTORS

Deep-seated social inequities such as systemic racism cannot be fixed with a single approach. Efforts on multiple fronts are needed to fully realize the vision of "liberty and justice for all." In addition to the political and civil debates occurring across the U.S., we believe that investors can and will play a role, and that companies and bond issuers will be held increasingly accountable for the impact they have on their colleagues, communities, and customers.

Our firm's ESG research process seeks to dynamically respond to complex problems. For many years, we have used this process in an effort to examine a wide range of factors that we believe influence an issuer's or a company's long-term health and prosperity, such as employee treatment, customer care, health and safety, and other responsible management practices. These factors are always meaningful for issuers and companies, and social issues such as the COVID-19 pandemic and racial inequality simply reinforce just how important these factors are.

We seek to continue to approach social issues, like racism, through ESG and fundamental research integration, proxy voting, and direct engagement with companies and bond issuers.

Engagement: We are actively promoting racial justice under our firm's three primary 2020 engagement priorities: Diversity, Climate Change and AI Ethics.

Diversity: Through engaging with companies and issuers on diversity and inclusion, we can encourage them to increase their representation of diverse identities—not just because it is the right thing to do, but because it is also good for business (for example, companies with above-average diversity scores are nearly 20% more likely to have increased innovation revenue compared to companies with below-average diversity).⁷ We can also encourage structural transformation to support racial justice; an example is investing in municipal bonds that seek to ensure equitable access to essential resources and services, like affordable housing, public transit, and education.

Climate Change: Through advocating for climate change mitigation, we can encourage businesses and communities to prepare for climate resiliency, knowing very well that climate change will likely affect communities of color disproportionately, as well as efforts to mitigate the damage from climate change.

AI Ethics: Our engagements focused on responsible AI Ethics and data privacy are aligned with our prioritization of anti-racism. Surveillance technology is often embedded with the human bias of those who program it, so it is not entirely surprising to find that technologies such as facial recognition are less accurate for people of color. In a landmark 2019 study, a majority of facial recognition algorithms in use across the U.S. showed worse performance for nonwhite faces versus white faces—in some cases, drastically worse.⁸ Another study showed that one technology misidentified a number of black U.S. lawmakers for criminals.⁹ AI Ethics is still an evolving topic, but AI is bound to play a material role in upholding human rights in the future. We have been in dialogue with the leading companies producing AI technology and making decisions about data privacy for the last two years. We were encouraged by the actions of several of these companies following efforts led by the Black community in the wake of the recent examples of police brutality highlighted in 2020. Several large technology companies will limit the use of their facial-recognition systems going forward, and will not sell the controversial technology to police departments until there is a federal law regulating the technology.

Proxy Voting: Our decisions regarding proxy voting help complement our engagement approach. As equity investors, we tend to vote in favor of shareholder proposals that encourage diversity and discourage institutional racism. For example, our firm voted in favor of a recent shareholder proposal that called on the company to evaluate its impact on communities of color as it relates to environmental justice. This vote was cast despite our proxy voting service provider recommending we vote against it.

Investment Choices: Beyond our engagement efforts with regard to racism, we proactively seek equity and fixed income investments that are impacting this issue positively, such as companies receiving high marks with regard to diversity and inclusion and bonds from issuers who are expanding access to basic human rights like clean water. By studying metrics around representation, pay parity, accessibility of products, arbitration policies, health and safety, and how companies and issuers are impacting the communities in which they operate, we seek to avoid investments that worsen racism and favor those that are working to solve for it.

CONCLUSION

Marginalized populations have suffered for many years from racial violence, unequal access to public health, disproportionate impact of climate change and many other injustices. These societal challenges are not new, and we expect them to grow in importance and materiality. At Brown Advisory, we are focused on using this global inflection point to further strengthen our commitment to diversity and equity. We have taken many of the actions we ask of companies and issuers, such as improved disclosure, goal-setting with regard to hiring and promotion, and forming a racial justice task force. There is more to do. And we will hold companies, bond issuers and ourselves accountable. [B](#)

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1. http://www.naacp.org/wp-content/uploads/2017/11/Fumes-Across-the-Fence-Line_NAACP_CATF.pdf
 2. <https://www.forbes.com/sites/isabeltogoh/2020/05/07/black-people-are-four-times-more-likely-to-die-from-coronavirus-uk-statistics-show/>
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 4. <https://qz.com/1226984/environmental-racism-has-left-black-americans-three-times-more-likely-to-die-from-pollution/>
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 9. <https://www.nytimes.com/2018/07/26/technology/amazon-aclu-facial-recognition-congress.html>

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