MIT MANAGEMENT SLOAN SCHOOL | IDEAS MADE TO MATTER

STRATEGIES FOR SUSTAINABLE BUSINESS

Companies are under pressure from multiple stakeholders to adopt sustainable business practices. These four articles offer actionable advice.

CONTENTS

4 strategies for sustainable business

by **Dylan Walsh**

Why It Matters

Companies are under pressure from multiple stakeholders to adopt sustainable business practices. Here are four foundational tenets to guide your strategy.

It took decades, but sustainability is finally a mainstream business practice.

Or is it?

Ten years ago, 20% of companies in the S&P 500 index published sustainability reports detailing their economic, environmental, and social impact. By 2019, the figure was 90%. The CEO of BlackRock, the world's largest asset manager, declared in a recent annual letter to CEOs that climate change was "a defining factor in companies' long-term prospects."

Widespread recognition of the importance of sustainability in business is "great news," said management professor John Sterman, co-founder of the MIT Sloan Sustainability Initiative. But it doesn't tell the full story.

As part of the initiative's commitment to "fundamentally shift how the business world embraces sustainability," Sterman and colleagues routinely poll business leaders about progress at their firms. Despite the proclaimed importance of sustainability, these leaders rarely report that sustainability action is embedded throughout their organization.

Rather, companies issue reports through public relations or government relations departments, engage in sustainability activities only when they believe it is profitable, or comply with applicable environmental laws and regulations — nothing more.

"This is a huge disconnect," Sterman said. "And it is also a huge opportunity." Firms that invest in sustainable practices, he said, will reduce risks and cut costs while likely gaining competitive advantage as demand for sustainable goods and services grows.

With that in mind, here are four guiding principles from MIT Sloan experts to help global leaders set sustainability strategy for their organizations:

1. Listen, internally and externally

MIT Sloan senior lecturer Jason Jay, director of the Sustainability Initiative, articulated two approaches that companies must balance when tackling sustainability.

The "outside-in" approach centers on listening to the concerns and demands of stakeholders, from investors to consumers to prospective employees. Listening allows companies to identify and shape their response to new sustainability issues as they emerge, Jay said.

It also helps them clarify their position relative to competitors and recognize novel opportunities for leadership. Jay highlighted the example of McDonald's. Confronted by Greenpeace over its use of soybeans grown on land cleared in the Amazon rainforest, the fast-food chain ultimately partnered with the global environmental organization to eliminate that soy from its supply chain.

The "inside-out" approach requires introspection; it is about convening those who define the culture of a company — board members, the C-suite, star employees — and discussing what the company exists for and the mark it wants to leave on the world.

Refining a company's social mission illuminates the issues on which it will take a stand. Examples can be found in "any of the purpose-driven companies that have been mainstays of the B Corp movement," Jay noted. As an example, he cited Patagonia, which, since its founding, has used the tools of business to address environmental crises.

"Ultimately, you can't get away from doing both," Jay said, but each approach comes with distinct challenges.

As companies turn inward, they may overlook the rise of new, urgent sustainability issues. Patagonia recently had several "tough engagements," as Jay put it, around the Black Lives Matter movement. Companies facing outward, to stakeholders, may be pulled in many directions at once, and, as a result, fail to exhibit meaningful and durable progress.

"An important point of reflection is to consider the balance between these modes of inquiry," Jay said. "If you're running in circles chasing stakeholder expectations, then you need to ground yourself with the internal work; if the world is changing around you and you aren't responding, you may be too self-satisfied and insular."

2. Deploy overlapping timelines

Richard Wilner, EMBA '19, head of business excellence and sustainability at Takeda's BioLife Plasma Services, likes to define solutions to any given sustainability challenge across several time scales — generally months, years, and decades. He described the case of plastic waste.

In the short term, BioLife is working to reduce plastic use and recycle specific components of their blood plasma collection kits, which are difficult to recycle because they are labeled biohazardous and are composed of several different polymers.

In the medium term — the next several years — BioLife is striving to work with its strategic suppliers to design a more circular system. Are there interventions that will allow them to take existing plastics, break them down, and feed them back into manufacturing?

Finally, in the longest time frame, the company's ambition is to fully eliminate

> *Overlapping time frames are a way to attack broad and often messy challenges.*
>
> **Richard Wilner** | BioLife Plasma Services

plastics. Though this could take decades given the operational, regulatory, and supply chain challenges associated with such work, their near-term and intermediate steps are designed to explicitly move them toward the big-picture goal.

"The objective is to get rid of this material altogether, but that is not the only place we're focusing energy," Wilner said. "There is much we can do to adjust our trajectory now so that when we get to the point of eliminating plastics, we have significantly attenuated the problem. These overlapping time frames are a way to attack broad and often messy challenges."

3. Develop a mix of metrics

Citing the work of Sustainability Initiative co-faculty director Roberto Rigobon, an MIT Sloan professor of applied economics, Jay described three distinct methods by which companies should measure their sustainability efforts.

First, companies should establish overarching intentions by drafting principles and mission statements; they can join coalitions and establish codes of conduct for supply chain partners. While these do not immediately sound like metrics, "a metric can be a binary variable," as Jay put it. Is Company Y part of the United Nations Global Compact: yes or no?

Such declarations are also becoming increasingly specific — and powerful — as companies adopt goals like net-zero carbon emissions by 2050. "Such a statement doesn't say there is a procedure in place, and it's not measuring any outcomes like total carbon footprint," Jay said. "It's a declaration of intention, an alignment to broader societal objectives, but some companies have it and others don't."

Sterman agrees, noting however that without specific, measurable, transparent actions and outcomes, goals like "net-zero by 2050" become meaningless or worse: corporate greenwashing. "Aspirations are great. Actions are essential," he said.

Second, companies should be clear about the processes they've established to move toward sustainability — what Jay, citing Rigobon, calls "procedural sustainability." How many of their factories, for instance, are ISO 14001 certified? How many materials come from sources certified as sustainable, or how many products are stamped with labels, like the Rainforest Alliance, that suggest a basic level of sustainability? "Ideally, these processes increase the likelihood of good outcomes," Jay said.

Third, companies must measure those outcomes. What are annual greenhouse gas emissions? How many tons of waste are generated per month? These outcome measures are used to benchmark progress toward sustainability. Importantly, these metrics must be granular enough to drive change — a point that arose on a panel at the recent MIT Sustainability Summit, where large companies like Salesforce, Amazon, and Google discussed how they measure climate impact.

Amazon started out by tracking its total carbon footprint. While a helpful figure in its own right, it could not inform investment or dictate specific actions. So the company built a detailed model showing carbon dioxide per unit shift as well as the electricity required to power data centers; this helped the company spotlight deficiencies and develop targeted responses, according to Dara O'Rourke, SB '89, a senior principal scientist at Amazon who spoke on the panel.

Rigobon notes that different approaches to metrics complement one another, Jay said. "The biggest mistake [companies] make is relying too heavily on only one of these three instead of measuring holistically."

4. Connect sustainability with diversity, equity, inclusion, and justice

Companies often separate DEIJ and environmental sustainability efforts. They shouldn't. "Climate change is necessarily a justice issue," Jay said.

Those who have been most affected and who will continue to be most affected by environmental degradation, he noted, are Black and brown people primarily in southern latitudes. "I think that racism ultimately underpins much of climate inaction. Lack of solidarity will always be toxic."

> *Climate change is necessarily a justice issue.*
>
> **Jason Jay** | MIT Sloan

Connecting these worlds opens tremendous opportunity. Sterman offered the example of increasing energy efficiency in low-income housing — an issue that companies like BlocPower are tackling.

The poorest and most disadvantaged communities are also those with the least efficient housing, and, as a result, every winter "too many are forced to choose between heating and eating," Sterman said.

"People turn down the heat and wear parkas inside. But they then suffer from higher rates of pneumonia, bronchitis, and other illnesses, often ending up in the emergency department or hospital. Kids stay home from school; parents miss work. Life outcomes suffer."

"But if you complete a deep energy retrofit on that housing, people can turn their thermostats up and still have lower energy bills, boosting their disposable income. Their health improves, reducing costly medical emergencies and hospitalizations. Parents are less likely to lose their jobs; kids do better in school," Sterman said. "You have a win for the environment and help redress longstanding inequalities in our society."

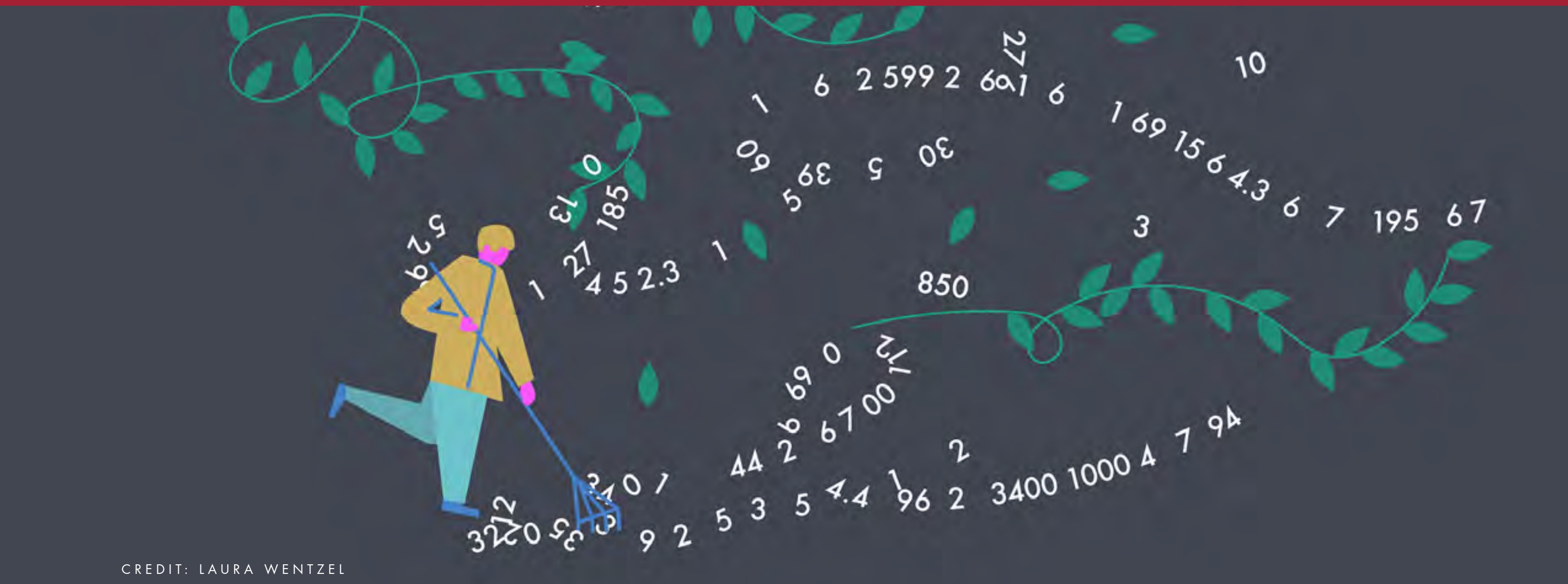
Jay described the broader imperative for the sustainability movement to embrace economic and political equity. "What's really essential is a just transition," he said. As industries like oil, gas, and coal are phased out, a "glide path" must be in place to help those displaced. Economic transitions have traditionally been racially exclusive, he said, and the current moment presents a chance to reimagine these transitions.

"It's obvious that we can't have prosperity, good health, security, equity, and peace if we destroy the environment," Sterman said. "But it's equally true that we won't have a healthy environment if people are poor and hungry, lack decent shelter, meaningful work, and opportunities to develop.

"Building a safe, equitable, sustainable world requires that we recognize the fundamental alignment of a healthy environment, healthy economy, and healthy society."

"Building a safe, equitable, sustainable world require that we recognize the fundamental alignment of a healthy environment, healthy economy, and healthy society."

John Sterman | MIT Sloan



CREDIT: LAURA WENTZEL

Why sustainable business needs better ESG ratings

by **Beth Stackpole**

Why It Matters

Environmental, social, and governance data is noisy — and may not help firms protect the planet. Here's what to keep in mind as you measure and invest.

As the financial community enthusiastically embraces environmental, social, and governance investing, there are two things it should know:

- ESG ratings are measured differently across agencies, and can therefore be an inconsistent measure of performance.
- Some experts are increasingly skeptical that ESG scores have any direct correlation to more sustainable business.

In a recent Q&A, Lenora Suki, product manager for sustainable finance solutions at Bloomberg LP, summed up the situation: "Right now, information about sustainability is often nonfinancial and so diffuse and diverse that it's difficult for decision-makers to digest and synthesize into strategic and operational decisions."

21%

Slightly more than a fifth of CEOs responding to a 2019 United Nations/ Accenture joint survey felt businesses are actually making a difference in the worldwide sustainability agenda.

And investors are evermore enthusiastic about ESG investing.

According to the Global Sustainable Investment Alliance, global sustainable investment reached $35.3 trillion at the start of 2020, a 15% increase over the past two years. In addition, the same report found that sustainable investment assets under management comprised more than a third (35.9%) of total assets under management in 2020, up from 33.4% in 2018.

A majority of business leaders are fully onboard with sustainability measures, while also aware their efforts may not have significant impact. In 2016, a United Nations/Accenture joint survey found that more than three-quarters (78%) of CEO respondents believed corporate efforts would contribute to the Global Goals adopted by the United Nations as a universal call to action to end poverty and protect the planet.

In the most recent survey (2019), slightly more than a fifth (21%) of responding CEOs felt that businesses are actually making a difference in the worldwide sustainability agenda. Nevertheless, almost half (48%) remain committed to implementing sustainability as part of their overall operations.

The disconnect between accelerating ESG activity and confidence in the results should serve as a wake-up call for companies and investors alike, according to Kenneth Pucker, SM '90, the former COO at Timberland.

Challenges include discrepancies in ESG measurements, ongoing data quality problems, and the pervasive greenwashing that can happen as companies try to spin their data in a positive light, said Pucker, who in June published "Overselling Sustainability Reporting" in Harvard Business Review.

"ESG rating firms take self-reported data from companies on their corporate social responsibility [CSR] activities, add their own information and weightings, and mix it in a caldron to come out with a rating for a company," said Pucker, now a senior lecturer at the Fletcher School at Tufts University.

"A problem is garbage in, garbage out," Pucker said. "The reporting is not complete, results are mostly unaudited, and they are not comparable, so ESG ratings often use bad data that's unaudited, extrapolated, and interpolated."

Why ESG ratings diverge—and what to do about it

The MIT Sloan Sustainability Initiative has taken up the cause with the launch of the Aggregate Confusion Project, aimed at improving the quality of ESG measurements.

> *Relying on the scores of several complementary [ESG] ratings yields better results.*
>
> **Florian Berg** | MIT Sloan

ESG ratings are used by individual investors and fund managers to guide investment strategies by understanding potential sustainability risks to business performance. Companies also leverage ESG ratings as an internal benchmarking tool to help improve sustainability performance and for potential public relations opportunities.

The problem, as defined by the MIT project, is that ESG data is noisy. That leads to a divergence in ratings from the independent agencies that evaluate and assign ESG ratings to firms, according to Florian Berg, a research associate working on the challenge. In turn, that leads to confusion and a much lower probability that ESG ratings have a direct correlation to financial performance, undermining their utility as an investment tool, Berg said.

Berg, along with research affiliate Julian Köelbel and MIT Sloan professor Roberto Rigobon, has published three papers on ESG rating divergence and its impact. Using a common taxonomy and various mathematical modeling techniques, the MIT team was able to fit the different rating agency approaches into a consistent framework to better understand the ratings' differences.

In the initial paper, the researchers identified the following takeaways:

There's ambiguity around ESG ratings. The research found the correlation among from six prominent ESG rating agencies — KLD, Sustainalytics, Moody's ESG (Vigeo Eiris), S&P Global (RobecoSAM), Refinitiv (Asset4), and MSCI — was on average 0.61. In comparison, mainstream credit ratings from Moody's and Standard & Poor's are correlated at 0.99.

The finding suggests that ESG ratings do not properly reflect ESG performance, making it difficult for decision-makers to identify outperformers and laggards.

Divergence in ratings also hampers the motivation of companies to improve their ESG performance, the paper states, because there are mixed signals from rating agencies about what to focus on and what is valued in the industry.

There are three factors driving rating divergence. ***Scope divergence*** occurs when ratings are based on different attributes — for example, one rating agency includes carbon emissions or labor practices while another does not — which leads to rating inconsistencies. ***Measurement divergence*** happens when agencies measure the same attributes, but do so using different raw data, which results in different assessments. The last factor relates to ***weight divergence***, which emerges when ESG rating agencies take different views on the relative importance of attributes.

They also identify something they call the "rater effect," namely, a firm receiving a high score in one category is more likely to receive high scores in other categories, particularly from that same rater.

As part of their ongoing research, the team is trying to understand the effects of ESG-driven investment flows on stock price and company behavior. They are also developing smarter ways to aggregate ESG factors into composite indices for use by portfolio managers and passively managed funds.

ESG ratings and stock performance

A subsequent paper depicts in detail a noise-correction procedure designed to tackle the bias caused by noisy ESG data and rating divergence. Using a variety of modeling techniques, the research team was able to demonstrate ESG ratings actually have a much higher impact on stock returns than previously anticipated.

Without the correction procedure, standard regression estimates of ESG ratings' impact on stock returns were biased downward by about 60%, Berg said.

"We found the link between financial performance and ESG performance to be stronger because it's not overshadowed, hidden by noise," he explained.

The practical takeaway from the research: "Relying on the scores of several complementary ratings yields better results," Berg said.

Addressing ESG shortcomings

Next steps for the Aggregate Confusion Project are to work with industry partners to gather data, solicit feedback, and create a set of best practices for use by ESG rating providers as well as the companies reporting CSR data for disclosure purposes.

Improving the measurement of raw data and formalizing best practices is all well and good, but Pucker is convinced it will take global standards and formal audits to demonstrably bolster the utility of ESG ratings.

Pucker explained that the environmental impacts of sustainability reporting and ESG investing have been oversold, hampered by lack of oversight into what goes into sustainability reports as well as huge gaps in data tracked to generate a complete picture of a company's carbon footprint.

As an example, Pucker cited Scope 3 emissions, which comprise all the upstream and downstream emissions generated by suppliers and customers. Figures from CDP, a global aggregator of corporate carbon emissions data, show that only about half of companies disclosing CSR data report on Scope 3 emissions even though that constitutes the bulk of their greenhouse gas impact.

More pointedly, Pucker contends that the problem is bigger than noisy data or rating discrepancies.

At its core, ESG investing may deliver better financial returns for investors, but it's not designed to deliver the intended impact for solving environmental problems.

"Asset managers have incentives to drive equity returns, not solve water problems in Egypt or deforestation in Malaysia," Pucker said. "It's not what they are paid to do."

Pucker believes that impact investing is better positioned to make more of a material difference. Estimated by the Global Impact Investing Network to be a $715 billion market, impact investing targets companies or institutions that have specific intentions to build products and services that generate social or environmental impact — for example, one that is actually developing technology that solves water problems.

This type of investment in companies pursuing climate tech to solve transportation, agricultural, energy, and land use challenges is more likely to deliver change, Pucker said.

More work to be done

Regardless of that debate, Pucker said that the industry has a lot of work to do to get better at CSR reporting and make ESG ratings a more effective tool.

Making reporting mandatory, creating comprehensive standards on what to report, increasing transparency in what is reported, and enacting some form of industry or regulatory governance is one piece of the equation. Efforts like the Aggregate Confusion Project for improving data quality and ESG measurements is another critical step.

"All those things will help the correlation of ratings converge among different raters; but to me, that's not a leveraged solution for impact," Pucker said. "Ultimately, addressing environmental and social externalities needs effective regulatory policy."

CREDIT: LAURA WENTZEL

5 up-and-coming jobs in sustainability, and what's next

by **Meredith Somers**

Why It Matters

Here are five jobs that reflect the booming sustainability space — and how they intersect with efforts toward diversity, equity, and inclusion.

Decades before environmental, social, and governance became the fast-growing investment area it is today, individual employees were creating sustainability opportunities in their organizations — leading a used-book drive, or advocating for double-sided printer settings.

Over time, that handful of concerned employees spread into different departments within a company. Supply chain managers started to examine their companies' sourcing, traceability, and relationships with distributors. Regulatory compliance roles began to emerge as laws like the Clean Air Act and Clean Water Act were enacted, and government relations divisions turned their attention to managing lobbying dollars and community outreach.

But it wasn't until the last 15 to 20 years when this shift from reactionary to proactive environmental practices became the norm, and a company's sustainability was tied to its success, explained Bethany Patten, lecturer and senior associate director of the Sustainability Initiative at MIT Sloan.

"Now there's a whole set of roles and industries that have popped up around socially responsible investing and ESG," Patten said.

Sustainability is no longer an afterthought in corporate strategy; it's embedded into every part of an organization. Even the public sector has realized this, she said, pointing to President Joseph Biden's "whole-of-government" approach to the climate crisis.

"The tides have changed in terms of organizational design," Patten said.

To reflect that change in companies, the MIT Sustainability Initiative shares with its students a matrix of where and what kinds of jobs are available in the field.

A Sampling of Sustainability Roles — and Where to Find Them

Type of Company/Organization

Job/Role	Traditional	Sustainability-Oriented
Traditional	Product Operations Lead, *Gusto* Product Marketing Manager, *Facebook Marketplace* Senior Manager, *Bain & Company* Director of Transportation Strategy, *Nike*	Investor, *Generate Capital* Co-founder and Chief Product Officer, *Spoiler Alert* Senior Director of Marketing Operations, *BlueWave Solar* Associate Manager, *Tesla*
Sustainability-Oriented	Principal Tech Business Development, *Amazon* VP of Sustainable Infrastructure and Growth Initiatives, *NHL* VP of Sustainability, *Salesforce* Operations Analytics and Performance Director, *Converse*	CEO, *Scaletech* Head of Growth and Partnerships, *Upstream Tech* Founder and CEO, *AgThentic* Associate Director of Climate Finance, *Climate Policy Initiative*

Credit: Distributed by the Sustainability Initiative at MIT Sloan. Matrix adapted from Katie Kross, "Profession and Purpose."

Here's a closer look at five MIT Sloan alumni with 21st-century sustainability jobs, and expert insight on how such roles can intersect with diversity, equity, and inclusion.

Neha Thatte Mallik
Keurig Dr Pepper

Senior product manager — Keurig Dr Pepper

Even though "sustainability" isn't in her job title, 90% of Neha Thatte Mallik's work at the beverage producer and distributor is related to it.

"My role is on the coffee pod innovation team, but the majority of my work is driving sustainability through understanding what consumers want, and coming up with an innovative product road map that delivers that through sustainable materials and processes," Mallik said.

Mallik joined the company in 2016 as a manager responsible for the brand and communication strategy for recyclable K-Cup pods. In 2019, she transitioned to her current role, which includes overseeing the strategy and execution of different sustainable pods due to launch in the future.

Mallik said she's seeing more of an integration of innovation with sustainability jobs, especially in the food and beverage and consumer packaged goods industries. Now job titles look more like vice president or director of innovation and sustainability, she said.

"You can't really become more sustainable without being innovative," Mallik said. "At a certain point, you need to be doing things differently. You need to innovate to be more sustainable, otherwise you're just stuck in the status quo."

Kelly Rincon
Sustainable Food Lab

Program director, agriculture and environment — Sustainable Food Lab

Kelly Rincon joined the Sustainable Food Lab after a two-year stint as the global sourcing manager for procurement and sustainability at Anheuser-Busch InBev.

The Sustainable Food Lab is a nonprofit founded in 2004 that helps food and beverage companies (including Anheuser-Busch InBev) be more sustainable. Rincon works on a team handling large-scale commodity agriculture — for example, corn, soybeans, and wheat — in North America, Australia, and some parts of Europe.

"We'll run these different labs where we bring companies together in precompetitive collaborations, so these companies can work through various aspects of sustainable agriculture together," Rincon said — such as aligning on how to account for Scope 3 emissions reductions. "It's a way for them to foster shared learning and find ways to partner on specific programs with farmers. We also consult for individual companies who want to dive deeper on a specific agriculture topic."

Rincon said she's also noticed more partnerships between sustainability and other corporate functions, such as sustainability and procurement teams working together on supply chains.

Lauren Schilling
Tatcha

Sustainability lead — Tatcha

There is no silver bullet for sustainability, according to Lauren Schilling, but she's doing her best to make a difference through her work at Tatcha, a Japanese skincare company.

Schilling works across the company's different departments — including packaging, product development, and operations — to develop and implement sustainability programs.

"That can be everything from trying to reduce our waste through packaging, but also through logistics such as looking at container utilization and how that would impact our carbon emissions," she said.

She also looks at ingredient sourcing and harvesting, in addition to end-of-life considerations for products, and she works with the marketing team to ensure Tatcha isn't greenwashing.

Schilling said she's seen suppliers and manufacturers that work with Tatcha also take a similar approach to weaving sustainability through a variety of departments.

"That just speaks to how many other companies that they work with are asking for those things as well," Schilling said.

Harini Sundaram
Energy Management Executive

Energy management executive

Harini Sundaram most recently worked for Schneider Electric USA, leading the commercial growth of its IoT platform, EcoStruxure, which offers data analytics to customers and partners to help them be more sustainable.

Schneider is not the only company pushing for more sustainability, Sundaram said.

Whether it's BlackRock CEO Larry Fink calling on his portfolio companies to disclose how a net-zero economy factors into their long-term plans, or younger talent pools showing their preference for greener employers, this "fire is everywhere," Sundaram said.

That's why more roles are emerging in sustainability consulting, she said. For example, someone who can help a hospital building operate more sustainably while not jeopardizing employees' and patients' safety.

"Ideally, the consultant role should have that knowledge; that's on the hard skills side," Sundaram said. "On the soft skills side, problem-solving, curiosity, and learning agility are critical give the rapid pace of change."

Andy Wu
Liberty Mutual Insurance

Senior consultant for environmental, social, and governance — Liberty Mutual Insurance

Andy Wu integrates sustainability into Liberty Mutual's underwriting and investing through the identification of ESG risks and opportunities. This is also where he said that he sees more roles being created in other companies.

"I am happy to see growth in those [sustainable finance] roles," Wu said. "I'm seeing a lot more organizations focus on integrating ESG topics into their investment decisions, and these are opportunities that I would say weren't as prevalent 10 years ago."

While the hiring efforts are long overdue, there's still a lot of room for progress, Wu said. Years ago, he and some of his peers had a conversation about what success would look like in their line of sustainability work.

"The picture that we painted for ourselves and in our roles was that we wouldn't be needed by an organization," Wu said. "If the ultimate goal is to embed sustainability into everything an organization does, our role wouldn't be needed. I think we still have quite a long runway to get to that point, where sustainability is truly integrated into every aspect of what an organization does."

More sustainability jobs mean more opportunities for inclusion

With sustainability roles developing across companies in every industry, the benefit is not just a greener economy, but more opportunities to reach untapped talent in a variety of spaces.

If you think about how the world has to transform to that 2050 net-zero world, there's so many opportunities," said David Miller, PhD '07, co-founder and managing director of Clean Energy Ventures. "What we're seeing is entrepreneurs, engineers, scientists — everyone is much more aware of the climate crisis, and there's a lot of motivation now. So folks are coming up with new technologies, new business models, new approaches to address the climate crisis across lots of different dimensions."

While Clean Energy Ventures usually deals with younger two- or three-person startups, the investment group is conscious of broader ESG and DEI goals, and includes specific clauses in its term sheets to address them.

For example, an early-stage company making solar panels might not be thinking about supply chain or diversity, said Miller.

"Once we invest, then we're following up on it and saying 'Look, when you hire, you need to think about diversity; when you're working, you have to think about using a sustainable supply chain, and you have to think about safety in the workplace.' Things like that," Miller said. "We're making sure that they are thinking about them, taking them into account, and we're tracking their progress on those measures."

Kerry Bowie, '94, MBA '06, founder of Browning the Green Space, is also working on improving DEI in the sustainability space. The coalition has a threefold mission to create jobs, create wealth, and reduce energy burden in communities of color. This is done, Bowie said, by creating a pipeline for career advancement, providing technical assistance and access to capital, and removing barriers to the adoption and uptake of green technology, products, and services in communities of color.

"How do we make sure that we have a just energy transition, that we are making sure that we have Black and brown folk, and women, as we do this work? How do we make sure we're getting them jobs, getting them trained, getting them the technical assistance and capital to launch startups?" Bowie said. "I think there's an opportunity for sustainability to mix with that."

CREDIT: LAURA WENTZEL

Sustainable investing: 4 questions to ask

by **Betsy Vereckey**

Why It Matters

Interest in ESG investing has never been higher. MIT Sloan investment expert Gita Rao suggests four questions to ask before you invest.

Once viewed as a niche investment strategy, environmental, social, and governance-led investing has never been higher. Business schools are offering classes in ESG. Exchange-traded funds are seeing record flows. Banks are contributing billions toward sustainable finance.

And yet, as the sector grows in complexity, concerns about accountability and reporting are on the rise. A company can say it's committed to ESG, but how is it doing so? Is it disclosing the metrics of its carbon footprint, increasing board diversity, or revealing the inner workings of its supply chain?

"ESG is about building sustainable businesses for the long run with a stakeholder perspective," said Gita Rao, a senior lecturer in finance at MIT Sloan. Stakeholders include "everybody that the company interacts with" and "anybody that the company's operations touch — employees, customers, suppliers" — and should include the emissions those suppliers generate, she said.

Rao has deep experience in the field, having managed socially responsible portfolios for more than two decades. She also developed and teaches MIT Sloan's course on impact investing. Rao recently shared her thoughts on some of the top issues in ESG that aren't often at the forefront of the conversation. Here are four questions to consider.

> *There is an inconsistency between the stated objectives of ESG funds and what they're doing.*
>
> **Gita Rao** | MIT Sloan

1. Do your ESG index funds vote in alignment with shareholder preferences?

ESG index funds contain stocks of companies that abide by good environmental, social, and governance practices. Investors who allocate their money toward ESG funds (usually using their retirement or investment savings) expect that their money will be invested in alignment with their values, whether that's reducing reliance on fossil fuels or promoting gender diversity in management.

However, research conducted by Rao revealed that a number of funds with an ESG mandate had proxy voting records that went against their stated objectives. Fund managers are responsible for voting on proxies on behalf of individual investors, leaving shareholders often unaware of how funds are voting on issues they care about.

"There is an inconsistency between the stated objectives of these funds and what they're doing," said Rao, whose study of Vanguard and BlackRock funds showed that "historically, they have not been voting in accordance with ESG standards."

Few companies vote to support gender pay equity, for example, an area Rao said desperately needs attention. Research by the Pew Research Center revealed that in 2020, women earned 84% of what men earned — which would require women to work an additional 42 days in order for them to earn what men did in the same year.

In her research, Rao examined resolutions on gender pay gap disclosure for the 2020 proxy voting season for the Vanguard Social Index Fund, which has assets under management of about $8 billion. She found that in every case where shareholders requested disclosure on gender pay gap for an individual company, the fund manager cast a vote against the proposal.

"As shareholders, this is our money, and if we believe in these issues, we need to advocate for them," Rao said.

Fortunately, change is happening, albeit slowly, Rao said. In October, BlackRock said it would give pension funds, universities, and other institutional investors (who usually don't have this power) more control over their voting, starting in 2022.

2. Are companies delivering on the "S" and the "G" in ESG?

When it comes to minimizing a company's environmental impact, companies are increasingly tracking their carbon emissions, among other metrics.

"There's more disclosure with 'E'," Rao said.

The "S," or social pillar of ESG, can pertain to human rights issues as well as diversity and inclusion. It isn't as easy to quantify as the environmental pillar, given the challenges surrounding how to define as well as measure it.

"Issues like the treatment of labor in the supply chain are hard to measure," Rao said. "The 'S' pillar is a very broad area covering everything from drug pricing to diversity in the workforce. Companies are not required to report on many of these issues, so there is little in the way of standardized disclosure."

Rao referenced an incident that occurred in 2013 when a handful of western retailers were forced to examine their labor practices and worker safety conditions after a Bangladesh factory collapsed, killing 1,138 workers.

The tragedy triggered labor code amendments, the creation of the Accord on Fire and Building Safety, and a promise from retailers to pay $30 million in compensation, according to the Center for International Private Enterprise.

Rao said more headway has been made as it relates to corporate governance, which refers to how a company makes decisions and conducts itself. For instance, in the aftermath of Pacific Gas & Electric's role in the catastrophic California wildfires, which killed 84 people and caused PG&E to file for bankruptcy protection, questions were raised about the company's board and whether members were fulfilling their fiduciary responsibilities by not doing more to ensure that the company had adequate safety protocols.

The company has since replaced its board.

One final matter to consider as it relates to governance, Rao said, is advocating for the separation of CEO and chair positions. Doing so can contribute positively to the governance of a company, because it helps distinguish management and board authority so that one position doesn't influence the other. Some, for instance, have raised concerns about the amount of power that Mark Zuckerberg, the founder of Facebook, has as both CEO and chairman of the board at the company now known as Meta.

This kind of ownership structure, where one leader has control of the board's decision-making, is "unprecedented at a company of this scale," said Marc Goldstein, head of U.S. research for the proxy adviser Institutional Shareholder Services, in an interview with The Washington Post. "Facebook at this point is by far the largest company to have all this power concentrated in one person's hands."

"On the 'G' side, we have some progress, but not a huge amount," Rao said. "You've got a company like Facebook with the misinformation issues, and Zuckerberg owns the majority of the shares. How much leeway and leverage do shareholders have? Many of these companies have governance issues in terms of their corporate structure, and Facebook exemplifies the consequences."

3. How should we price environmental transition risk?

Transition risk is the risk that can occur when a company is on a path to becoming carbon neutral, but is not yet there. If it's not on investors' radar, it should be, Rao suggested.

A coal-fired utility company, for example, is a significant emitter of greenhouse gases. As such, it will be a substantial cost to the utility to transition from coal to a renewable source, given that the plant will probably have to be shut down or retrofitted along the way. Apart from the financial cost, there is risk in this process. Implementing technological change isn't easy, and missteps can affect a company's reputation.

"Transition risk is not currently priced into asset prices. It is long-term, difficult to measure, and not easy to quantify using the traditional finance frameworks of balance sheets and income and cash flow statements," Rao said. "Correctly pricing transition risk will dramatically change the valuation landscape for some sectors."

Task Force on Climate-related Financial Disclosures (TCFD) is helping with standardization. Its 2020 status report is designed to serve as a resource for companies looking for guidance as they disclose the transition risks and opportunities from climate change.

"There is clear and growing consensus among investors and regulators on the importance of climate-related disclosure and the need for standardized, transparent data to support capital allocation decisions," Mary Schapiro, head of the TCFD, told Reuters.

To help correctly price transition risk, organizations like "the TCFD are doing important work towards standardization," Rao said.

Clear data and standardized procedures are essential to avoid greenwashing. Rao said investors need to hold companies accountable as they transition their operations.

> *As investors, we must look carefully at what companies are promising, over what time frame, and partner with them to advance our collective goals.*
>
> **Gita Rao** | MIT Sloan

"The devil is in the details," Rao said. "It's not enough that companies set forth these goals. As investors, we must look carefully at what companies are promising, over what time frame, and partner with them to advance our collective goals."

4. What are companies doing to address pandemic- and climate-related inequality?

COVID-19 highlighted the "S" in ESG by exacerbating existing inequalities in the labor force. Low-paid essential workers were laid off without health insurance or forced to work in person, exposing themselves to the virus. Many had no access to paid leave when they fell ill or needed days off if they had side effects from being vaccinated.

"The pandemic exposed in stark detail the inequalities in our society," Rao said. "The question is: What are companies doing about it? And how can shareholders hold them accountable?"

> *The pandemic exposed in stark detail the inequalities in our society. The question is: What are companies doing about it?*
>
> **Gita Rao** | MIT Sloan

Rao said that regulation is essential if investors want better disclosure. And it appears to be coming. U.S. Securities and Exchange Commission Chair Gary Gensler, a former MIT Sloan professor, recently asked SEC staff to begin thinking about a "human capital" disclosure requirement for public companies. This could include metrics on compensation, benefits, or workforce demographic information on diversity.

In a tweet, Gensler said: "Investors want to better understand one of the most critical assets of a company: its people."

"Both COVID and climate change disproportionately affect people who are poorer and [belong to] communities of color," Rao said. "Some regulation is required so companies have a road map," and investors have transparency.

A way forward

There is plenty to consider as ESG continues to evolve. Some believe that soon, there will be a pricing differential between companies that are truly green and those that aren't. Going forward, as companies disclose risks and measure their progress, those that deliver on environmental, social, and governmental practices will be rewarded by investors.

Jason Jay, director of the MIT Sloan Sustainability Initiative, noted "a whole broader constellation of things that are happening surrounding investor action," while speaking at the MIT Impact Investing Initiative spring speaker series.

When "investor action plays together with corporation action, public policy action, civil society action," that's when impact can be achieved. Having investors exercise their shareholder power, invest capital, or encourage a price on carbon —

"those actions are going to affect business, government, and civil society," he said.

Rao acknowledged that ESG issues are complicated but still encouraged investors to "think of it as a dialogue" with companies, particularly when it comes to climate change.

"Getting companies to report on greenhouse gas emissions will take time," she said, noting that shareholders have a responsibility to "advocate for analysis, transparency, and disclosure."

MIT Sloan Office of Communications
Building E90, 9th Floor
1 Main Street, Cambridge, MA 02142

Questions and Comments: thinkingforward@mit.edu
mitsloan.mit.edu

MIT MANAGEMENT SLOAN SCHOOL | IDEAS MADE TO MATTER