Does ESG really matter—and why?

Although valid questions have been raised about ESG, the need for companies to understand and address their externalities is likely to become essential to maintaining their social license.

by Lucy Pérez, Vivian Hunt, Hamid Samandari, Robin Nuttall, and Krysta Biniek

Since the acronym “ESG” (environmental, social, and governance) was coined in 2005, and until recently, its fortunes were steadily growing. To take one example, there has been a fivefold growth in internet searches for ESG since 2019, even as searches for “CSR” (corporate social responsibility)—an earlier area of focus more reflective of corporate engagement than changes to a core business model—have declined. Across industries, geographies, and company sizes, organizations have been allocating more resources toward improving ESG. More than 90 percent of S&P 500 companies now publish ESG reports in some form, as do approximately 70 percent of Russell 1000 companies. In a number of jurisdictions, reporting ESG elements is either mandatory or under active consideration. In the United States, the Securities and Exchange Commission (SEC) is considering new rules that would require more detailed disclosure of climate-related risks and greenhouse-gas (GHG) emissions. Additional SEC regulations on other facets of ESG have also been proposed or are pending.

The rising profile of ESG has also been also plainly evident in investments, even while the rate of new investments has recently been falling. Inflows into sustainable funds, for example, rose from $5 billion in 2018 to more than $50 billion in 2020—and then to nearly $70 billion in 2021; these funds gained $87 billion of net new money in the first quarter of 2022, followed by $33 billion in the second quarter. Midway through 2022,
global sustainable assets are about $2.5 trillion. This represents a 13.3 percent fall from the end of Q1 2022 but is less than the 14.6 percent decline over the same period for the broader market.\(^5\)

A major part of ESG growth has been driven by the environmental component of ESG and responses to climate change. But other components of ESG, in particular the social dimension, have also been gaining prominence. One analysis found that social-related shareholder proposals rose 37 percent in the 2021 proxy season compared with the previous year.\(^5\)

In the wake of the war in Ukraine and the ensuing human tragedy, as well as the cumulative geopolitical, economic, and societal effects, critics have argued that the importance of ESG has peaked.\(^7\) Attention, they contend, will shift increasingly to the more foundational elements of a Maslow-type hierarchy of public- and private-sector needs,\(^8\) and in the future, today’s preoccupation with ESG may be remembered as merely a fad and go the way of similar acronyms that have been used in the past.\(^8\) Others have argued that ESG represents an odd and unstable combination of elements and that attention should be only focused on environmental sustainability.\(^10\) In parallel, challenges to the integrity of ESG investing have been multiplying. While some of these arguments have also been directed to policy makers, analysts, and investment funds, the analysis presented in this article (and in the accompanying McKinsey piece, “How to make ESG real,” August 2022) is focused at the level of the individual company. In other words: Does ESG really matter to companies? What is the business-grounded, strategic rationale?

A critical lens on ESG

Criticisms of ESG are not new. As ESG has gone mainstream and gained support and traction, it has consistently encountered doubt and criticism as well. The main objections fall into four main categories.

1. **ESG is not desirable, because it is a distraction**
   Perhaps the most prominent objection to ESG has been that it gets in the way of what critics see as the substance of what businesses are supposed to do: “make as much money as possible while conforming to the basic rules of the society,” as Milton Friedman phrased it more than a half-century ago.\(^11\) Viewed in this perspective, ESG can be presented as something of a sideshow—a public-relations move, or even a means to cash in on the higher

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\(^5\) “Global Sustainable Fund Flows,” 2022.
\(^10\) See, for example, “ESG should be boiled down to one simple measure: emissions,” Economist, July 21, 2022.
motives of customers, investors, or employees. ESG is something “good for the brand” but not foundational to company strategy. It is additive and occasional. ESG ratings and score provider MSCI, for example, found that nearly 60 percent of “say on climate” votes in 2021 were only one-time events; fewer than one in four of these votes were scheduled to have annual follow-ups. Other critics have cast ESG efforts as “greenwashing,” “purpose washing,” or “woke washing.” One Edelman survey, for example, reported that nearly three out of four institutional investors do not trust companies to achieve their stated sustainability, ESG, or diversity, equity, and inclusion (DEI) commitments.

2. ESG is not feasible because it is intrinsically too difficult
A second critique of ESG is that, beyond meeting the technical requirements of each of the E, S, and G components, striking the balance required to implement ESG in a way that resonates among multiple stakeholders is simply too hard. When solving for a financial return, the objective is clear: to maximize value for the corporation and its shareholders. But what if the remit is broader and the feasible solutions vastly more complex? Solving for multiple stakeholders can be fraught with trade-offs and may even be impossible. To whom should a manager pay the incremental ESG dollar? To the customer, by way of lower prices? To the employees, through increased benefits or higher wages? To suppliers? Toward environmental issues, perhaps by means of an internal carbon tax? An optimal choice is not always clear. And even if such a choice existed, it is not certain that a company would have a clear mandate from its shareholders to make it.

3. ESG is not measurable, at least to any practicable degree
A third objection is that ESG, particularly as reflected in ESG scores, cannot be accurately measured. While individual E, S, and G dimensions can be assessed if the required, auditable data are captured, some critics argue that aggregate ESG scores have little meaning. The deficiency is further compounded by differences of weighting and methodology across ESG ratings and scores providers. For example, while credit scores of S&P and Moody’s correlated at 99 percent, ESG scores across six of the most prominent ESG ratings and scores providers correlate on average by only 54 percent and range from 38 percent to 71 percent. Moreover, organizations such as the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB) can measure the same phenomena differently; for example, GRI considers employee training, in part, by amounts invested in training, while SASB measures by training hours. It is to be expected, therefore, that different ratings and scores providers—which incorporate their own analyses and weightings—would provide diverging scores. Moreover, major investors often use their own proprietary methodologies that draw from a variety of inputs (including ESG scores), which these investors have honed over the years.

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12 Say-on-climate votes are generally nonbinding resolutions submitted to shareholders (similar to “say-on-pay” resolutions), which seek shareholder backing for emissions reductions initiatives. See, for example, John Galloway, “Vanguard insights on evaluating say on climate proposals,” Harvard Law School Forum of Corporate Governance, June 14, 2021.
13 “Say on climate: Investor distraction or climate action?,” blog post by Florian Sommer and Harlan Tufford, MSCI, February 15, 2022.
4. Even when ESG can be measured, there is no meaningful relationship with financial performance

The fourth objection to ESG is that positive correlations with outperformance, when they exist, could be explained by other factors and, in any event, are not causative. It would indeed challenge reason if ESG ratings across ratings and scores providers, measuring different industries, using distinct methodologies, weighting metrics differently, and examining a range of companies that operate in various geographies, all produced a near-identical score that almost perfectly matched company performance. Correlations with performance could be explained by multiple factors (for example, industry headwinds or tailwinds) and are subject to change. Several studies have questioned any causal link between ESG performance and financial performance. While, according to a recent metastudy, the majority of ESG-focused investment funds do outperform the broader market, some ESG funds do not, and even those companies and funds that have outperformed could well have an alternative explanation for their outperformance. (For example, technology and asset-light companies are often among broader market leaders in ESG ratings; because they have a relatively low carbon footprint, they tend to merit higher ESG scores.) The director of one recent study proclaimed starkly: “There is no ESG alpha.”

In addition to these four objections, recent events and roiled markets have led some to call into question the applicability of ESG ratings at this point. It is true that the recognized, pressing need to strengthen energy security in the wake of the invasion of Ukraine may lead to more fossil-fuel extraction and usage in the immediate term, and the global collaboration required for a more orderly net-zero transition may be jeopardized by the war and its aftermath. It is also likely that patience for what may be called “performative ESG,” as opposed to what may be called true ESG, will likely wear thin. True ESG is consistent with a judicious, well-considered strategy that advances a company’s purpose and business model.

Yet, many companies today are making major decisions, such as discontinuing operations in Russia, protecting employees in at-risk countries, organizing relief to an unprecedented degree, and doing so in response to societal concerns. They also continue to commit to science-based targets and to define and execute plans for realizing these commitments. That indicates that ESG considerations are becoming more—not less—important in companies’ decision making.

**Sustainable performance is not possible without social license**

The fundamental issue that underlies each of the four ESG critiques is a failure to take adequate account of social license—that is, the perception by stakeholders that a

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18 See, for example, James Mackintosh, “Credit Suisse shows flaws of trying to quantify ESG risks,” Wall Street Journal, January 17, 2022.
True ESG is consistent with a company’s well-considered strategy and advances its business model.

**Environmental**
- Addresses impact on the physical environment and the risk of a company and its suppliers/partners from climate events
  - Climate change and greenhouse-gas emissions (GHG)
  - Air pollution (non-GHG)
  - Water and wastewater management
  - Waste and hazardous-materials management; circularity
  - Biodiversity and ecosystems; rehabilitation

**Social**
- Addresses social impact and associated risk from societial actions, employees, customers, and the communities where it operates
  - Labor practices
  - Health and safety
  - Community engagement; diversity and inclusion
  - Community relations, local economic contribution
  - Product and service attributes

**Governance**
- Assesses timing and quality of decision making, governance structure, and the distribution of rights and responsibilities across different stakeholder groups, in service of positive societal impact and risk mitigation
  - Business ethics, data security
  - Capital allocations, supply chain management
  - Governance structure and engagement; incentives
  - Policies; external disclosures; position and advocacy

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1 Examples are not exhaustive

business or industry is acting in a way that is fair, appropriate, and deserving of trust. It has become dogma to state that businesses exist to create value in the long term. If a business does something to destroy value (for example, misallocating resources on “virtue signaling,” or trying to measure with precision what can only be imperfectly estimated, at least to date, through external scores), we would expect that criticisms of ESG could resonate, particularly when one is applying a long-term, value-creating lens.

But what some critics overlook is that a precondition for sustaining long-term value is to manage, and address, massive, paradigm-shifting externalities. Companies can conduct their operations in a seemingly rational way, aspire to deliver returns quarter to quarter, and determine their strategy over a span of five or more years. But if they assume that the base case does not include externalities or the erosion of social license by failing to take externalities into account, their forecasts—and indeed, their core strategies—may not be achievable at all. Amid a thicket of metrics, estimates, targets, and benchmarks, managers can miss the very point of why they are measuring in the first place: to ensure that their business endures, with societal support, in a sustainable, environmentally viable way.

Accordingly, the responses to ESG critics coalesce on three critical points: the acute reality of externalities, the early success of some organizations, and the improvement of ESG measurements over time. And the case for ESG cannot be dismissed by connections between ESG scores and financial performance and changes in ESG scores over time. (For a discussion about ESG ratings and their relationship to financial performance, see sidebar, “ESG ratings: Does change matter?”)

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ESG ratings: Does change matter?

Among the most sharply debated questions about environmental, social, and governance (ESG) is the extent to which ESG, as measured by ratings, can offer meaningful insights about future financial or TSR performance—particularly when ratings and scores providers use different, and sometimes mutually inconsistent, methodologies. A number of studies find a positive relationship between ESG ratings and financial performance.¹ Other research suggests that while scoring well in ESG does not destroy financial value, the relationship between ESG ratings at any given time, and value creation at the identical time, can be tenuous or nonexistent.² Because of the short time frame over which the topic has been studied, and the resulting lack of robust analyses, conclusions from the analyses should be tempered.³

In exploring the connection between ESG ratings and financial performance, another approach is to look at the effect of a change in ESG ratings. This approach mitigates issues deriving from differences among various ESG rating methodologies (assuming the methodologies are relatively consistent over time). It stands to reason that demonstrating real improvement—if reflected in the scores—could, in turn, drive TSR outperformance for multiple reasons, including those we explore in this article. Our initial research indicates, however, that it is too soon to tell. We found that on average companies that show an improvement in ESG ratings over multiyear time periods may exhibit higher shareholder returns compared with industry peers in the period after the improvement in ESG scores. We found, too, that the effect of this result has increased in recent years (exhibit). This initial finding is in line with some of the recent academic research and was also generally consistent across data from multiple ratings and scores providers.

Still, the findings are not yet conclusive. For example, only 54 percent of the companies we categorize as “improvers” and less than one-half of those categorized as “slight improvers” demonstrated a positive excess TSR. The research also does not prove causation. It is important to bear in mind that ESG scores are still evolving, observations in the aggregate may be less applicable to companies considered individually, and exogenous factors such as headwinds and tailwinds in industries and individual companies cannot be fully controlled for.

Most important, this research does not explain the mechanism of TSR outperformance and whether the outperformance is sustainable. We know from decades of research that companies with a higher expected return

on capital and growth are ultimately TSR outperformers and that there is clear, statistically significant correlation. Are ESG ratings a sign of greater expected resilience of margins in the transition, an indication of higher growth through green portfolios—or do they suggest something else? Will these increased expectations relative to peers ultimately materialize, or will they revert to the mean? ESG ratings are very new compared with financial ratings, and therefore, it will take time for them to evolve. We will continue to research these questions as data sets increase and refinements to ESG scores continue to be refined.

Regardless of current ratings scores, many companies are already advancing in ESG to improve their long-term financial performance. High performers consider and seek to learn from ESG ratings, but they do not get unduly distracted or make superficial changes merely to score higher. Companies should focus on ESG improvements that matter most to their business models, even if the improvements do not directly translate to higher ratings.

Since conclusions about the relationship between ESG ratings and financial performance are not yet certain, they might not be compelling enough, on their own, to persuade executives to invest significant resources in ESG. But there is a tangible cost to waiting. In fact, companies should adopt a bias toward focusing on ESG today; if companies, particularly those with significant externalities (such as high-emitting industries), hold out for perfect data and a “flawless” rating process, they may not have a business in 20 to 30 years.

Exhibit

Changes to ESG scores seem to be correlated to TSR, but given the underlying measurement challenges the result is not conclusive.

<table>
<thead>
<tr>
<th>TSR by change in ESG score¹</th>
<th>Median of annualized, excess TSR² from 2017–21, %</th>
<th>Companies³ with positive excess in TSR, %⁴</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deteriorators</td>
<td>−2.8</td>
<td>39</td>
<td>221</td>
</tr>
<tr>
<td>Slight deteriorators</td>
<td>−1.5</td>
<td>45</td>
<td>220</td>
</tr>
<tr>
<td>Slight improvers</td>
<td>−0.2</td>
<td>49</td>
<td>1,097</td>
</tr>
<tr>
<td>Improvers</td>
<td>1.5</td>
<td>54</td>
<td>1,097</td>
</tr>
</tbody>
</table>

¹Based on ESG scores of S&P Global for fiscal years 2017–2021; 2021 data is updated through Jan 18, 2022.
²Annualized TSR is defined as the CAGR of the dividend-adjusted share price between 2017 and 2021 in companies’ local currency.
³Companies decreasing in S&P Global ESG score are categorized as deteriorators and slight deteriorators. Companies increasing in S&P Global ESG score are categorized as improvers and slight improvers.
⁴Results statistically significant (p-value < 0.01) with Mann-Whitney U test between improvers and deteriorators, but not (p-value ~0.2) between slight deteriorators and deteriorators.
Source: S&P Global Sustainable1; McKinsey ESG Insights.
1. Externalities are increasing
Company actions can have meaningful consequences for people who are not immediately involved with the company. Externalities such as a company’s GHG emissions, effects on labor markets, and consequences for supplier health and safety are becoming an urgent challenge in our interconnected world. Regulators clearly take notice. Even if some governments and their agencies demand changes more quickly and more forcefully than others, multinational businesses, in particular, cannot afford to take a wait-and-see approach. To the contrary, their stakeholders expect them to take part now in how the regulatory landscape, and broader societal domain, will likely evolve. More than 5,000 businesses, for example, have made net-zero commitments as part of the United Nations’ “Race to Zero” campaign. Workers are also increasingly prioritizing factors such as belonging and inclusion as they choose whether to remain with their company or join a competing employer. Many companies, in turn, are moving aggressively to reallocate resources and operate differently; nearly all are feeling intense pressure to change. Even before the Ukraine war induced dramatic company action, the pandemic had prompted companies to reconsider and change core business operations. Many have embarked on a similar path with respect to climate change. This pressure, visceral and tangible, is an expression of social license—and it has been made more pressing as rising externalities have become more urgent.

2. Some companies have performed remarkably, showing that ESG success is indeed possible
Social license is not static, and companies do not earn the continued trust of consumers, employees, suppliers, regulators, and other stakeholders based merely upon prior actions. Indeed, earning social capital is analogous to earning debt or equity capital—those who extend it look to past results for insights about present performance and are most concerned with intermediate and longer-term prospects. Yet unlike traditional sources of capital, where there are often creative financing alternatives, there are ultimately no alternatives for companies that do not meet the societal bar and no prospect of business as usual, or business by workaround, under conditions of catastrophic climate change.

Because ESG efforts are a journey, bumps along the way are to be expected. No company is perfect. Key trends can be overlooked, errors can be made, rogue behaviors can manifest themselves, and actions can have unintended consequences. But since social license is corporate “oxygen”—thus impossible to survive without it—companies cannot just wait and hope that things will all work out. Instead, they need to get ahead of future issues and events by building purpose into their business models and demonstrating that they benefit multiple stakeholders and the broader public. Every firm has an implicit purpose—a unique raison d’être that answers the question, “What would the world lose if this company disappeared?” Companies that embed purpose in their business model not only mitigate risk; they can also create value from their values. For example, Patagonia, a US outdoor-equipment and clothing retailer, has always been purpose driven—and announced boldly that it is “in business to save our home planet.” Natura &Co, a Brazil-based cosmetics and personal-care company in business to “promote the harmonious relationship of the individual with oneself, with others and with nature,” directs its ESG

26 “‘Great Attrition’ or ‘Great Attraction’? The choice is yours,” McKinsey Quarterly, September 8, 2021.
efforts to initiatives such as protecting the Amazon, defending human rights, and embracing circularity. Multiple other companies, across geographies and industries, are using ESG to achieve societal impact and ancillary financial benefits, as well.

3. Measurements can be improved over time

While ESG measurements are still a work in progress, it is important to note that there have been advancements. ESG measurements will be further improved over time. They are already changing; there is a trend toward consolidation of ESG reporting and disclosure frameworks (though further consolidation is not inevitable). Private ratings and scores providers such as MSCI, Refinitiv, S&P Global, and Sustainalytics, for their part, are competing to provide insightful, standardized measures of ESG performance.

There is also a trend toward more active regulation with increasingly granular requirements. Despite the differences in assessing ESG, the push longitudinally has been for more accurate and robust disclosure, not fewer data points or less specificity. It is worth bearing in mind, too, that financial accounting arose from stakeholder pull, not from spontaneous regulatory push, and did not materialize, fully formed, along the principles and formats that we see today. Rather, reporting has been the product of a long evolution—and a sometimes sharp, debate. It continues to evolve—and, in the case of generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) reporting, continues to have differences. Those differences, reflecting how important these matters are to stakeholders, do not negate the case for rigorous reporting—if anything, they strengthen it.

While the acronym ESG as a construct may have lost some of its luster, its underlying proposition remains essential at the level of principle. Names will come and go (ESG itself arose after CSR, corporate engagement, and similar terms), and these undertakings are by nature difficult and can mature only after many iterations. But we believe that the importance of the underlying ideas has not peaked; indeed, the imperative for companies to earn their social license appears to be rising. Companies must approach externalities as a core strategic challenge, not only to help future-proof their organizations but to deliver meaningful impact over the long term. Q

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