

ESG: Not Just for Tree Huggers

Introduction

Rather than viewing environmental, social and governance investing (ESG) factors through a political lens, these factors can be related to potential financial risk harming the earnings of companies.

The following sections will discuss how these factors can have measurable impact on a company's bottom line.

E - Environmental

Environmental risks exist in many industries, especially those that transport hazardous materials. As an example, a derailment in East Palestine, OH in February 2023 was caused by a rail car's overheating bearings not identified between heat sensors spaced 20 miles apart on the track lines. The rail car appears to not have been inspected in a timely fashion. The initial costs for the spill cleanup and site restoration due to the derailment were estimated to be nearly \$400 million.¹ As of January 2025, the actual costs have exceeded \$2 billion, of which approximately \$1.4 billion were not covered by insurance.²

S - Social

Social exposure for a company can be thought of not only in terms of how the company interacts with society as a whole, but also in terms of employee relations. Below are a few areas in which poor employee relations can affect expenses.

Employee turnover can be costly. It can be particularly costly in times when labor markets are tight, and wages are rising. It is estimated that employee turnover costs the US economy \$1 trillion in 2019.³ At the company level, it has been estimated that costs to replace a lost employee can be between 50%-400% of the annual salary of the position. Of those costs, it is estimated that 30-40% are real time expenses. Lost productivity and other indirect costs 60% of the costs.⁴

In addition to turnover, costs due to work related injuries and time lost is substantial. The National Safety Council estimated that such incidents costs US businesses \$176 billion in 2023.⁵

It is clear that businesses have real dollar incentives to take care of their employees and provide a safe working environment.

G - Governance

When one thinks of governance topics, one might think only of outright fraud. This thinking would recall the tremendous financial mismanagement of companies like Enron or WorldCom.

During the financial crisis of 2007-09, there are examples of companies that suffered losses by not paying attention to the complexity of asset backed securities in their portfolios. Many of these complex securities experienced significant losses as the financial system weakened.

However, even portfolios consisting primarily of US Treasury and agency securities can experience losses when good governance practices are not followed. Rapidly rising interest rates in early 2023 put pressure on bond prices, including Treasuries. Some banks lost money on their Treasury holdings because they were forced to sell at a loss to make liquidity for their depositors. In certain extreme cases, bank failed and were taken over by FDIC.⁶

Conclusion

The basic profit equation for a business is Revenues – Expenses = Profits. As noted above, poorly managed ESG factors can lead to significant increases in expenses and decreases in profits. Extreme examples have resulted in the total loss of the business.

We suggest looking beyond ESG factors as potentially political, and perhaps tangential to investment management. Rather, recognize that the increased transparency around these factors could assist in identifying well-run, high-quality businesses.

Footnotes:

1. <https://norfolksouthern.investorroom.com/2023-04-26-Norfolk-Southern-reports-first-quarter-2023-results>
2. <https://www.wfmj.com/story/52275141/norfolk-southern-bill-for-east-palestine-derailment-reaches-dollar22b>
3. <https://www.gallup.com/workplace/247391/fixable-problem-costs-businesses-trillion.aspx>
4. <https://www.applauz.me/resources/costs-of-employee-turnover>
5. <https://injuryfacts.nsc.org/work/costs/work-injury-costs/>
6. <https://www.fdic.gov/news/press-releases/2023/pr23019.html>

Ted Berry

Senior Vice President, Financial Advisor

Senior Portfolio Manager

NMLS# 1261936

Ternion Planning Team at Morgan Stanley

1747 Pennsylvania Avenue, Suite 900

Washington, DC 20006

202-778-1588

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided, nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

The returns on a portfolio consisting primarily of Environmental, Social and Governance (“ESG”) aware investments may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness