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ESG Impact Is Hard to Measure — But It's Not Impossible

By Jennifer Howard-Grenville January 22, 2021

Summary.

ESG measurement is an increasingly popular way of holding companies accountable when it comes to sustainability efforts, and of giving companies an incentive to improve them. But measurement, no matter how sophisticated, is much better at capturing easily quantifiable inputs than complex and messy outcomes and impacts. Companies need to do everything they can to understand those outcomes and impacts — and that requires doing more than just measurement. In particular, companies need to do three things: (1) zoom in to develop insights on processes, (2) zoom out to see broader systems, and (3) value curiosity and learning.

Around the globe, a third of all professionally managed assets, or roughly $30 trillion, are now subject to ESG criteria. That's a remarkable sum, one that represents an increase of more than 30% since 2016. Between April and June of 2020 alone, investors poured more than $70 billion into ESG equity funds, vastly exceeding recent annual flows.

These numbers reflect a growing awareness — among companies, investors, and shareholders alike — that to remain viable, businesses must think about and manage their impact on the planet in new ways. Sustainability is the new aspiration, and the key to achieving it, according to a rapidly emerging consensus, is the development of sophisticated ways of measuring ESG activities and impact. Make those measurements known using a robust scoring system, the theory goes, and companies will find themselves compelled to improve.

But our current focus on ESG measurement is dangerously narrow. It fails to capture the complex, systemic nature of social and environmental systems, and indeed that of business organizations themselves. In this article, recognizing that measurement is both necessary and inevitable, I will offer precautions on its use and interpretation, and guidance on what businesses must do to act effectively on issues threatening our planet and societies.

How Measures Mislead

Measuring signals, missing processes

"What gets measured gets managed" — that old mantra rings true for most businesses. But measurement often fails to provide insight into messy underlying processes, which is where important and actionable information can be found.

To do better, we can't just develop increasingly precise measures. Many ESG measures already very effectively capture inputs, but they presume causality — that adding women to top management teams, say, will produce better outcomes. But measures that capture *inputs* (such as the numbers of women on those teams) don't capture *outcomes* (such as decision-making that reflects diverse perspectives)

and *impacts* (such as the social value created by such decisions). Research shows, for example, that top management teams make complex decisions better when not dominated by either gender. The underlying processes that lead to that kind of outcome are what we need to pay attention to — which means that we have to look behind the numbers and ask how, why, and under what conditions they came about.

Measuring the apparent, missing the system

When seeking to capture causality, we often draw the wrong boundaries around the problems we seek to address. When this happens, measurement can easily lead us astray — and make us collectively less capable of undertaking bigger and bolder actions.

Consider what happened in the United States in the 1970s, after the government required that car companies produce passenger-car fleets with a higher average fuel economy. The idea seemed smart: To reduce consumption and emissions, first you set fuel-economy standards for the companies, then you measure how well their fleets meet those standards, and finally you ratchet up the standards over time to compel those companies to improve. But things didn't work out that way. That's because the government had created fuel-economy standards that were more stringent for cars than light trucks. Not surprisingly, the companies began shifting their production from cars to SUVs and trucks — in an extremely significant manner. In the 1970s, SUVs and trucks accounted for 3% of all U.S. new automobile sales, but by the early 2000s the number had risen above 50%.

All of this created unintended consequences. Emissions didn't drop as much as they were supposed to. Traffic fatalities increased, because more heavy vehicles were colliding with lighter ones. More broadly, by demanding measurable improvements to fuel economy at the fleet level, the government encouraged car companies to devote themselves narrowly to solving (or skirting) that problem rather than developing broader, more-sustainable innovations and solutions. The latter, like electric vehicles or reimagined models for mobility, required fundamentally different capabilities. Without incentives to develop them, U.S. manufacturers fell behind relative to their foreign counterparts.

Similar examples — in which we fixate on one small part of a complex system, and in so doing come up with solutions to the wrong problem — abound. ESG measures can perpetuate this behavior, especially when the measures and investor rewards remain tied to individual firms. At an individual level, for example, BP can take credit for reducing its emissions by selling its petrochemicals business. But that business and its emissions, of course, have not gone away.

Measuring the monetizable, missing the valued

Some things are inherently easier to measure than others. But that doesn't mean they're more valuable.

CO2 equivalent emissions are a case in point. They're easy to measure, and in a single number they convey the impact created by a range of greenhouse gases, whose cause-effect relationship between emission and climate change is well established. Further, CO2eq emissions, once measured, can be monetized, in the form of a carbon price, which enables comparison across companies and activities.

Much harder to capture and compare are impacts on biodiversity and habitat, where cause-and-effect relationships are devilishly more complex. But those impacts can be hugely consequential.

Consider crop production. Much of the industry, worth hundreds of billions annually, relies on pollinating insects—and those insects are in serious decline. But it's almost impossible to measure what different companies have done to contribute to this decline. A variety of important factors are involved: land-use change, intensive agriculture, pesticide use, climate change, disease, and more. But even if such measurements were possible, would they add up to the value of nature?

Even with clear and comparable ESG measures, there is considerable hubris in allowing today's investors, asset managers, and business managers to decide what will constitute and enable a good life for our children. Shifts in underlying values and preferences could fundamentally alter the relevance of even the best current ESG measures. Will our children thank us for enabling asset managers to reward the airlines that most effectively shift to biofuels or aggressively offset their carbon emissions? Or will our children measure the value of their investments and their lives in a different way — say, through the quality of relationships they sustain or the time they have for leisure?

Beyond Measures: Keys to Effective Action

These concerns — that ESG measures can obscure important insight into processes, misdirect our attention away from systems, and dangerously misrepresent broader values — don't mean that companies shouldn't measure. They should. But they need to do more. Here are three ways they can widen their focus to capture information not just about inputs but also about the processes and systems governing outcomes and impacts.

1. Zoom in to develop insights on processes
To grasp underlying processes, companies should focus on deeply understanding a handful of issues most germane to their core activities. Through this, they stand a greater chance of deeply understanding the causal threads that enable improved impact, and ultimately directing sufficient resources to act on these.

When Nike was critiqued for its suppliers' labor practices in the 1990s, for example, it took the time to interview 67,000 workers to explore the issues through their experiences, enabled by board member Jill Ker Conway's network of researchers and women's organizations. From this, the company was able to create a longer-term strategy involving disclosure, partnering with other brands to improve working conditions, and mobilizing community support.

2. Zoom out to see broader systems
Zooming out brings a longer term and broader perspective on issues that demand deep insight. Beginning with the end state and soliciting diverse stakeholder inputs are two approaches to understanding systems and one's role within them.

Consider climate change. Carbon emissions dominate the headlines, of course, but zoom out and you'll start to see the extent to which water stress is a problem that we are going have to confront: By 2030, the world will require 40% more water than it does today.

Some companies with agricultural supply chains, like Cargill, Diageo, and Unilever, have acknowledged a future of shared responsibility for watersheds at the catchment level, leading them to develop approaches to regenerative agriculture and watershed restoration that involve local populations and are tailored to local conditions.

Zooming out demands significant engagement beyond organizational boundaries, which should also tap diverse perspectives, enabling a company to learn from and with others on collaborative approaches to systemic issues.

3. Value curiosity and learning

Many people are calling for firms to articulate a purpose beyond profit maximization, so that they can better serve societal values. But purpose is empty without the capacity to execute on it. Getting started with focused "doing" is a more grounded — and potentially complementary — approach that can leverage existing capabilities and talent.

For all the promise of the circular economy to reimagine how we think about waste, some entirely unglamorous possibilities have been unlocked by companies that are doggedly learning from what their people on the front lines do. Years ago, Xerox repair technicians and engineers worked out that simple parts on its leased photocopiers — plastic roller wheels or metal brackets — could be redesigned to make them fail less often, and reusable even after they had failed. Similarly, Patagonia knows that zippers give out far sooner than fabric wears out. Tapping the wisdom of its repair team helps the company rethink product construction so zippers can be replaced without destroying a down sleeping bag or jacket.

The commonality in the above is an emphasis on doing and learning — that is, on not being driven by measures alone. Robust ESG and impact measures can help us keep score, and, when necessary, make course corrections. Ultimately, however, no matter how and what we measure, we need to act our way into greater understanding, insight, and even purpose.

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