



THE REAL PROBLEM OF ESG

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If you could improve environmental and social problems by investing

in companies that make the world better while still earning market-rate financial returns, wouldn't you do it?

This is the promise underlying an investment strategy called environmental, social, and governance—ESG for short—that has swept the world, accumulating about \$30 trillion of assets under management, or about a quarter of the global total.¹

We are all invested in ESG, directly or indirectly. Many of us have stakes in mutual funds following ESG guidelines. In addition, the banks that hold our deposits, the insurance companies that pay our claims, the pension funds that provide our retirement income—most maintain a portion of their assets in ESG securities.

But what is ESG? Most people who have heard of it think that ESG measures corporate social responsibility. They see it as a holistic assessment of a company's contribution to the well-being of not just shareholders but all "stakeholders," including employees, customers, suppliers, the communities in which it operates, the environment, and society at large. Companies with high ESG ratings are assumed to be social benefactors to the world.

In a survey of retail investors, more than three-quarters, 77 percent, said that companies held in an ESG fund aligned with their values, while 63 percent disagreed with the statement that a company's role is to maximize earnings, not pursue social or environmental goals.²

But how many of those in the survey had examined ESG closely? In fact, they were looking through the wrong end of the telescope. ESG is asset management, not social activism. The only stakeholder whose interest ESG takes into account is the shareholder.

Yes, ESG analyzes social and environmental risks but only those that could significantly affect a company's financial performance—that is, shareholder value. ESG's mission is not to save the world. It is to deliver market-rate or better returns by favoring companies adept at dealing with threats to their profitability posed by the environmental and social problems they face in their businesses.

To understand what this means in practice, consider the most antisocial industry imaginable: cigarettes. The products kill the customers. Surely, the ESG rating of tobacco companies is zero?

Well, no. Cigarette makers typically achieve ESG ratings in the middle of the pack (so to speak), high enough that some ESG funds invest in them.

How can this be? Because smoking is legal, and cigarette makers rarely face substantial liability for the death it causes. The harm that comes from cigarettes doesn't appear on the balance sheets of the tobacco companies. Therefore, it does not count for much in ESG ratings.

There are, certainly, some environmental and social risks that could affect the cigarette companies' bottom line. For example, tobacco is a thirsty crop and depletes the soil. In addition, like other manufacturers, cigarette makers are concerned with issues like workplace safety and employee turnover.

By dealing relatively effectively with these sorts of risks, cigarette companies can achieve respectable ESG ratings and enter into stock portfolios—where they add significant investment value, since their customers are addicted and will keep buying at any cost. (This is a tragic example of what economists coldly call “price insensitivity.”) This also benefits ESG fund managers since, like other fund managers, they earn higher fees from higher financial returns.

Similarly, fossil fuel companies—also typically high earners—often obtain decent ESG ratings, so 80 percent of ESG funds invest in them despite their role in bringing about climate catastrophe.³ Big Oil is not charged for the damage that its carbon dioxide (CO₂) emissions inflict on the world.

Casinos, junk food producers, liquor manufacturers—many companies whose products can ruin lives boast superior ESG scores and appear prominently in ESG portfolios.

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ESG financing does not prod companies to be better social performers, since it only deals with issues that risk managers should be aware of in any case, as they are financially material, by definition. If a company thinks its profits will rise by switching to renewable power, or by improving its employees' benefits, it will do so, whether or not ESG takes notice. By only including risks that already appear on the company's agenda, ESG is a cheerleader, not a player.

But the hypocrisy of ESG goes deeper. Most ESG funds attempt to generate market-rate returns for their investors by tracking the performance of a general market index. However, that means their portfolios look very similar to the index, and hence the ESG scores of those portfolios are also quite close. An ESG fund is hard to distinguish from a market fund, except in one respect—it usually charges higher fees.

Although it is by far the largest form of “socially responsible investment” (SRI)—the general term for investing with both social and financial objectives—ESG is not the only SRI investment style. (Note that SRI and “sustainable investment” are used synonymously now, although “sustainable” originally had more of an environmental overtone.)

Besides ESG, the other large focus of SRI, sometimes overlapping with ESG, is “climate finance”—investments aimed at reducing global warming, directly or indirectly. Climate finance is as problematic as ESG. Big corporations that commit to achieving “net-zero” emissions rarely follow through, the evidence shows. Investor alliances dedicated to facilitate the climate transition through their financing policies do not practice what they preach. And voluntary “carbon offsets”—projects meant to compensate for carbon emissions, like reforestation or solar energy—is a market rife with phony deals.

Even “green bonds,” the most dynamic area of climate finance, are green in name only. Green bonds are debt securities whose proceeds are used for environmental projects, like renewable energy. The market for green bonds is large (\$3 trillion⁴) and liquid. Green bonds owe their popularity in large part to the common perception that they facilitate green projects. But in financial terms, they don’t.

Green bonds customarily have the same risk standing as general-purpose bonds from the same issuer. Because bond buyers accept the same risk of default on the green bond as on the issuer’s other bonds, they require the same yield. And because of this, the projects funded with green bonds must generate the same return on investment as any of the bond issuer’s other projects. If not, the issuer might have difficulty repaying the bond. Since green bonds are economically equivalent to the issuers’ other bonds, they do not make green projects any more attractive financially.

What we mostly see in SRI, whether in ESG or climate finance, is the finance industry holding up a big sign advertising social and environmental value, behind which they conduct business as usual. Investors seek market-rate returns, and companies strive to maximize shareholder value. The trade-off of financial for social performance is ignored, or even denied.

The exception to this is “impact investing,” a sector that does put social objectives ahead of, or on a par with, financial ones. But it only accounts for about \$1 trillion of investment, 53 percent the size of ESG, as companies on the social side of the social-financial trade-off tend to be smaller and riskier than those on the other side, and deliver below-market investment returns.

The structure of the finance industry, not moral weakness, is to blame for SRI's failure to stimulate greater corporate social responsibility. Most of the capital in the stock market, about 80 percent,⁵ is managed by institutional money managers. Many of them are under a legal obligation, called "fiduciary duty," requiring them to act in the best interests of their clients. This is usually interpreted as aiming for the best financial returns available within specified risk parameters.

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An institutional investor, like a pension fund, that invested in companies with high social performance but subpar profitability could be accused of breaching their fiduciary duty— and might even run the risk of being unable to honor its obligations.

We should not forget that these are commercial enterprises, competing for capital and wanting to show that they can produce investment returns as good as, or better than, their peers. Whether fiduciaries or not, the business of asset managers is making money for their clients.

Nor can we fault companies for prioritizing financial returns over social ones. In free markets, companies have to compete to attract capital. The stock exchange does not reward companies for serving other stakeholders unless shareholders benefit as well.

True, long-term profitability might improve if corporations upped their social responsibility game. Operating conditions would be more propitious in a world without climate warming and social injustice.

But the deck is stacked against corporate farsightedness. Directors on the board who don't maximize proximate value for shareholders run the risk of being fired by them. In addition, stock prices respond more to short-term earnings forecasts than long-range ones.⁶ One reason for this is that projections are more uncertain the farther out they venture. A bigger reason is that money managers are rewarded for quarterly, or even monthly, performance.

Once economic arguments are exhausted, civic virtue is the last refuge of the social investment advocate. After all, aren't corporations people, too—or at least managed by them? Even at some financial cost, executives should be good citizens and embody loftier goals than mere shareholder returns in their leadership.

But in practice, psychology tells us, organizations, including companies, often form tight communities whose members, consciously or not, subordinate personal values in the common quest to achieve strategic goals. "Groupthink" can lead to behavior and outcomes, validated by the group, that individual members might recoil from in a different context.

In our capitalist system, the government has traditionally acted as the counterweight to shareholder value, changing the parameters when the imbalances inherent in free markets threatened to cause irreparable harm. Far from handicapping corporations, the reforms of the Progressive Era and the New Deal left them more dynamic than before.

Today we are again at an inflection point, with income inequality at worse levels than during the Gilded Age of robber barons and Dickensian poverty. Socioeconomic mobility is on a decades-long decline,⁷¹⁰ and the future of the planet is threatened by unremitting atmospheric emissions. But rather than a battering ram for change, SRI is a bulwark of the status quo.

Instead of betting that social investment will improve corporate social behavior, we should direct our efforts toward the political process. If we want the outcome of the game to change, we have to revise the rules.

Solutions are available—but they will be found in legislative assemblies, not corporate boardrooms. And only if we make our voices heard. 🗣️



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Endnotes

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