



SOUNDING GOOD OR DOING GOOD: A SKEPTICAL LOOK AT ESG

Morality plays in markets!

Buzz Words and Magic Bullets!

- In my four decades in corporate finance and valuation, I have seen many "new and revolutionary" ideas emerge, marketed as the solution to all of the problems in business decision making.
- Most of the time, these ideas represent either a repackaging of existing concepts, with a healthy dose of marketing and selling, usually by consultants and bankers, and their magic fades quickly once their limitations come to the surface, as they inevitably do.
- The latest entrant in this game is ESG (Environmental, Social and Governance), and the sales pitch is wider and deeper. Companies that improve their social goodness standing will not only become more profitable and valuable over time, we are told, but they will also advance society's best interests, thus resolving one of the fundamental conflicts of private enterprise, while also enriching investors.

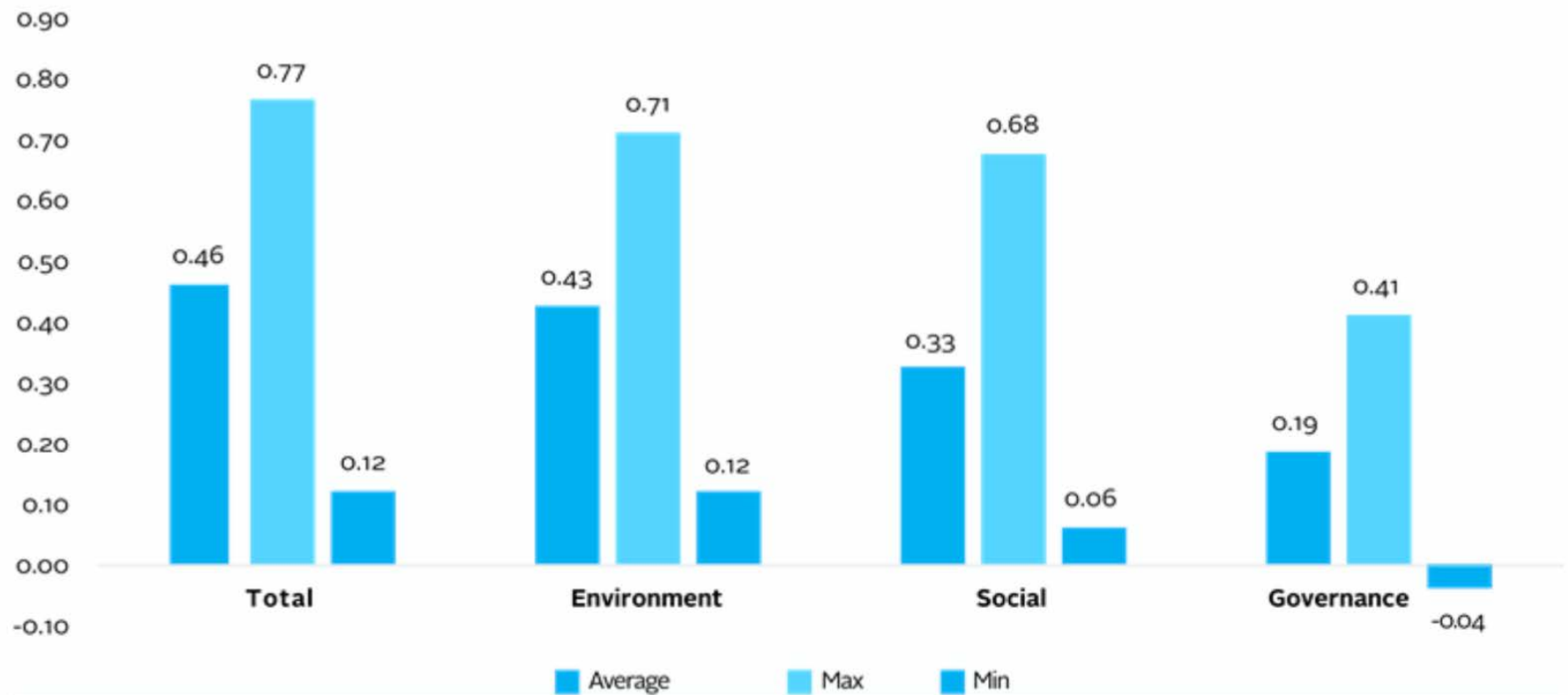
Why now?

- 50 years since Friedman: The first is that it is the fiftieth anniversary of one of the [most influential opinion pieces in media history](#), where Milton Friedman argued that the focus of a company should be profitability, not social good.
- COVID and ESG: The second were multiple news stories about how "good" companies have done better during the COVID crisis and how much money was flowing into ESG funds.
- The Establishment has bought in: The third is a more long-standing story line, where the establishment seems to have bought into ESG consciousness, with business leaders in the [Conference Board signing on to a "stakeholder interest" statement](#) last year and institutional investors shifting more money into ESG funds.

Measuring ESG: Challenges

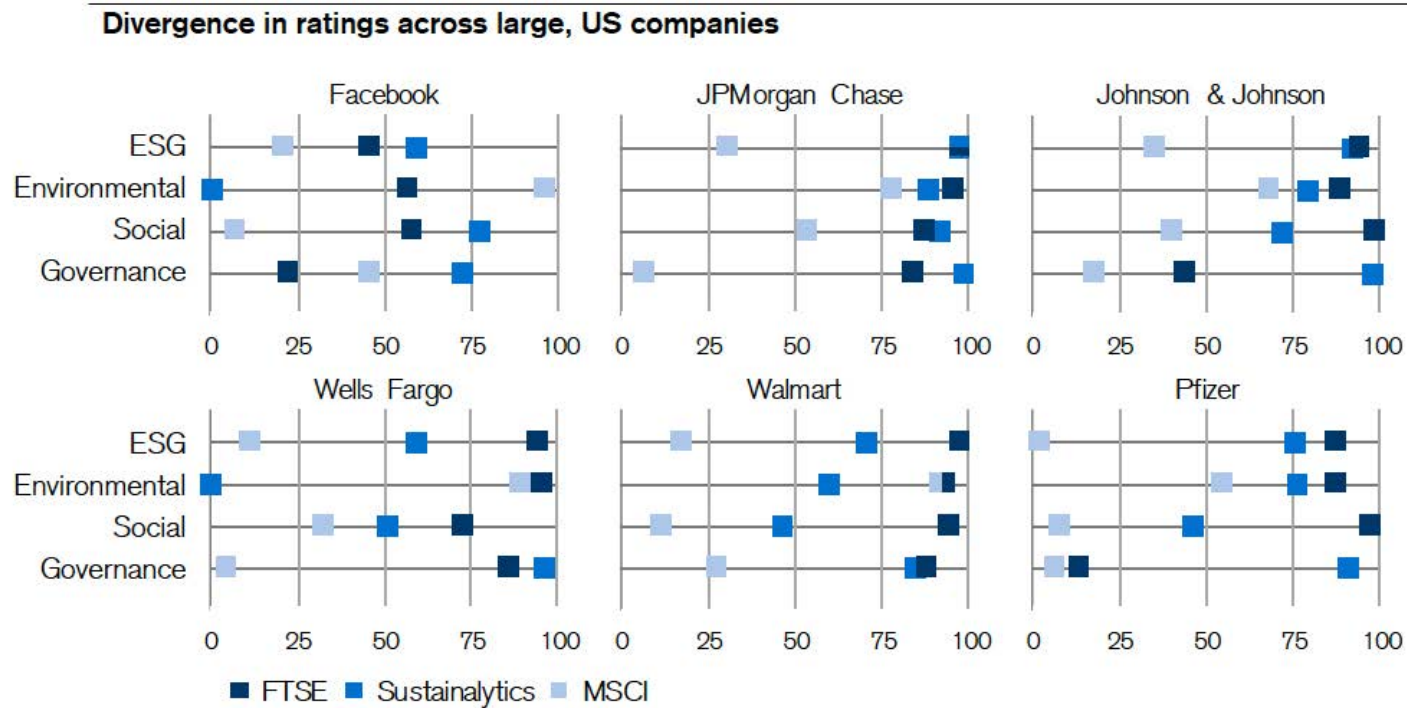
- It is fuzzy: The first is that much of social impact is qualitative and developing a numerical value for that impact is difficult to do.
- And entirely subjective: The second is even trickier, which is that there is little consensus on what social impacts to measure, and the weights to assign to them.
- But it is still being measured: If your counter is that there are multiple services now that measure ESG at companies, you are right, but the lack of clarity and consensus results in the companies being ranked very differently by different services.

ESG Services disagree...



Average, minimum, and maximum correlations across providers

Even on high profile companies...



And the differences will persist...

- There are some who believe that this reflects a measurement process that is still evolving, and that as companies provide more disclosure on ESG data and ESG measurement services mature, there will be consensus. I don't believe it, because. *if there were consensus, it is unlikely that we would not need to convince businesses to reflect that consensus.*
- Even if you overlook disagreements on ESG as growing pains, there is one more component that adds noise to the mix and that is the direction of causality:
 - *Do companies perform better because they are socially conscious (good) companies, or do companies that are doing well find it easier to do good?*
 - Put simply, if ESG metrics are based upon actions/measures that companies that are doing better, either operationally and/or in markets, can perform/deliver more easily than companies that are doing badly, researchers will find that ESG and performance

The ESG Promises: Cake for all, with no calories!

- For companies, the promise is that being "good" will generate higher profits for the company, at least in the long term, with lower risk, and thus make them more valuable.
- For investors in these companies, the promise is that investing in "good" companies will generate higher returns than investing in "bad" or middling companies.
- For society, the promise is that not only would good companies help fight problems directly related to ESG, like climate change and low wages, but also counter more general problems like income inequality and healthcare crises.

The ESG Questions

The Big Questions on ESG

How does ESG affect a firm's operations & value?

Increase value by improving profitability and/or reducing risk.

Reduce value by increasing costs and/or increasing risk.

Research on the links between ESG and
- Growth (Revenues & Earnings)
- Profits (Margins, Accounting Returns)
- Risk (Discount Rates & Shocks)

How does the market price the consequences of ESG?

Price overadjusts to value change.

Price correctly reflects value change

Price underadjusts to value change.

Research on the links between a company's ESG and how its stock is priced (PE, PBV, Tobin's Q or EV multiple)

Do investors make excess returns on ESG stocks

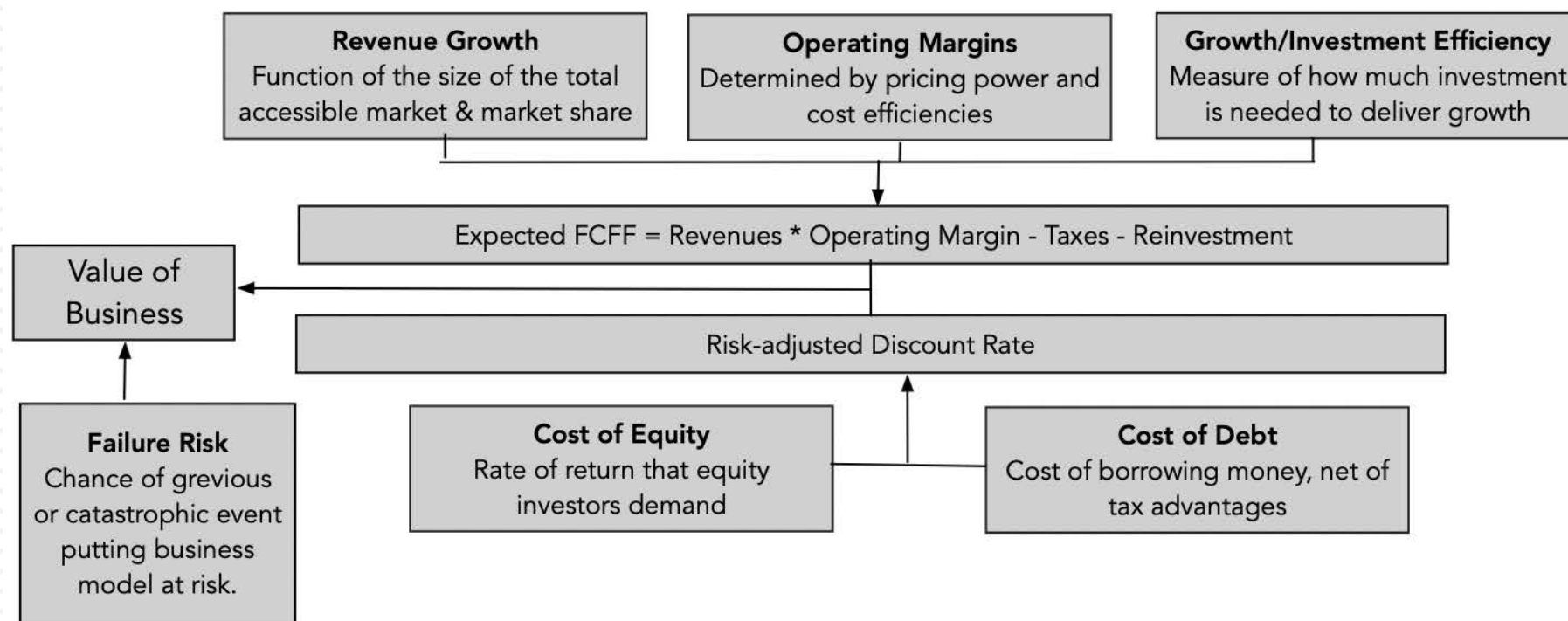
Investors make positive excess returns

Investors make "fair rate" of returns

Investors make positive excess returns

Research on whether stocks that score high on ESG or funds with an ESG focus deliver higher or lower returns than expected, given risk.

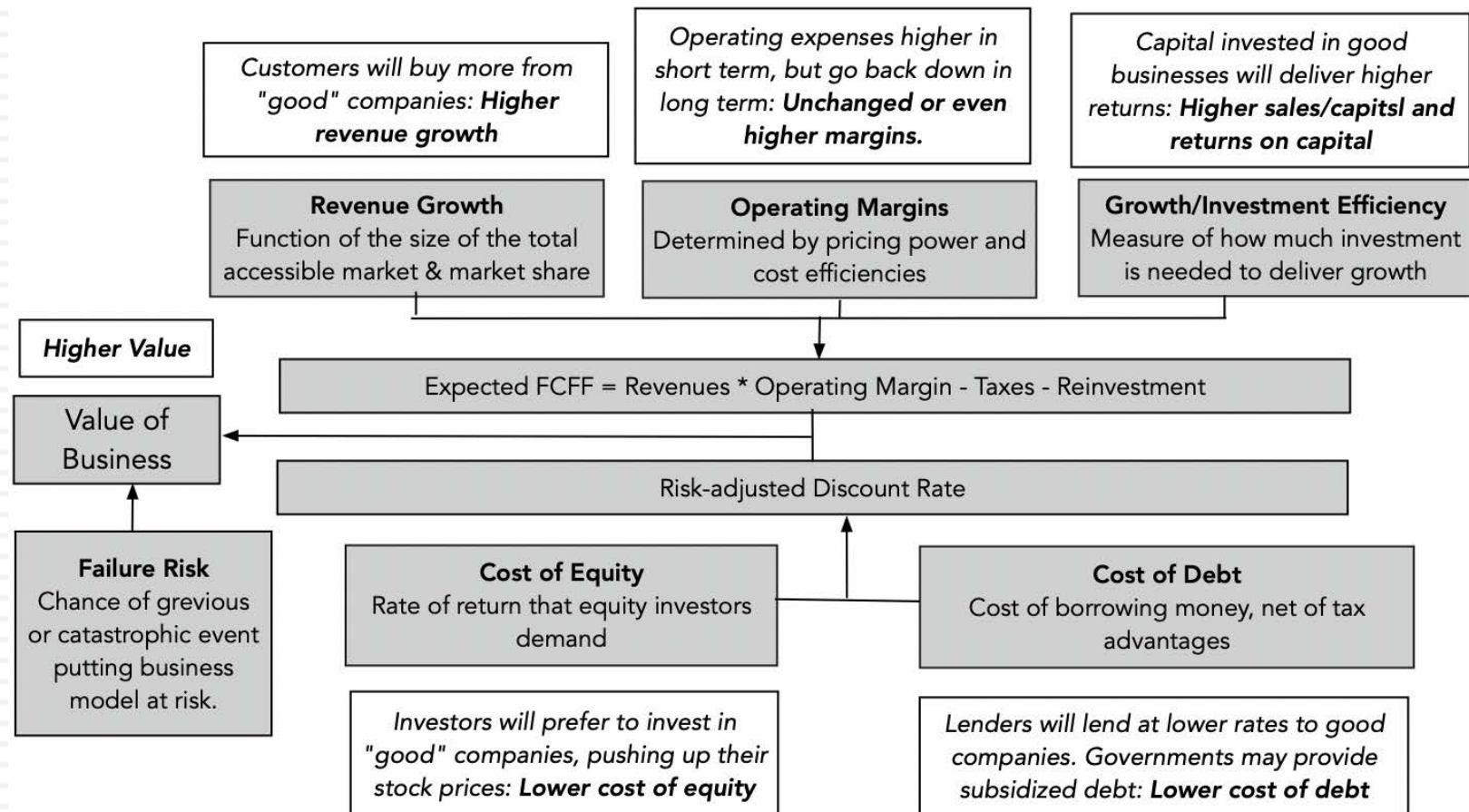
I. ESG and Value



The "It Proposition": For "it" to affect value, "it" has to affect either the cash flows or the risk in those cashflows.

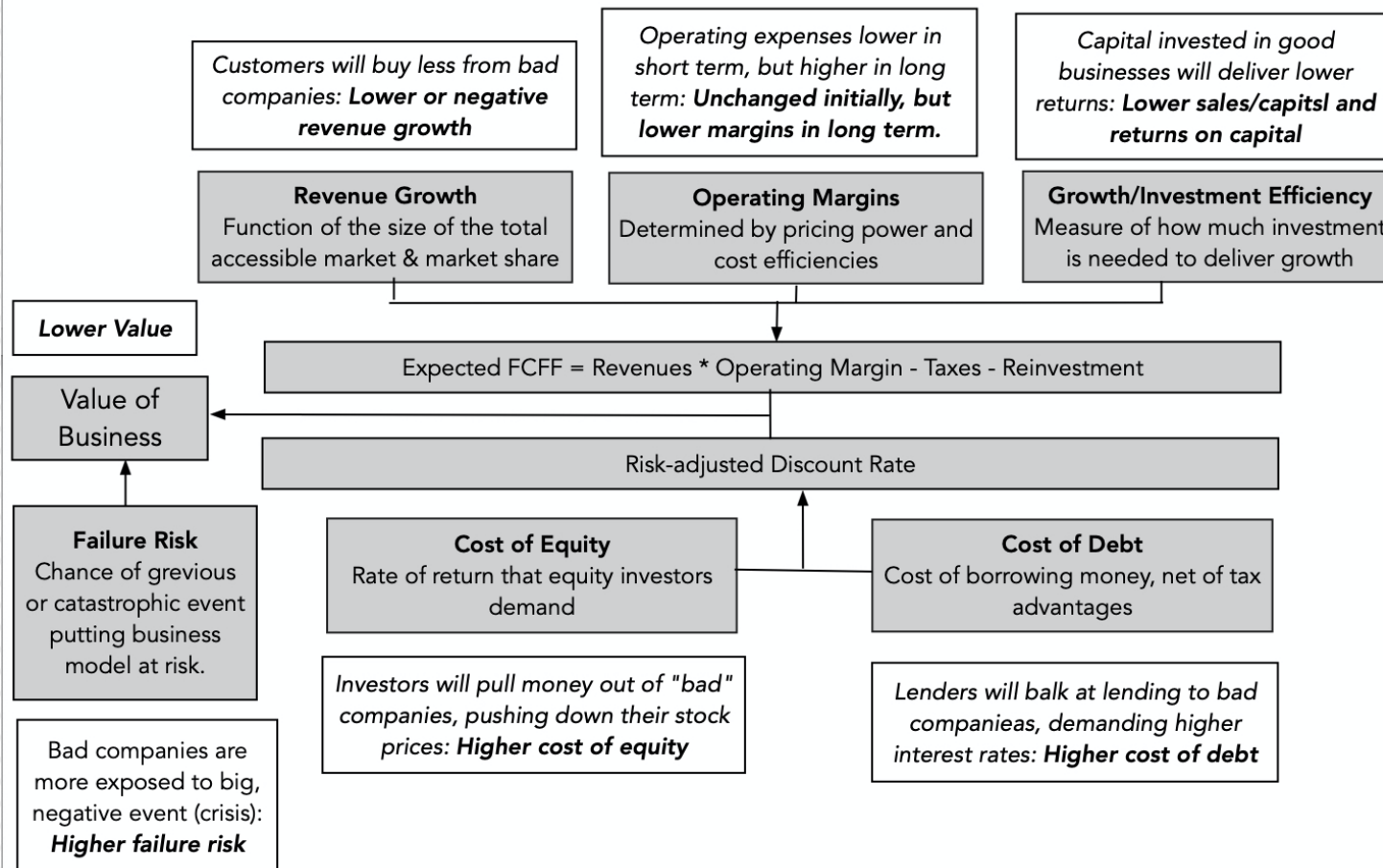
The Good shall be rewarded

Figure 2: The Payoff to Being Good: The Virtuous Cycle



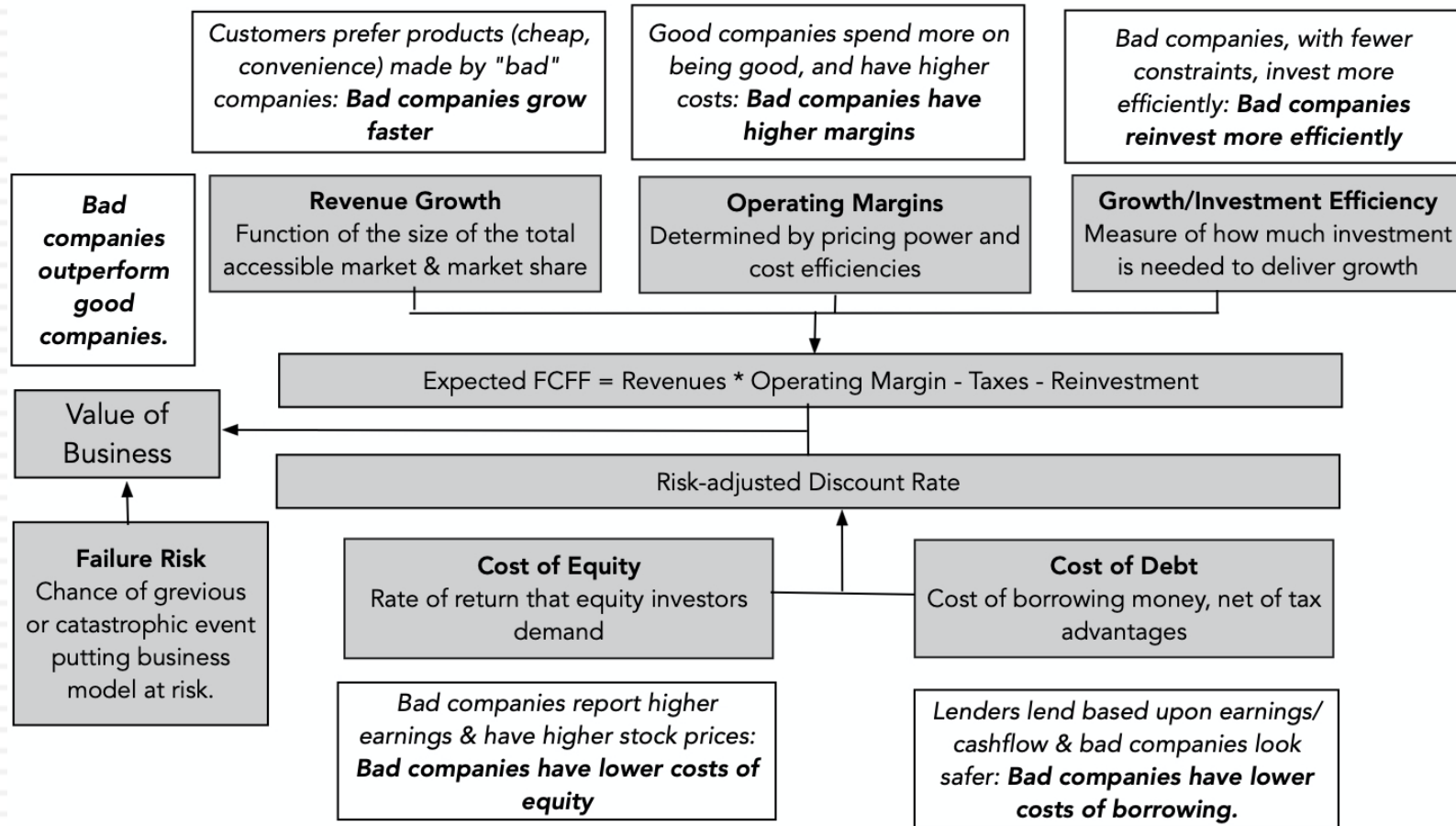
The Bad shall be punished

Figure 3: The Punishment for Being Bad: The Punitive Vision



The Bad Guys win: Hell on Earth?

Figure 4: The "Bad" Companies win: The Dystopian Vision



Value and ESG: The Evidence

- A Weak Link to Profitability: There are [meta studies](#) (summaries of all other studies) that shine summarize hundreds of ESG research papers, and find *a small positive link between ESG and profitability*, but one that is very sensitive to how profits are measured and over what period. Breaking down ESG into its component parts, [some studies](#) find that environment (E) offered the strongest positive link to performance and social (S) the weakest, with governance (G) falling in the middle.
- A Stronger Link to Funding Costs: [Studies of “sin” stocks](#), i.e., companies involved in businesses such as producing alcohol, tobacco, and gaming, find that these stocks are less commonly held by institutions and that they face higher costs for funding, from equity and debt). The evidence for this is strongest in sectors like tobacco (starting in the 1990s) and fossil fuels (especially in the last decade), but these findings come with a troubling catch. While these companies face higher costs, and have lower value, investors in these companies generate higher returns.
- And to Failure/Disaster Risk: “Bad” companies are exposed to disaster risks, where a combination of missteps by the company, luck, and a failure to build in enough protective controls (because they cost too much) can cause a disaster, either in human or financial terms. [One study](#) created a value-weighted portfolio of controversial firms that had a history of violating ESG rules and reported negative excess returns of 3.5% on this portfolio, even after controlling for risk, industry, and company characteristics.

II. ESG and Returns

- Constrained optimal? To begin with, the notion that adding an ESG constraint to investing increases expected returns is counter intuitive. After all, a constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost.
- Truth in Advertising: In one of the few cases where honesty seems to have prevailed over platitudes, the TIAA-CREF Social Choice Equity Fund explicitly acknowledges this cost and uses it to explain its underperformance, stating that *“The CREF Social Choice Account returned 13.88 percent for the year [2017] compared with the 14.34 percent return of its composite benchmark ... Because of its ESG criteria, the Account did not invest in a number of stocks and bonds ... the net effect was that the Account underperformed its benchmark.”*
- Internal contradiction: In fact, there is an inherent contradiction, at least on the surface, between arguing that ESG leads to higher value and stock prices, made to CEOs and CFOs of companies, and simultaneously arguing that investors in ESG stocks will earn higher (positive excess) returns.

Why returns to ESG are tough to read...

Value Effect	Market Pricing	Investor Returns to ESG
ESG increases value	Markets overreact, pushing up prices too much	Negative excess returns for investors in good ESG firms.
ESG decreases value	Markets overreact, pushing down prices too much	Positive excess returns for investors in good ESG firms.
ESG increases value	Markets underreact, with prices going up too little.	Positive excess returns for investors in good ESG firms.
ESG decreases value	Markets underreact, with prices going down too little.	Negative excess returns for investors in good ESG firms.
ESG increases value	Markets react correctly, with prices increasing to reflect value.	Zero excess returns for investors in good ESG firms.
ESG decreases value	Markets underreact, with prices going down too little.	Zero excess returns for investors in good ESG firms.

And the research is all over the place...

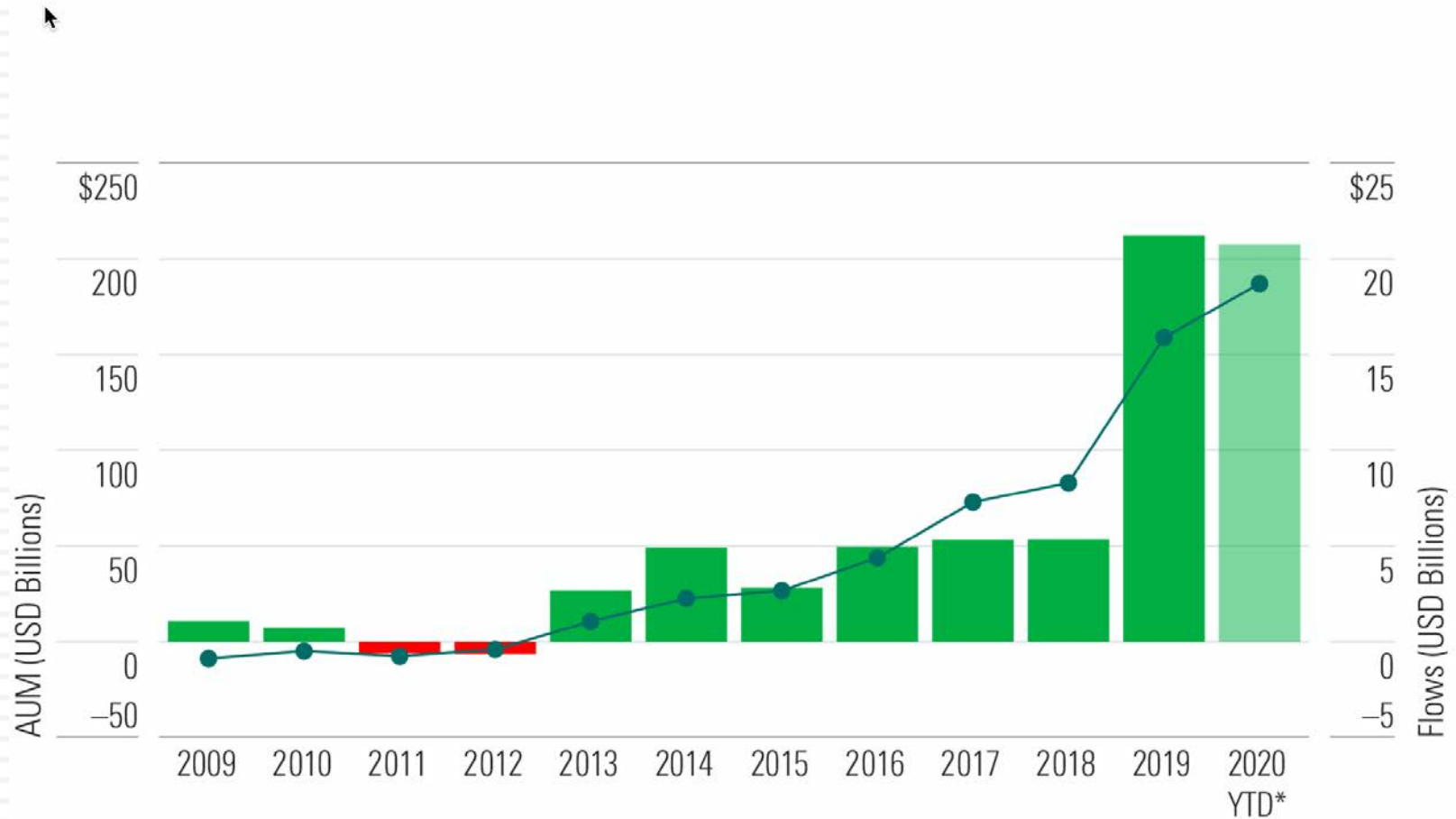
- ❑ Invest in bad companies: [A comparison](#) of two Vanguard Index funds, the Vice fund (invested in tobacco, gambling, and defense companies) and the FTSE Social Index fund (invested in companies screened for good corporate behavior on multiple dimensions) and note that a dollar invested in the former in August 2002 would have been worth almost 20% more by 2015 than a dollar invested in the latter.
- ❑ Invest in good companies: At the other end of the spectrum, there are studies that seem to indicate that there are positive excess returns to investing in good companies. [A study](#) showed that stocks in the Anno Domini Index (of socially conscious companies) outperformed the market, but that the outperformance was more due to factor and industry tilts than to social responsiveness. Some of the strongest links between returns and ESG come from the governance portion, which, as we noted earlier, is ironic, because the essence of governance, at least as measured in most of these studies, is fealty to shareholder rights, which is at odds with the current ESG framework that pushes for a stakeholder perspective.
- ❑ ESG has no effect: Splitting the difference, there are other studies that find little or no differences in returns between good and bad companies. In fact, studies that more broadly look at factors that have driven stock returns for the last few decades find that much of the positive payoff attributed to ESG comes from its correlation with momentum and growth.

Glimmers of hope?

- While the overall evidence linking ESG to returns is weak, there are two pathways that offer promise:
 - Transition Period Payoff: The first scenario requires an adjustment period, where being good increases value, but investors are slow to price in this reality. During the adjustment period the highly rated ESG stocks will outperform the low ESG stocks, as markets slowly incorporate ESG effects, but that is a one-time adjustment effect.
 - Limit Downside: To the extent that socially responsible companies are less likely to be caught up in controversy and court disaster, the argument is that they will also have less downside risk as their counterparts who are less careful.
- Investing lesson: Investors who hope to benefit from ESG *cannot do so by investing mechanically* in companies that already identified as good (or bad), but have to adopt a more dynamic strategy built around either aspects of corporate social responsibility that are not easily measured and captured in scores, or from *getting ahead of the market in recognizing aspects of corporate behavior that will hurt or help the company in the long term.*

The COVID effect: ESG Fund Flows

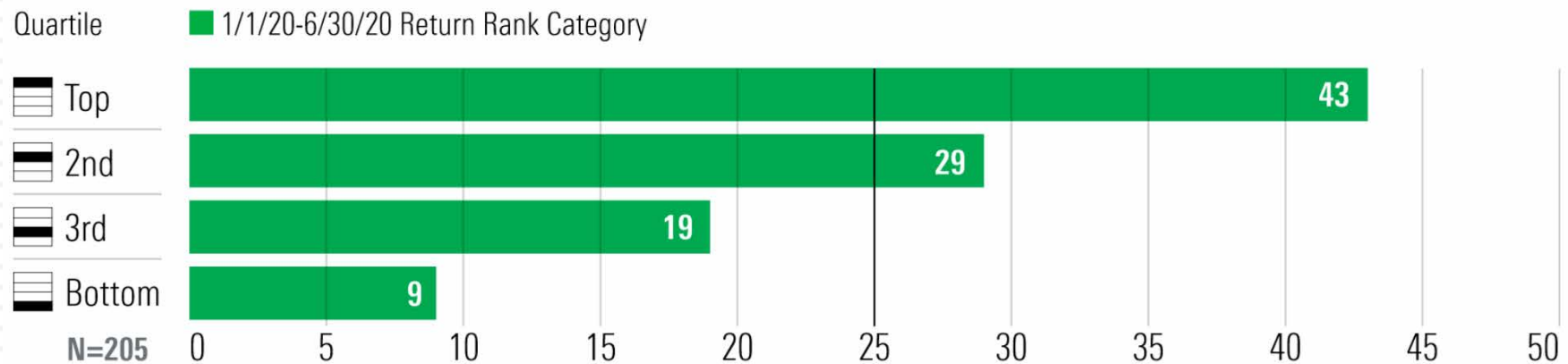
Sustainable Funds Estimated Annual Flows



Source: Morningstar Direct. Data as of 6/30/2020. *YTD 2020 as of 6/30/2020.

The COVID effect: ESG Returns

Sustainable Equity Funds: YTD Return Rank By Morningstar Category Quartile



With some pushback

- The consensus view that ESG investing outperformed the market is now getting push back, with some arguing that once you control for the sector tilt of ESG funds (they tend to be more heavily invested in tech companies), ESG, by itself, provided no added payoff during the down period of the crisis (February and March 2020) and pushed returns down during the recovery phase.
- If success in active investing is defined as attracting investor money, ESG has had a successful run during COVID, but if it is defined as delivering returns, it is far too early to be doing victory dances in the end zone.

To conclude..

- In many circles, ESG is being marketed as not only good for society, but good for companies and for investors. In my view, the hype regarding ESG has vastly outrun the reality of both what it is and what it can deliver, and the buzzwords (sustainability, resilience) are not helpful.
- Much of the ESG literature starts with an almost perfunctory dismissal of Milton Friedman's thesis that companies should focus on delivering profits and value to their shareholders, rather than play the role of social policy makers. The more that I examine the arguments that advocates for ESG make for why companies should expand mission statements, and the evidence that they offer for the proposition, the more I am inclined to side with Friedman.
- The ESG bandwagon may be gathering speed and getting companies and investors on board, but when all is said and done, a lot of money will have been spent, a few people (consultants, ESG experts, ESG measurers) will have benefitted, but companies will not be any more socially responsible than they were before ESG entered the business lexicon.