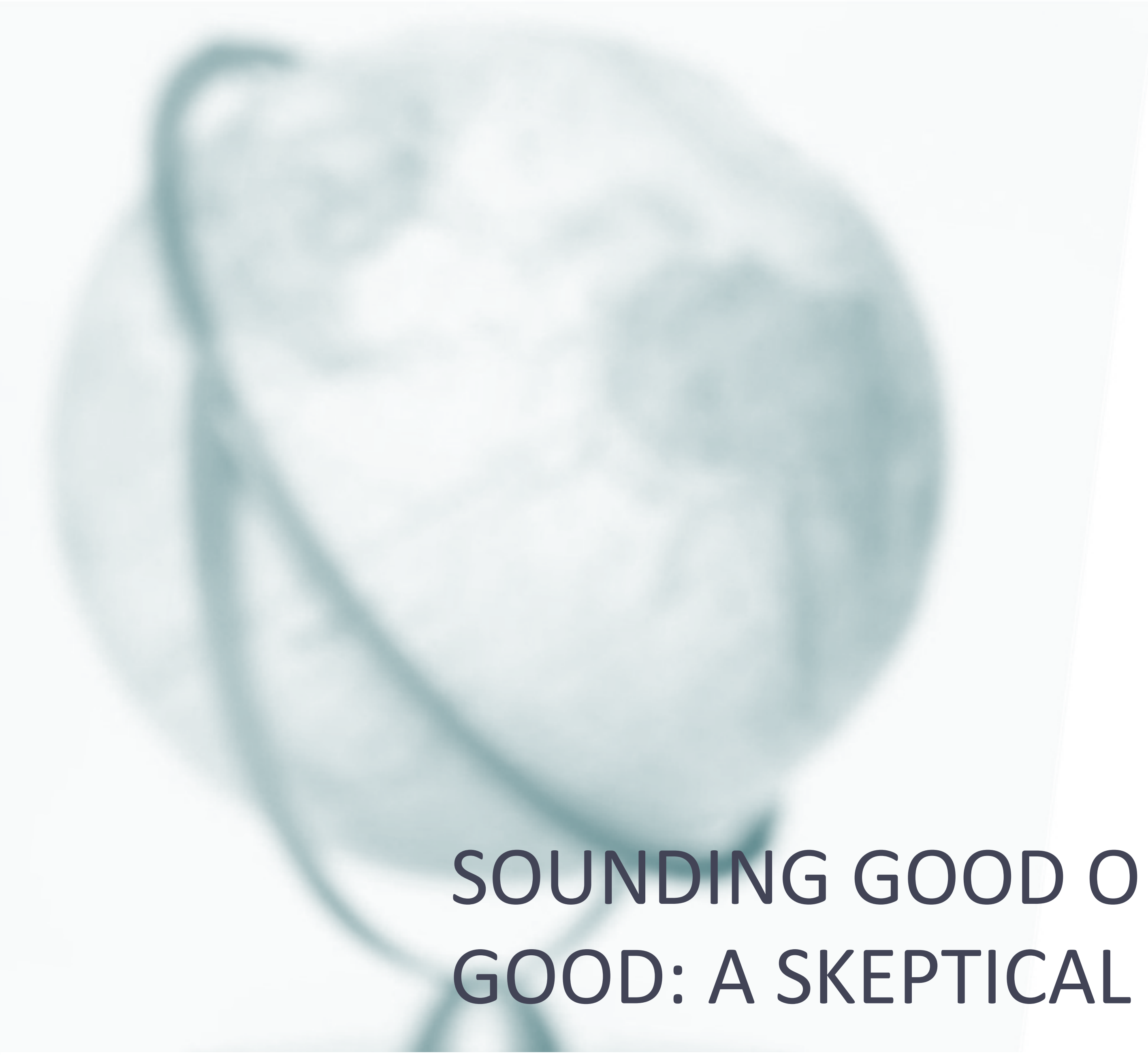


SOUNDING GOOD OR DOING GOOD: A SKEPTICAL LOOK AT ESG

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.

The Four Big Questions

1. What is ESG and can it be measured?
2. How (if at all) does ESG affect value?
3. As an investor, can (will) you make money investing based on ESG?
4. Is society better off, if companies follow the ESG path?

What is “goodness”?

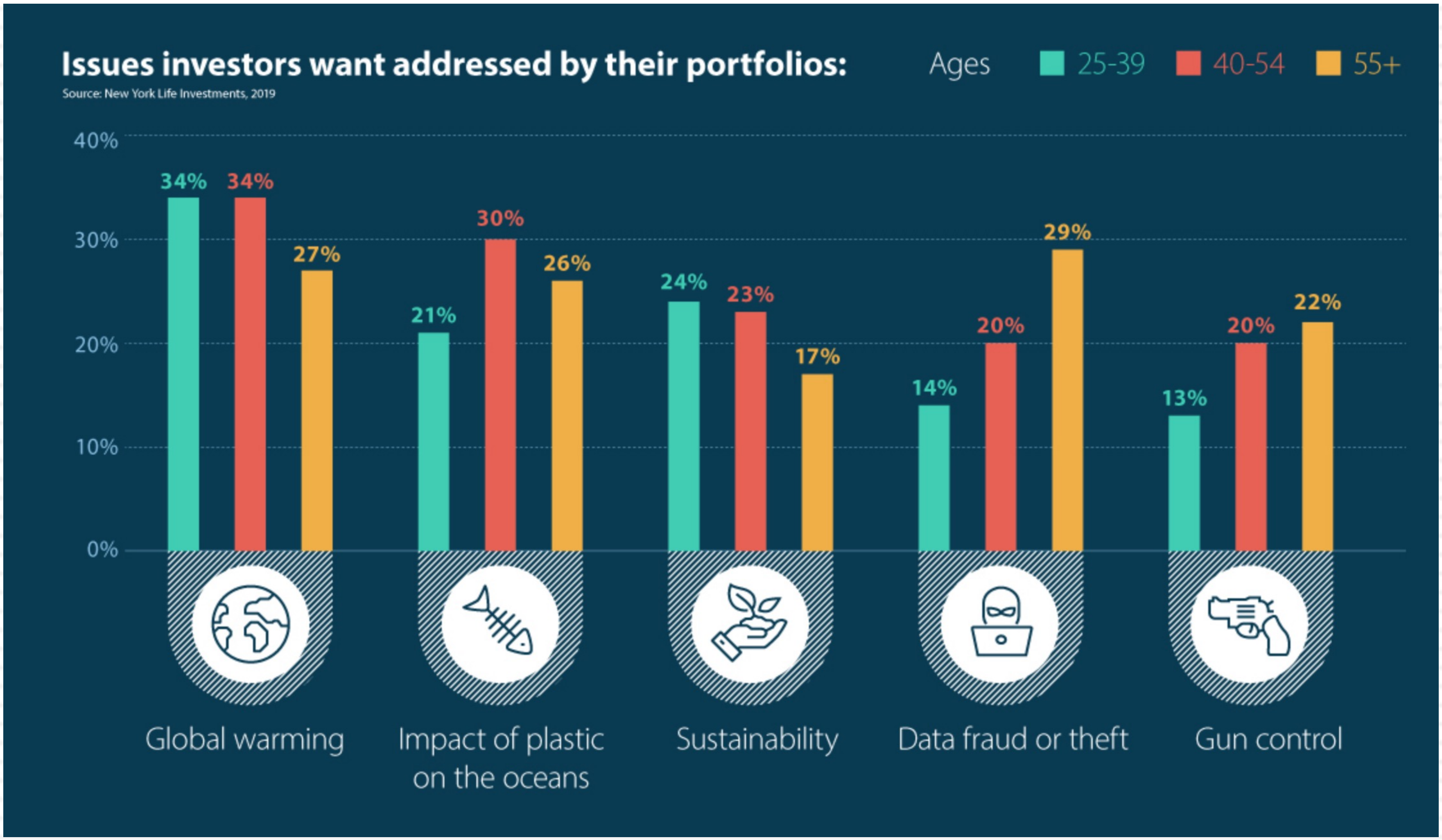
- As an investor, rank the following companies from best to worst purely on goodness:

Company	*Your Rank (1 = Best on ESG, 2 (Worst on ESG)*
Exxon Mobil	
Tesla	
Altria	
Facebook	
Microsoft	
Coca Cola	
Apple	

What ESG Services think…

ISS ESG Ranking	*MSCI ESGI Rating*	*S&P ESG Score*
High Score = More ESG Risk	*Higher Rating = Better on ESG*	*High Score = Less ESG Risk*
Microsoft (15)	Microsoft (AAA)	Microsoft (58)
Apple (17)	Coca Cola (AA)	Altria (37)
Altria (25)	Tesla (A)	Exxon Mobil (36)
Facebook (25)	Exxon Mobil (BBB)	Coca Cola (33)
Coca Cola (25)	Apple (BBB)	Apple (29)
Tesla (31)	Altria (BB)	Tesla (15)
Exxon Mobil (35)	Facebook (B)	Facebook (14)

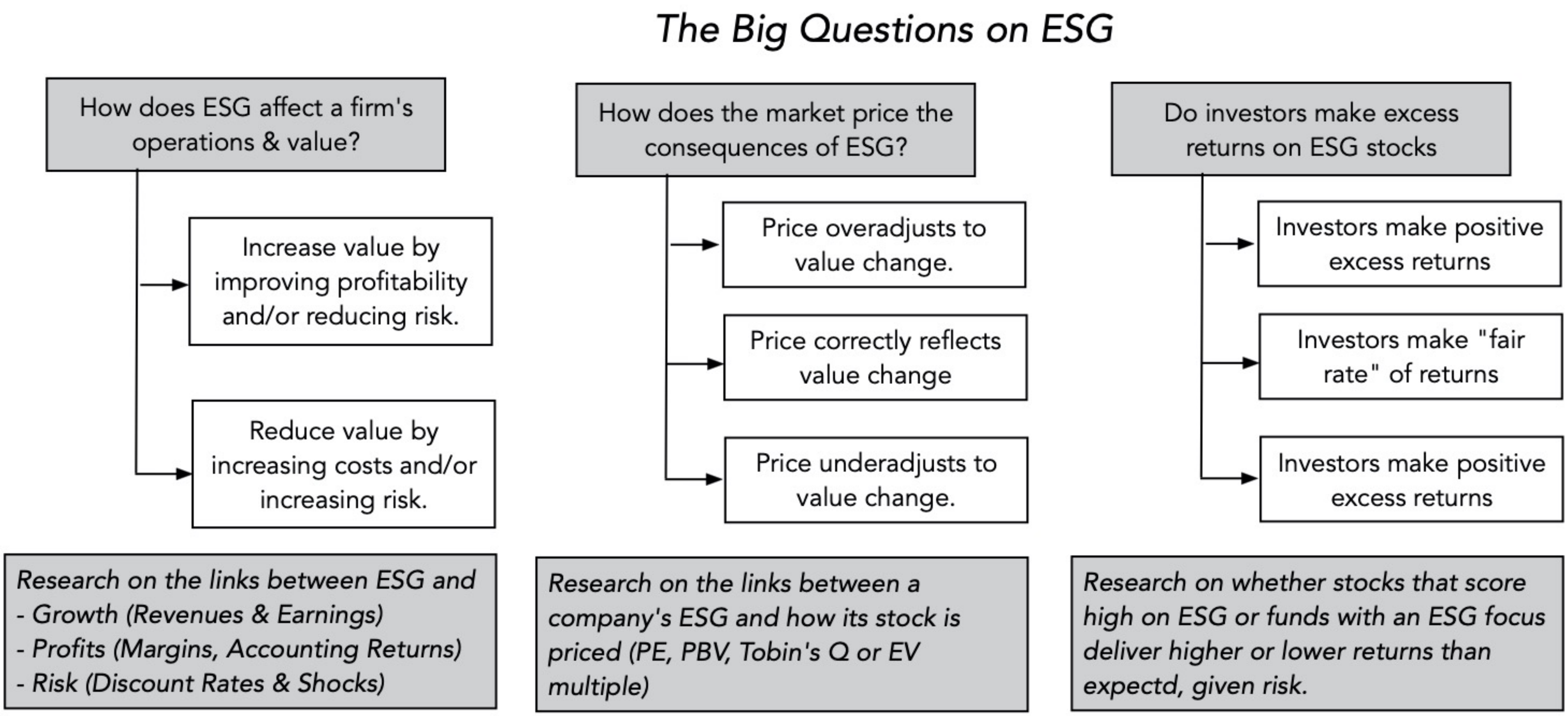
Value Issues for Investors



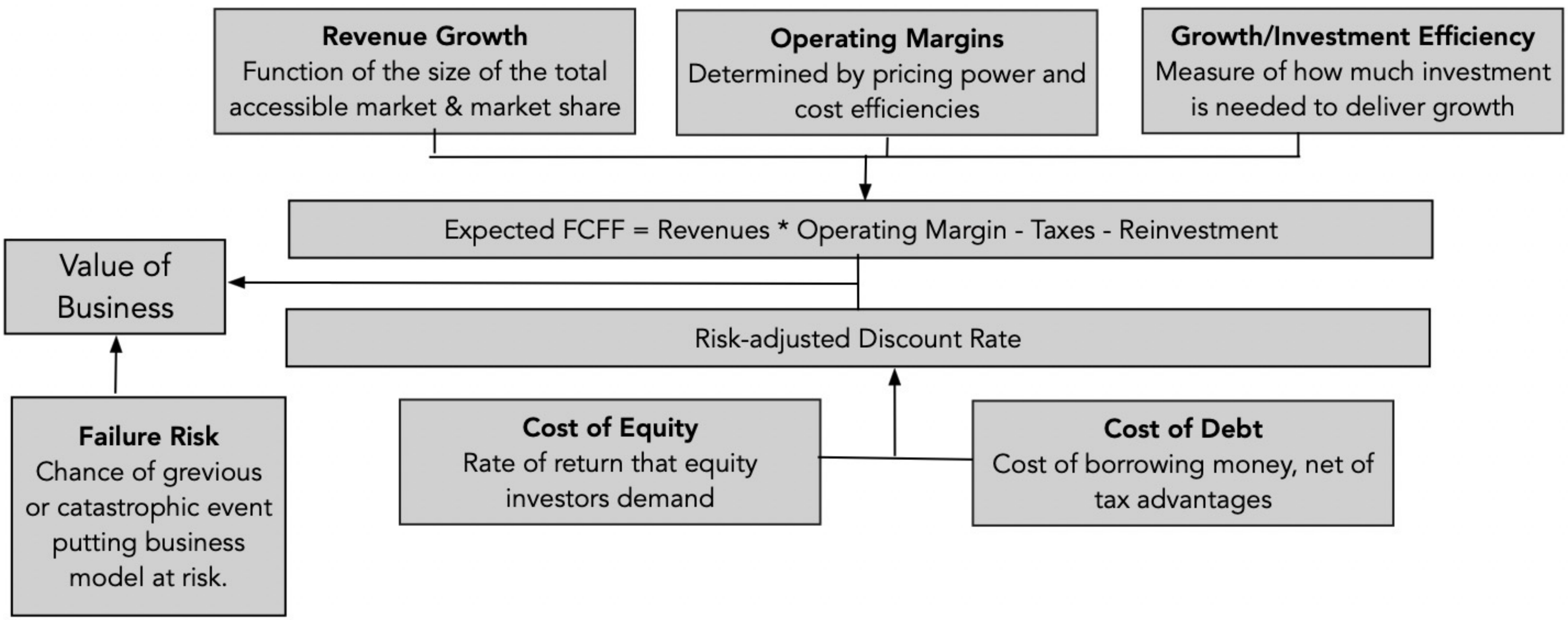
And the differences will persist…

- 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 Questions



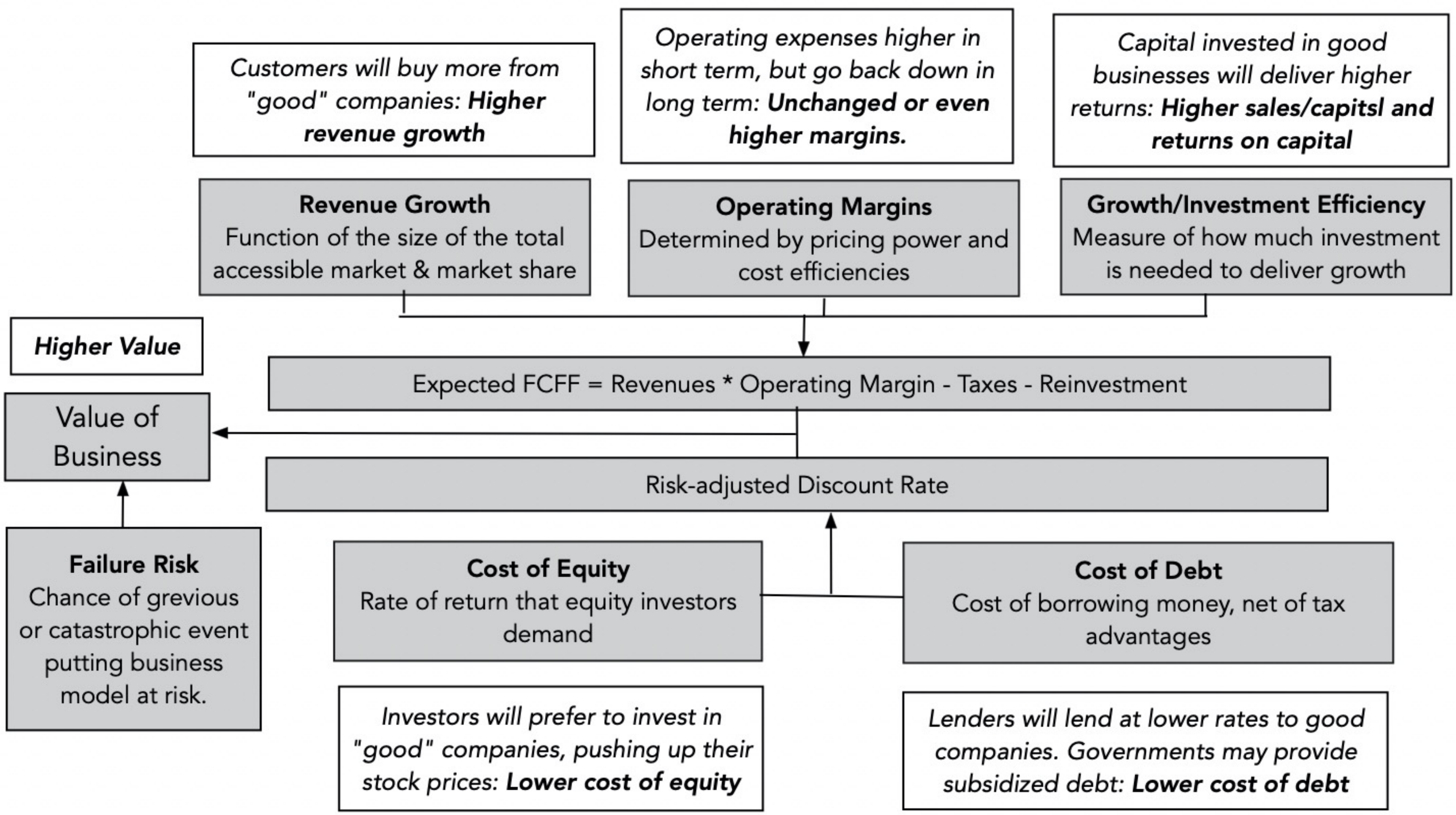
I. ESG and Value



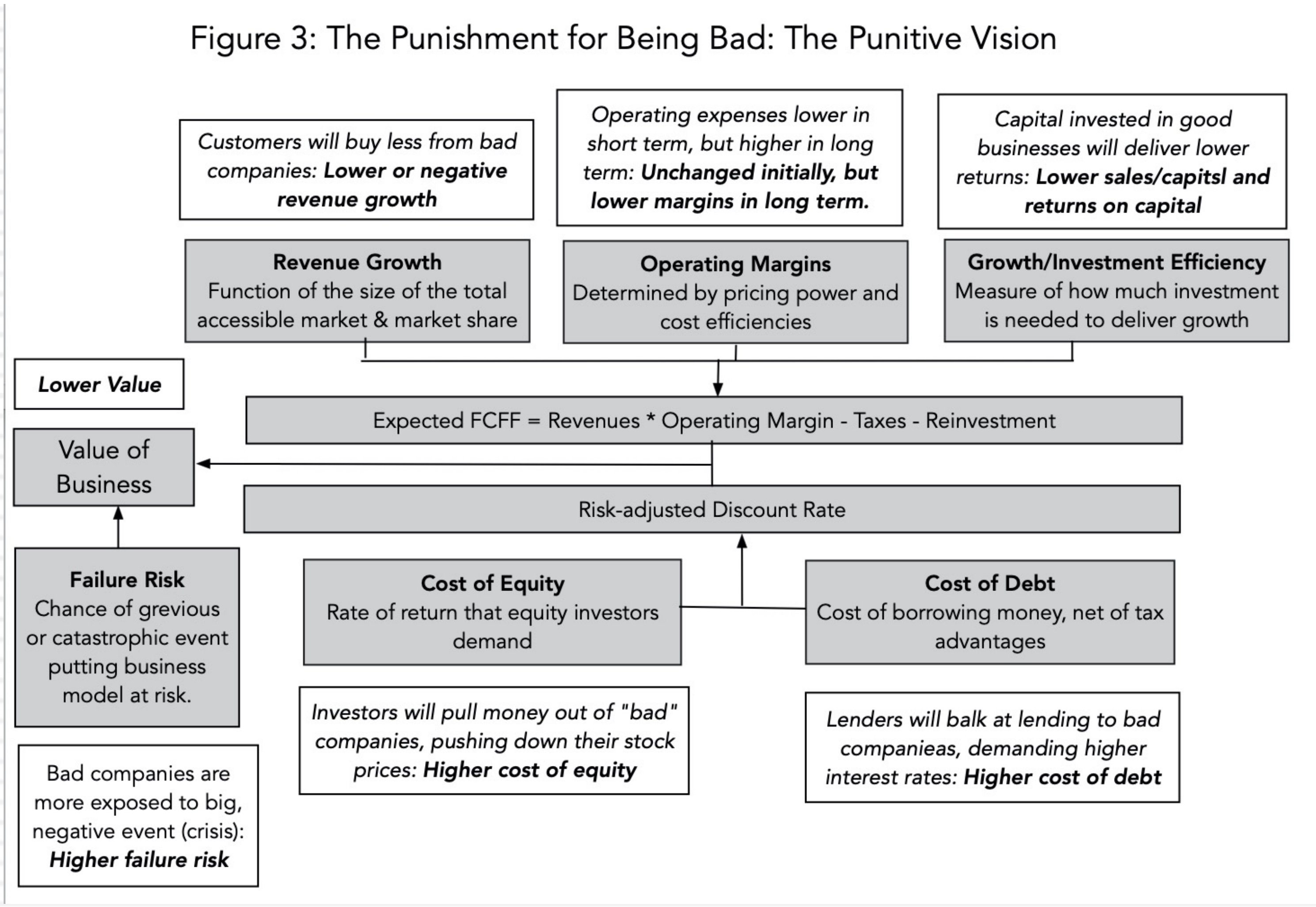
The "It Proposition": For *"it" to affect value, "it" has to affect either the cash flows or the risk in those cashflows.*

The Good shall be rewarded

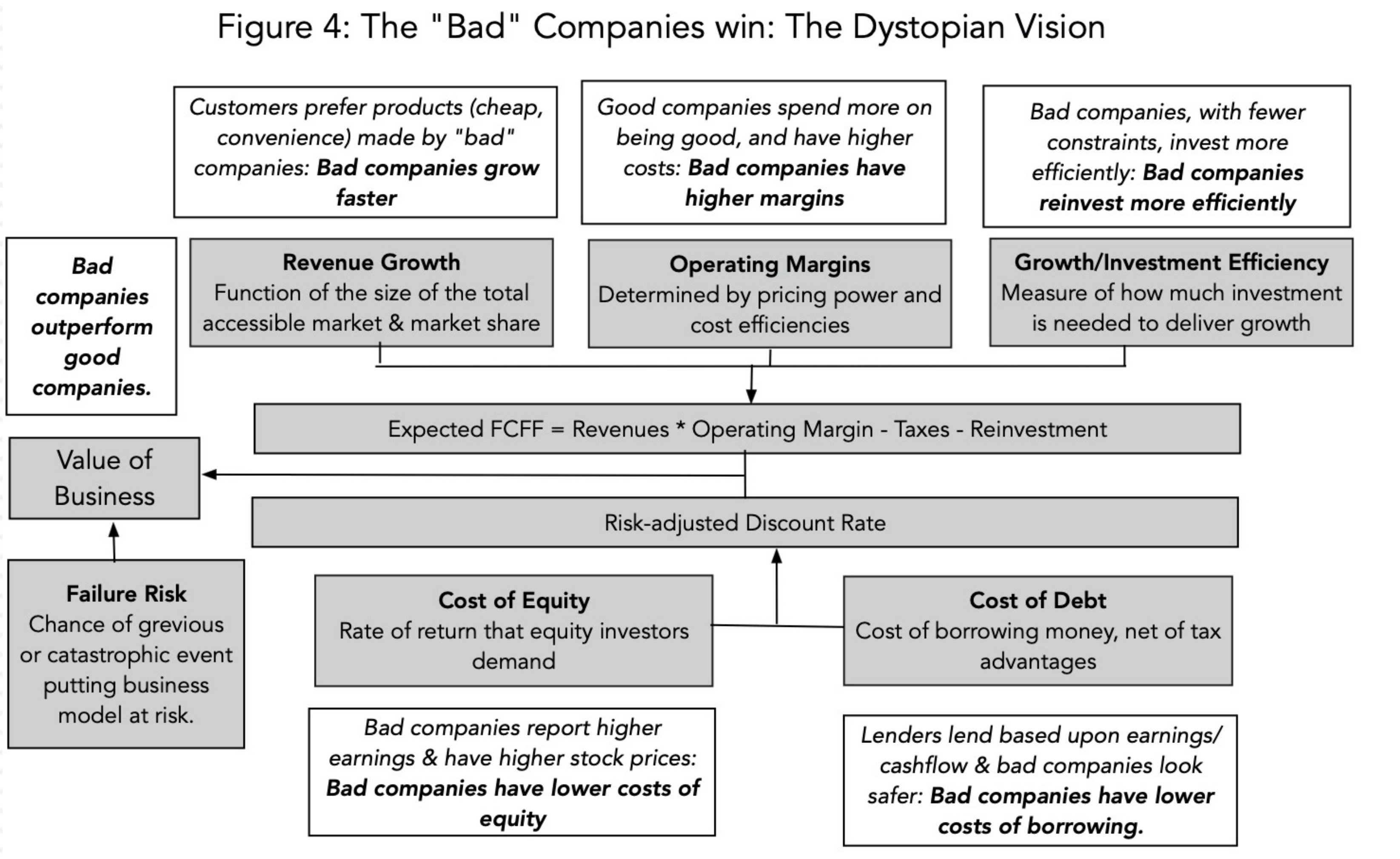
Figure 2: The Payoff to Being Good: The Virtuous Cycle



The Bad shall be punished



The Bad Guys win: Hell on Earth?



ESG and Profitability

- The link to profitability is weak: There are meta studies (summaries of all other studies) that find *a small positive link between ESG and profitability*, but one that is very sensitive to how profits are measured and over what period.
- E, S and G have different payoffs: 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. Others find that governance is the dominant variable, but if so, it is the one variable that predates ESG and actually pushes in the opposite direction.
- Uncertainty about direction of Causation: The studies that find a link between profitability and ESG scores face the question of which direction the causation runs: are good firms more profitable or are more profitable firms more likely to be picked as good firms?

ESG and Funding Costs

- There is 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.
- If this is the argument, though, be clear about the consequences:
  - Equity investors in good companies will settle for much lower returns, given risk, on their investment than in bad companies.
  - Lenders to good companies will earn lower interest rates, given default risk, than lenders to bad companies.

ESG and Catastrophic Risk

- Legal ≠ Sensible: The peril of playing fast and loose with the rules is that sooner or later, you will be entangled in a ”scandal”, and that scandal will not only damage you in the near term but also create reputational damage that can haunt you in the long term.
- There is a link 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, in human and 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.

ESG and Value: Propositions

- **Proposition 1**: Don’t be a “bad” company. The costs of being bad exceed any benefits you may get from operating close to the edge of what is legal or a business model that is at the edge of social acceptance.
- **Proposition 2**: If you want to go beyond ”not being bad” and try to be “good”, do it with the recognition that goodness will often cost you in the short term (lost business, higher costs), and that you may not recover that cost even in the very, very long term. Put simply, the notion that being good is always good for value is nonsense.
- **Proposition 3**: If being good is at the base of your business model, and you generate benefits from that perception, in terms of earnings and cash flows, you may have to accept a lower scale (and settle for being a smaller company).

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.

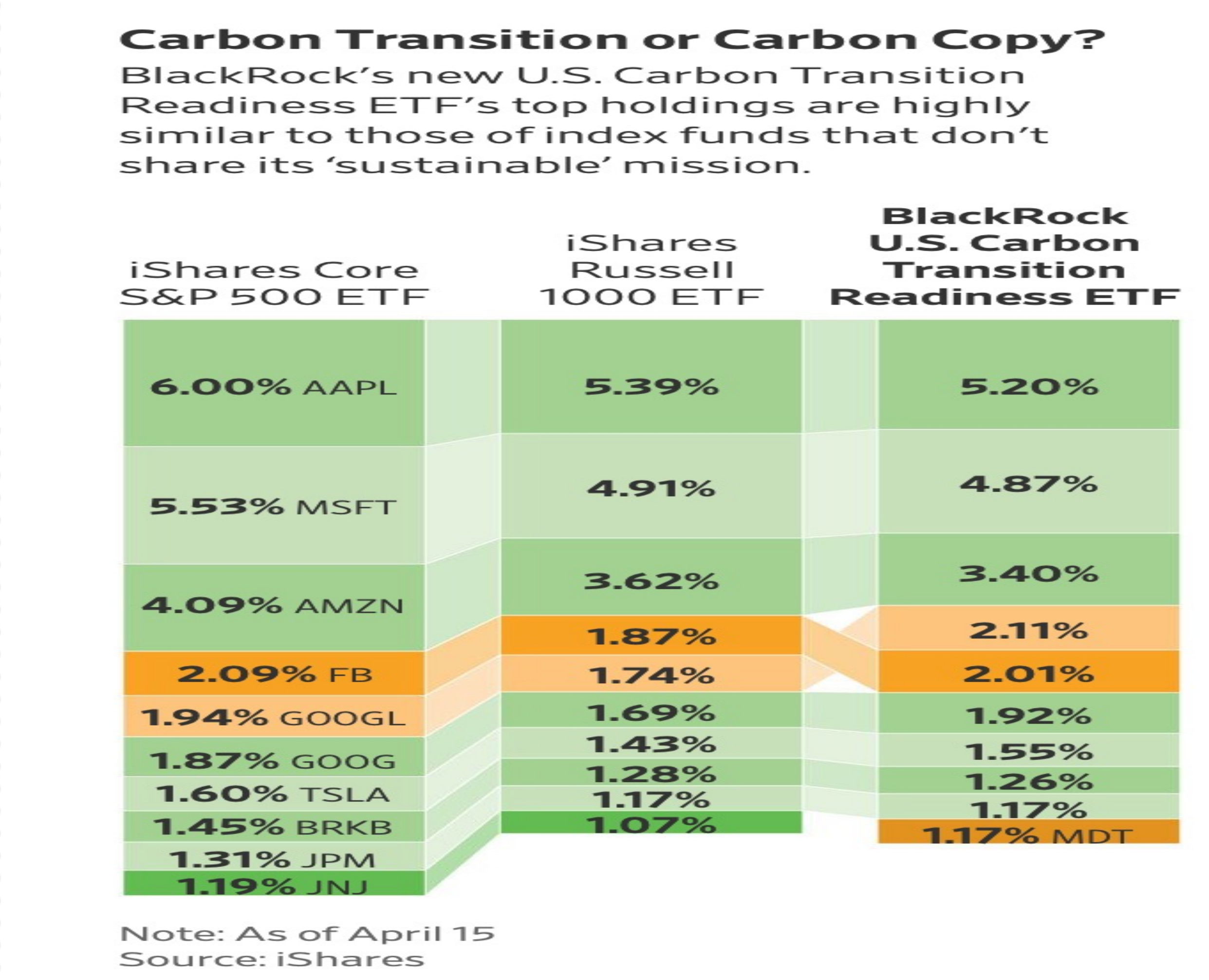
Why returns to ESG are tough to read…

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.

Two plays on ESG investing

- ESG Exclusionary Investing
  - You remove firms that you classify as “bad” firms from your investment universe.
  - Implicitly, you are assuming that bad firms are more likely to deliver negative returns and that avoiding them will improve returns on your portfolio.
- ESG Inclusionary Investing
  - You seek out firms that are “good’ firms for your portfolio
  - Implicitly, you are assuming that firms that do good are also good investments and that adding them will raise the returns on your portfolio.

Fake ESG? BlackRock's Carbon Transition ETF

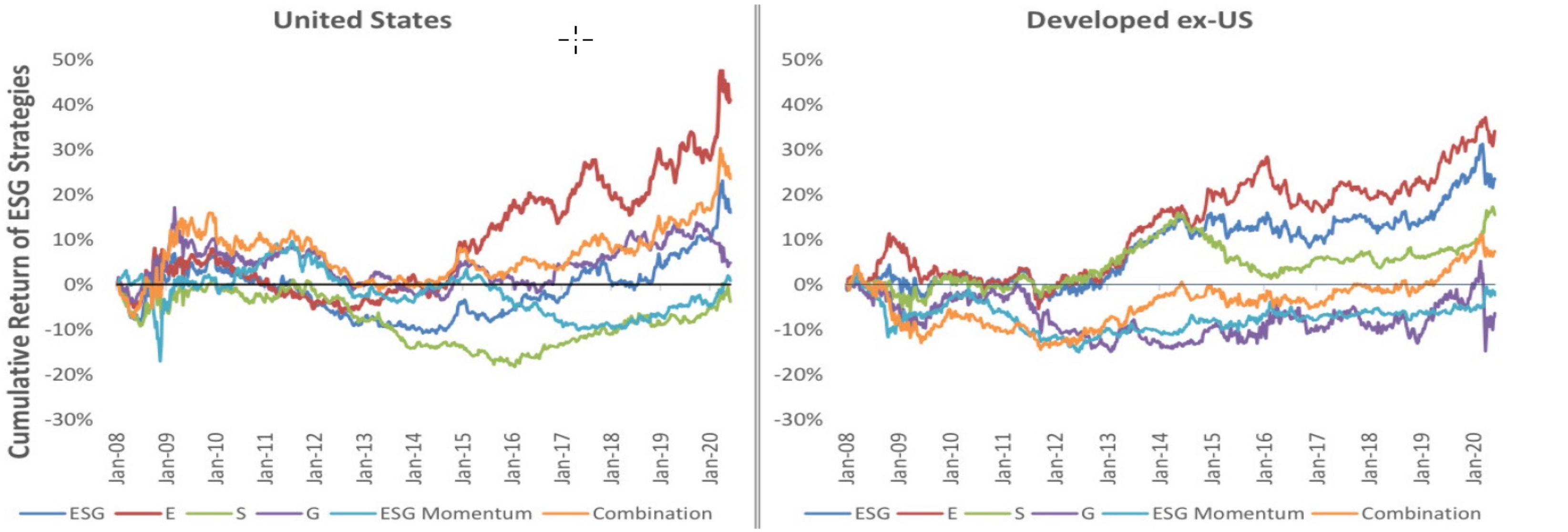


Expenses: 0.03%

Expenses: 0.15%

A Sales Pitch for ESG Investing

Exhibit 3: Cumulative Returns of ESG Strategies



The plots show the time series of cumulative returns of the strategies, calculated from daily returns for the entire sample period. The sample period ranges from 1/01/2008 to 30/06/2020. The strategies refer to the Scientific Beta US universe and Scientific Beta Developed ex-US universe.

Jan 2008 - Jun 2020	ESG		E		S		G		ESG Momentum		Combination	
Geographic Universe	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US
Ann. Return	1.29%	1.63%	2.89%	2.43%	-0.23%	1.07%	0.45%	-0.85%	0.15%	-0.26%	1.92%	0.48%
t-statistic	0.85	0.90	1.71	1.59	-0.05	0.70	0.40	-0.05	0.19	-0.11	1.23	0.36
CAPM Alpha	2.57%	1.63%	3.99%	2.43%	0.54%	1.08%	1.30%	-0.52%	0.06%	-0.14%	2.84%	0.53%
t-statistic	1.55	1.05	2.28	1.68	0.35	0.79	0.84	-0.23	0.04	-0.12	1.62	0.37
7 Factor Alpha	-0.33%	1.31%	0.96%	1.95%	-1.17%	1.95%	-0.22%	-1.75%	0.00%	0.86%	0.96%	0.52%
t-statistic	-0.24	0.85	0.68	1.43	-0.84	1.43	-0.16	-0.78	0.00	0.73	0.59	0.36

Source: Honey, I shrunk the ESG alpha

With a caveat…

ESG scores are correlated with many factors that we know already generated excess returns during the 2008-2020 time period. For instance, tech companies have historically had higher ESG scores than non-tech companies. Correcting for these factor skews in ESG rankings, the alphas become much smaller.

Jan 2008 – Jun 2020	ESG		E		S		G		ESG Momentum		Combination	
Universe	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US
Without Sector Neutrality												
Ann. Return	1.29%	1.63%	2.89%	2.43%	-0.23%	1.07%	0.45%	-0.85%	0.15%	-0.26%	1.92%	0.48%
t-statistic	0.85	0.90	1.71	1.59	-0.05	0.70	0.40	-0.05	0.19	-0.11	1.23	0.36
With Sector Neutrality												
Ann. Return	-0.58%	1.33%	0.48%	1.28%	-0.72%	0.91%	0.87%	0.36%	0.10%	-0.14%	0.74%	0.67%
t-statistic	-0.36	0.74	0.46	0.86	-0.52	0.62	0.81	0.31	0.16	-0.03	0.62	0.46
CAPM Alpha	0.25%	1.28%	1.03%	1.19%	-0.16%	0.86%	1.51%	0.55%	0.06%	0.04%	1.21%	0.69%
t-statistic	0.2	0.83	0.82	0.91	-0.14	0.67	1.29	0.26	0.05	0.03	0.91	0.49
7 Factor Alpha	-1.09%	0.79%	-0.32%	0.92%	-1.28%	1.58%	0.40%	-0.30%	0.31%	0.85%	-0.05%	0.81%
t-statistic	-0.99	0.52	-0.29	0.74	-1.19	1.23	0.35	-0.14	0.24	0.78	-0.04	0.58

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.*

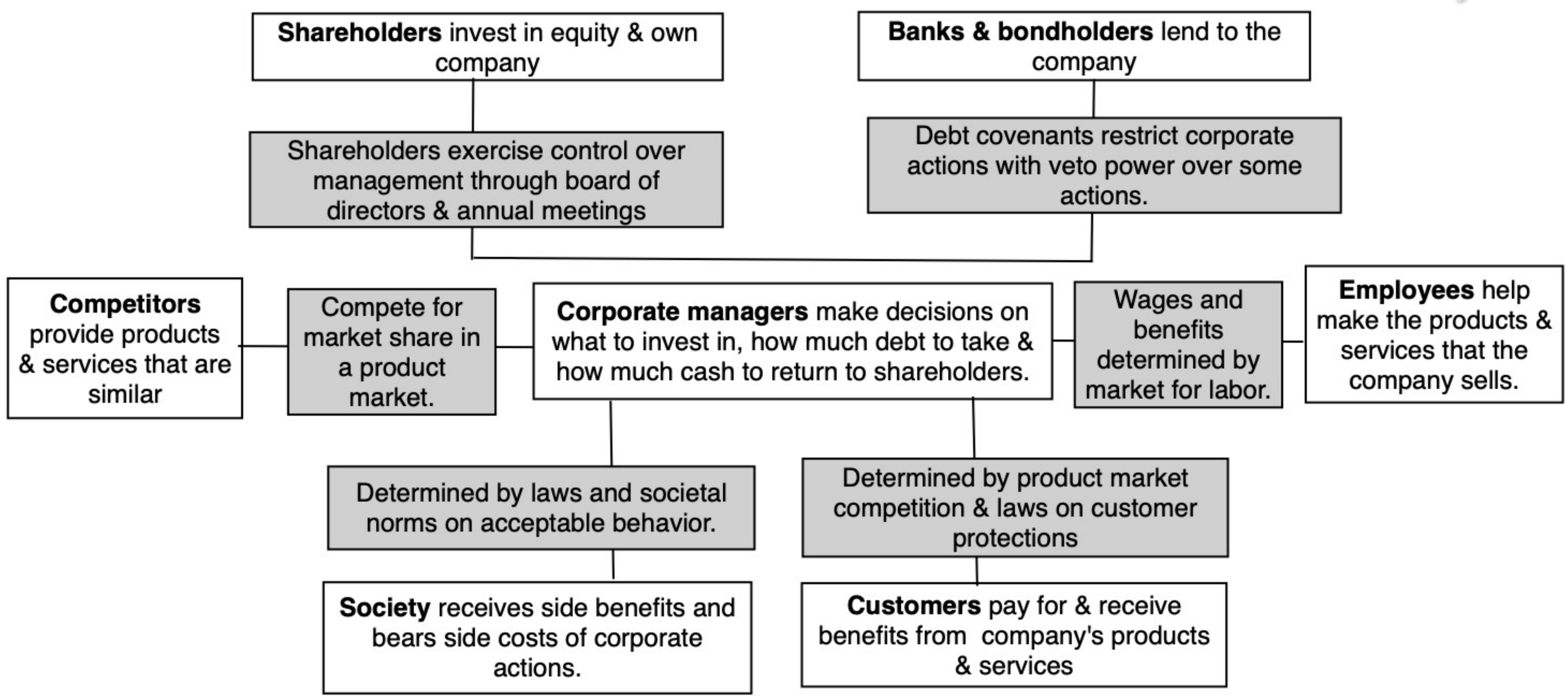
The Bottom Line

- 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.
- 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, has provided little or no payoff to those investing on its basis.
- The more serious challenge is that the sales pitch to investors that ESG is good for investors is at cross purposes with the sales pitch to companies that ranking high on ESG will reduce their risk and give them lower costs of equity and debt.

The Payoff for Society

- There are some who believe that even if ESG makes firms less valuable and investors make lower returns, it is a net positive for society.
  - It is premised on the notion that society has developed a consensus on what comprises goodness.
  - It is also based upon the presumption that companies that behave well will create less side costs for society and perhaps even contribute to societal good.
- If you accept this proposition, the trade off will be positive for society.

Do you want corporate managers and big fund managers to be arbiters of good and bad?



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 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.