THE ESG MOVEMENT: THE GOODNESS GRAVY TRAIN ROLLS ON!

Charity begins at home
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?**
   - Implicit in the ESG movement is the assumption that there is collective consensus on what comprises good, and that it can be measured.
   - But is there?

2. **How (if at all) does ESG affect value?**
   - ESG is being marketed to companies as being value increasing.
   - The marketing pitch is based upon anecdotal evidence (usually from fossil fuel/mining companies) and studies that are more advocacy than serious research.

3. **As an investor, can (will) you make money investing based on ESG?**
   - Investment funds are pushing ESG to the forefront, with the pitch that investors in “good” companies will earn higher returns.

4. **Is society better off, if companies follow the ESG path?**
   - If all of the above fail to convince you, the fall back is that since it is good for society, why does it matter?
   - But is it?
1. Goodness is difficult to measure, and the task will not get easier.

- The starting point for the ESG argument is the premise that we can come up with measures of goodness that can then be targeted by corporate managers and used by investors. To meet this demand, services have popped up around the world, claiming to measure ESG with scores and ratings.

- As I noted in my last post, there seems to be little consensus across services on how to measure goodness, and the low correlation across service measures of ESG has been well chronicled.

- The counter from the ESG services and ESG advocates is that these differences reflect growing pains, and just as bond ratings agencies found convergence on measuring default risk, services will also find commonalities. I think that view misses a key difference between default risk and goodness, insofar as default is an observable event and services were able to learn from corporate defaults and fine tune their ratings.
Different value systems

![Issues investors want addressed by their portfolios](chart)

Source: New York Life Investments, 2019

- Global warming: 34% (25-39), 27% (40-54), 29% (55+)
- Impact of plastic on the oceans: 21% (25-39), 26% (40-54), 20% (55+)
- Sustainability: 24% (25-39), 23% (40-54), 17% (55+)
- Data fraud or theft: 14% (25-39), 20% (40-54), 13% (55+)
- Gun control: 13% (25-39), 20% (40-54), 22% (55+)

Aswath Damodaran
ESG Scores and Company Size

Source: MSCI, Refinitiv, Sustainalytics and QS Investor. Universe is ACWI IMI. Data is average for December 2012-2018 period. Global universe is ranked by ESG and divided into deciles, where decile 10 is comprised of the stocks with highest ESG rating. Rating Agency 1 represents MSCI ESG ratings; Rating Agency 2 represents Thomson Reuters ESG ratings; Rating Agency 3 represents Sustainalytics ESG ratings.
ESG Scores and Disclosure Bulk

As the number of ESG disclosure items has increased...

<table>
<thead>
<tr>
<th>Year</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Max</th>
<th>Min</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>295.2</td>
<td>107.6</td>
<td>581</td>
<td>12</td>
</tr>
<tr>
<td>2014</td>
<td>303.7</td>
<td>100.5</td>
<td>583</td>
<td>12</td>
</tr>
<tr>
<td>2015</td>
<td>348.4</td>
<td>100.8</td>
<td>633</td>
<td>12</td>
</tr>
<tr>
<td>2016</td>
<td>371.9</td>
<td>98.4</td>
<td>684</td>
<td>12</td>
</tr>
<tr>
<td>2017</td>
<td>382.0</td>
<td>90.3</td>
<td>671</td>
<td>12</td>
</tr>
<tr>
<td>2018</td>
<td>390.1</td>
<td>82.4</td>
<td>658</td>
<td>1</td>
</tr>
<tr>
<td>2019</td>
<td>397.0</td>
<td>71.4</td>
<td>628</td>
<td>16</td>
</tr>
</tbody>
</table>

The average ESG score for companies has also gone up...
And if your argument is that it measures risk, not goodness...

**ESG funds/S&P correlated to...**

- Russell 2000 (small cap index)
- Technology index
- Change in oil prices
- Change in inflation
- Change in interest rates

Note: A correlation coefficient can also extend to -1.0 (the prices move 100% of the time in opposite directions).
Source: Derek Horstmeyer, George Mason University

Aswath Damodaran
2. Being good will help some firms, hurt others and do others unaffected!

ESG and Value: Just the facts!

- **Revenue Growth**: Function of the size of the total accessible market & market share
- **Operating Margins**: Determined by pricing power and cost efficiencies
- **Growth/Investment Efficiency**: Measure of how much investment is needed to deliver growth

Expected FCFF = Revenues * Operating Margin - Taxes - Reinvestment

Risk-adjusted Discount Rate

- **Value of Business**
- **Failure Risk**: Chance of grievous or catastrophic event putting business model at risk

**ESG effect**: Neutral to Positive
- **Evidence**: Evidence indicates that bad companies are more likely to be exposed to crises and catastrophic risk.

**ESG effect**: Positive (for subset of firms)
- **Evidence**: Studies indicate that investor aversion to buying shares in “bad” companies can lead to higher costs of equity for these firms, but the evidence comes primarily from fossil fuel firms.

- **Cost of Equity**: Rate of return that equity investors demand
- **Cost of Debt**: Cost of borrowing money, net of tax advantages

**ESG effect**: Positive (for subset of firms)
- **Evidence**: Studies indicate that “good” companies are able to borrow money at lower rates, but much of that is isolated to the “green energy” space.
Is ESG good for companies?

- The notion that ESG is good for companies is being sold strongly, with research that is:
  - Anecdotal, in the form of case studies
  - From advocates, with strong priors that ESG matters
  - Statistically a mess, because it is so difficult to tell the direction of causation

- The truth is much grayer and predates the entire ESG movement, and is that:
  - Companies that are “bad” or perceived to be so, because they have crossed a good corporate citizen line are exposed to punishment. That punishment, right now, is coming from investors and lenders more than from customers and employees.
  - There are some companies that benefit from being “good”, but they have trouble scaling up
  - For other companies, ESG is just a marketing tactic, which loses (or already has lost) its effectiveness, as everyone uses it.

Aswath Damodaran
3. The ESG sales pitch is internally inconsistent and fundamentally incoherent

Aswath Damodaran

ESG and Investor Returns: The Market Pricing Effect

How does ESG affect value?
- Being good increases value, either by increasing cash flows or reducing risk
- Being good has no effect on value, with any benefits being offset by costs

How is the market pricing ESG?
- Market is **over estimating** the benefits of being good and/or the costs of being bad.
- Market is **fairly estimating** the benefits of being good and/or the costs of being bad.
- Market is **under estimating** the benefits of being good and/or the costs of being bad.

Long term Returns to ESG investing
- Investing in bad companies will generate higher risk adjusted returns than investing in good companies.
- Investing in good companies will generate similar risk adjusted returns to investing in bad companies.
- Investing in good companies will generate higher risk adjusted returns than investing in bad companies.

Whether you earn higher or lower risk adjusted returns on good companies, relative to bad companies, is entirely a function of how markets price ESG, not ESG’s effect on value.
Implications for investing

- The first is that it suggests that much of the research on the relationship between ESG and returns yields murky findings. Put simply, there is very little that we learn from these studies, whether they find positive or negative relationships between ESG and investor returns, since that relationship is compatible with a number of competing hypotheses about ESG, value and price.

- The second is that bringing in market pricing does shed some light on perhaps the only aspect of ESG investing that seems to deliver a payoff for investors, which is investing ahead or during market transitions.
  - I pointed to this study that find that activist investors who take stakes in "bad" companies and try to get them to change their ways generate significant excess returns from doing so.
  - Another study contends that investing in companies that improve their ESG can generate excess returns of about 3% a year, but skepticism is in order because it is based upon a proprietary ESG improvement score (REIS), and was generated by an asset management firm that invests based upon that score.

- If you are interested in making market transitions on ESG work in your favor, you also have to be clear about the strengths you will need to get the payoffs, including skills in divining not only what social values are gaining and losing ground and which changes have staying power.
4. Outsourcing your conscience is a salve, not a solution!

- The ESG movement has given each of us an easy way out of having to make choices, by outsourcing these choices to corporate CEOs and investment fund managers, asking them to be “good” for us, while not charging us more for their products and services and delivering above-average returns.

- Implicit in the ESG push is the presumption that unless companies that are explicitly committed to ESG, they cannot contribute to society, but that is not true. Consider Bill Gates and Warren Buffett, two men who built extraordinarily valuable companies, with goodness a factor in decision making only if it was good for business. Both men have not only made giving pledges, promising to give away most of their wealth to their favorite causes in their lifetimes, and living up to that promise, but they have also made their shareholders wealthy, and many of them give money back to society.

- As I see it, the difference between this “old” model of business and the proposed “new ESG” version is in who does the giving to society, with corporate CEOs and management taking over that responsibility from shareholders. I am not willing to concede, without challenge, that a corporate CEO knows my value system better than I do, as a shareholder, and is better positioned to make judgments on how much to give back to society, and to whom, than I am.
An inside perspective...

- For a perspective more informed and eloquent than mine, I would strongly recommend [this piece by Tariq Fancy](#), whose stint at BlackRock, as chief investment officer for sustainable investing, put him at the heart of the ESG investing movement.

  - He argues that trusting companies and investment fund managers to make the right judgments for society will fail, because their views (and actions) will be driven by profits, for companies, and investment returns, for fund managers.

  - He also believes that governments and regulators have been derelict in writing rules and laws, allowing companies to step into the void.

- While I don’t share Tariq’s faith that government actions are the solution, I share his view that entities whose prime reasons for existence are to generate profits for shareholders (companies) or returns for investors (investment funds) all ill suited to be custodians of public good.

Aswath Damodaran
Cui Bono? (Who benefits?)

The ESG Gravy Train (or Circle)

ESG Disclosures
Cui: Accounting firms
Bono: Push for more disclosure requirements, and by making them complicated enough, make themselves indispensable.

ESG Consulting advice for fees

ESG Consulting
Cui: Consulting firms (with ESG arms)
Bono: Advice companies on ESG disclosure and on how to improve ESG scores & standing with ESG investors.

ESG Investment
Cui: Investment Funds
Bono: Create passive ETF indices and/or active ESG investment funds, and charge extra fees for doing so.

ESG scores/indices as raw material

Information on ESG investing criteria

ESG scores/indices as raw material

Disclosure data as raw material

Push for more ESG indices

Lobby for more disclosure
Fake ESG? BlackRock’s Carbon Transition ETF

Carbon Transition or Carbon Copy?
BlackRock’s new U.S. Carbon Transition Readiness ETF’s top holdings are highly similar to those of index funds that don’t share its ‘sustainable’ mission.

<table>
<thead>
<tr>
<th>iShares Core S&amp;P 500 ETF</th>
<th>iShares Russell 1000 ETF</th>
<th>BlackRock U.S. Carbon Transition Readiness ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.00% AAPL</td>
<td>5.39%</td>
<td>5.20%</td>
</tr>
<tr>
<td>5.53% MSFT</td>
<td>4.91%</td>
<td>4.87%</td>
</tr>
<tr>
<td>4.09% AMZN</td>
<td>3.62%</td>
<td>3.40%</td>
</tr>
<tr>
<td>2.09% FB</td>
<td>1.87%</td>
<td>2.11%</td>
</tr>
<tr>
<td>1.94% GOOGL</td>
<td>1.74%</td>
<td>2.01%</td>
</tr>
<tr>
<td>1.87% GOOG</td>
<td>1.69%</td>
<td>1.92%</td>
</tr>
<tr>
<td>1.60% TSLA</td>
<td>1.43%</td>
<td>1.55%</td>
</tr>
<tr>
<td>1.45% BRKB</td>
<td>1.28%</td>
<td>1.26%</td>
</tr>
<tr>
<td>1.31% JPM</td>
<td>1.17%</td>
<td>1.17%</td>
</tr>
<tr>
<td>1.19% JNJ</td>
<td></td>
<td>1.17% MDT</td>
</tr>
</tbody>
</table>

Note: As of April 15
Source: iShares

Expenses: 0.03%  Expenses: 0.15%
Given that shareholders in companies and investors in funds are paying for this gravy, you may wonder why corporate CEOs not only go along with this charade, but also actively encourage it, and the answer lies in the power it gives them to bypass shareholders and to evade accountability.

After all, these are the same CEOs who, in 2019, put forth the fanciful, but great sounding, argument that it is a company’s responsibility to maximize stakeholder wealth, rather than cater to shareholders, which I argued in a post then that being accountable to everyone effectively meant that CEOs were accountable to no one.

In some cases, flaunting goodness has become a way that founders and CEOs use to cover business model weaknesses and overreach. It is a point that I made in my posts on Theranos, at the time of its implosion in October 2015, and on WeWork, during its IPO debacle in 2019, noting that Elizabeth Holmes and Adam Neumann used their “noble purpose” credentials to cover up fraud and narcissism.
A Roadmap for being and doing good

1. *Start with a personalized measure of goodness, and don’t overreach:* The key with moral codes is that they are personal, and for goodness to be incorporated into your investment and business decisions, you have to bring in your value judgments, rather than leave it to ESG measurement services or to portfolio managers.

2. *As a business person, be clear on how being good will affect business models and value:* If you own a business, bring your personal views on morality into your business decisions, but if you do so, you should be at peace with the fact that staying true to your values may, and probably will, cost you money. If you are making decisions at a publicly traded company, as an employee, manager or even CEO, you are investing other people’s money and if you choose to make decisions based upon your personalized moral code, you have an obligation to be open about what your conscience will cost your shareholders.

3. *As an investor, understand how much goodness has been priced in:* If you are an investor, you don’t have to compromise on your values, as long as you realize, at least in the long term, you will have to accept lower returns than you would have earned without that constraint.

4. *As a consumer and citizen, make choices that are consistent with your moral code:* Your consumption decisions (on which products and services you buy) and your citizenship decisions (on voting and community participation) have as big, if not greater, an effect.

Aswath Damodaran
In conclusion..

- On a personal note, I have always found that the people that I've known who do good, spend very little time talking about being good or lecturing other people on goodness. I would extend that perspective to companies and investment funds as well, and I reserve my skepticism for those companies that spend hundreds of pages of their annual filings telling me how much "good" they do.

- The ESG movement’s biggest disservice is the sense that it has given those who are torn between morality and money, that they can have it all. Telling companies that being good will always make them more valuable, investors that they can add morality constraints to their investments and earn higher returns at the same time, and young job seekers that they can be paid like bankers, while doing peace corps work, is delusional.

- In the long term, as the truth emerges, it will breed cynicism in everyone involved, and if you care about the social good, it will do more damage than good. The truth is that, most of the time, being good will cost you and/or inconvenience you (as businesses, investors or employees), and that you choose to be good, in spite of that concern.