THE THEOCRATIC TRIFECTA: DECODING ESG, SUSTAINABILITY AND STAKEHOLDER WEALTH

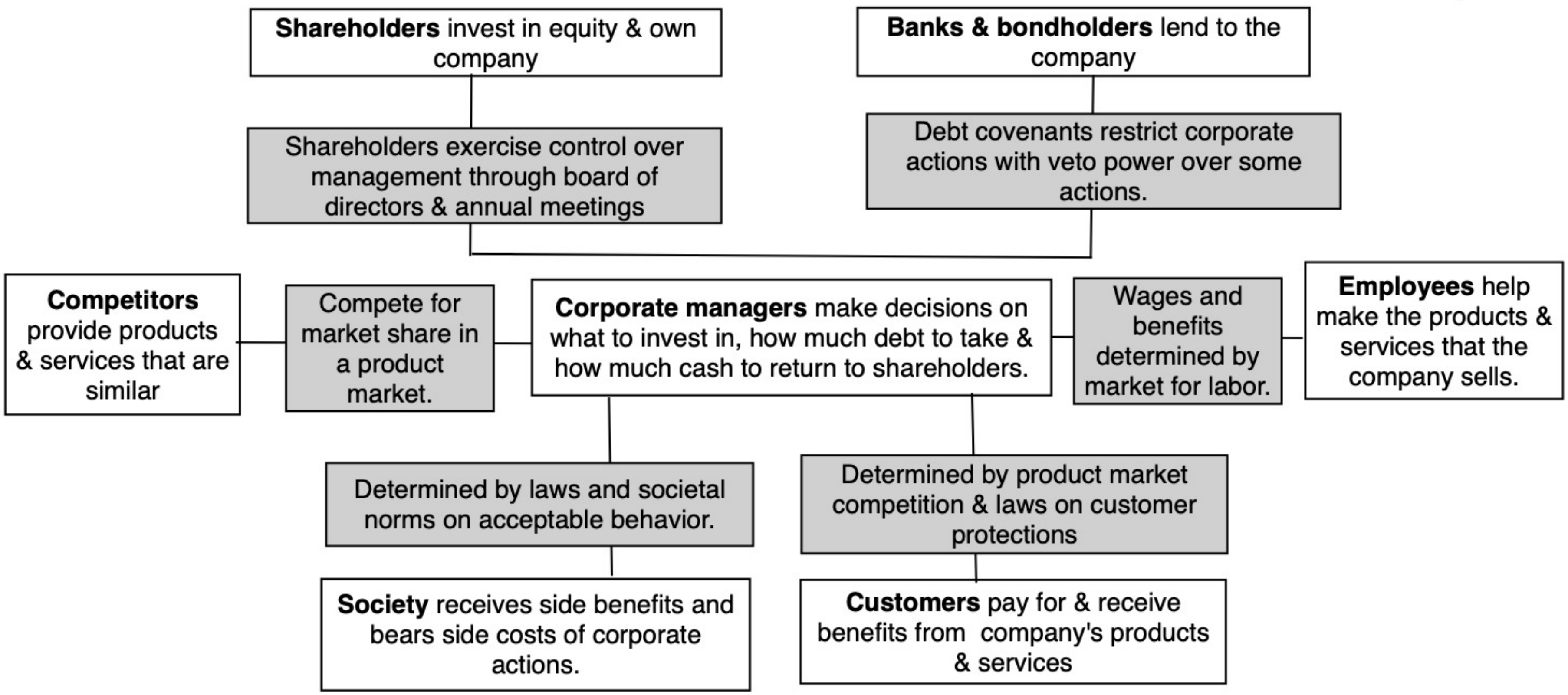
Morality and Markets!

The End Game in Business

- Businesses have always struggled with mission statements. Put simply, what should the end game of a business?
  - The simplest and most pragmatic answer is that it is to sell products and services that customers want, while generating the most you can in profits for their owners, over the long term.
  - The pushback, often from non-business critics, has been that businesses should also serve society, not just minimizing social costs but also providing social benefits.
- In recent years, that pushback has found backing within business, with movements to expand business missions:
  - To put business sustainability first
  - To maximize the value to all stakeholders, not just owners
  - To incorporate environmental, social and governance goals

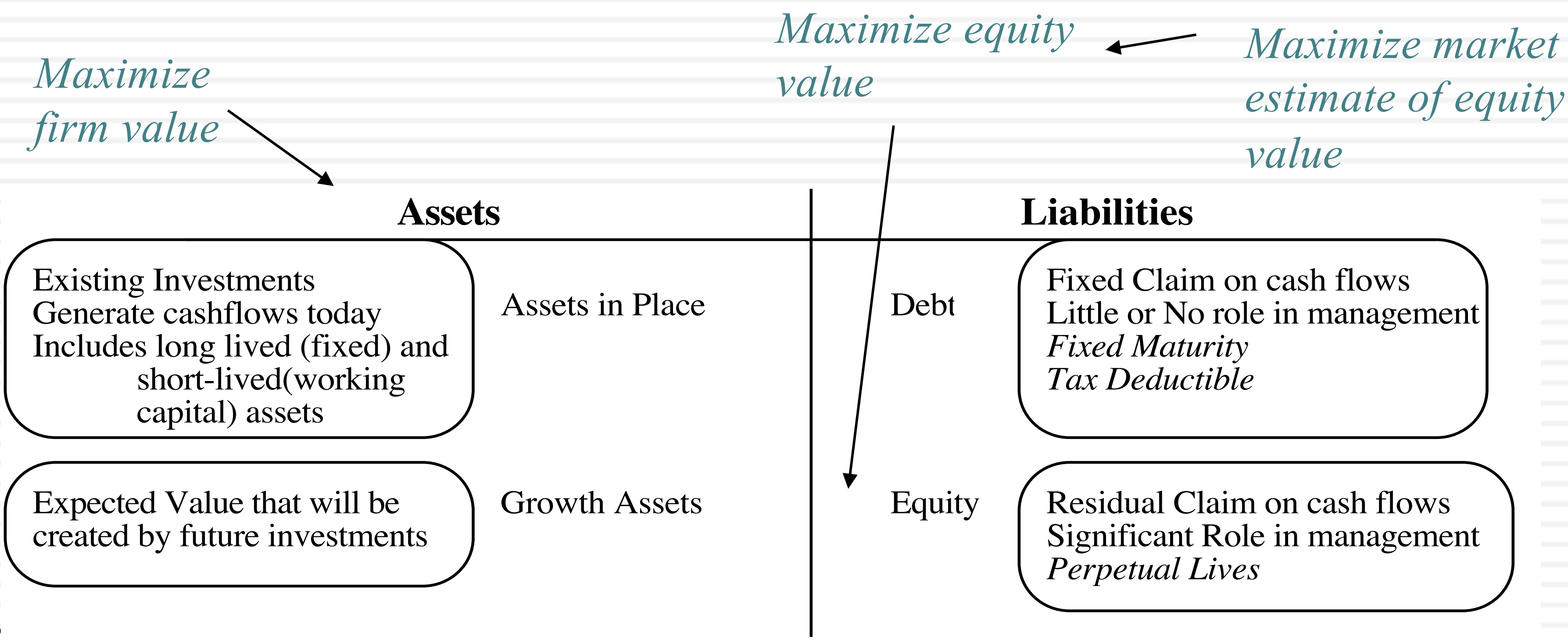
Corporate Finance 101

A business has many stakeholders…



In running a business, one of these stakeholders has to be given primacy…

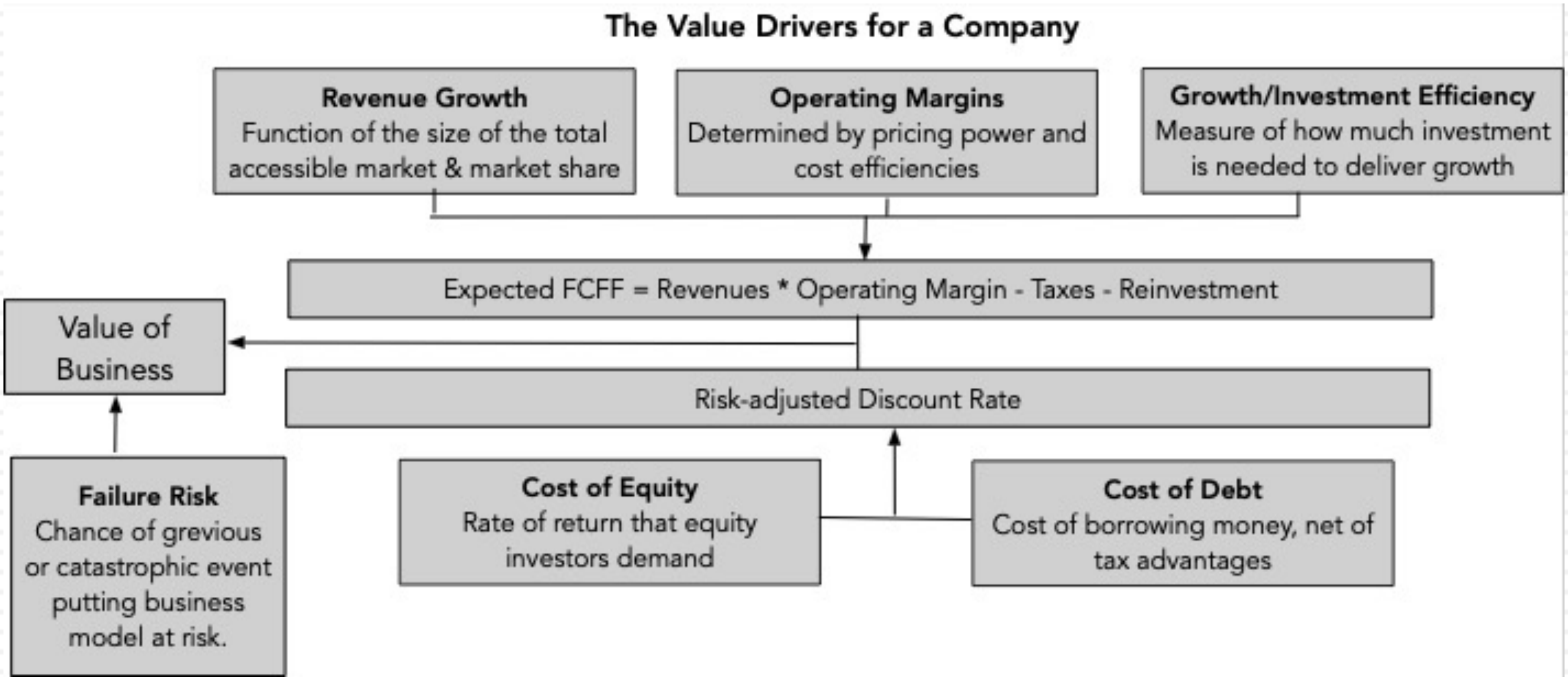
- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.
- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.



Giving corporate finance its focus…

- Maximize the value of the business (firm)
  - **The Investment Decision**
    Invest in assets that earn a return greater than the minimum acceptable hurdle rate
    - The **hurdle rate** should reflect the riskiness of the investment and the mix of debt and equity used to fund it.
    - The **return** should reflect the magnitude and the timing of the cashflows as well as all side effects.
  - **The Financing Decision**
    Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations
    - The **optimal mix** of debt and equity maximizes firm value
    - The **right kind** of debt matches the tenor of your assets
  - **The Dividend Decision**
    If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business
    - **How much cash** you can return depends upon current & potential investment opportunities
    - **How you choose** to return cash to the owners will depend on whether they prefer dividends or buybacks

Intrinsic Value: The Drivers



The Pushback..

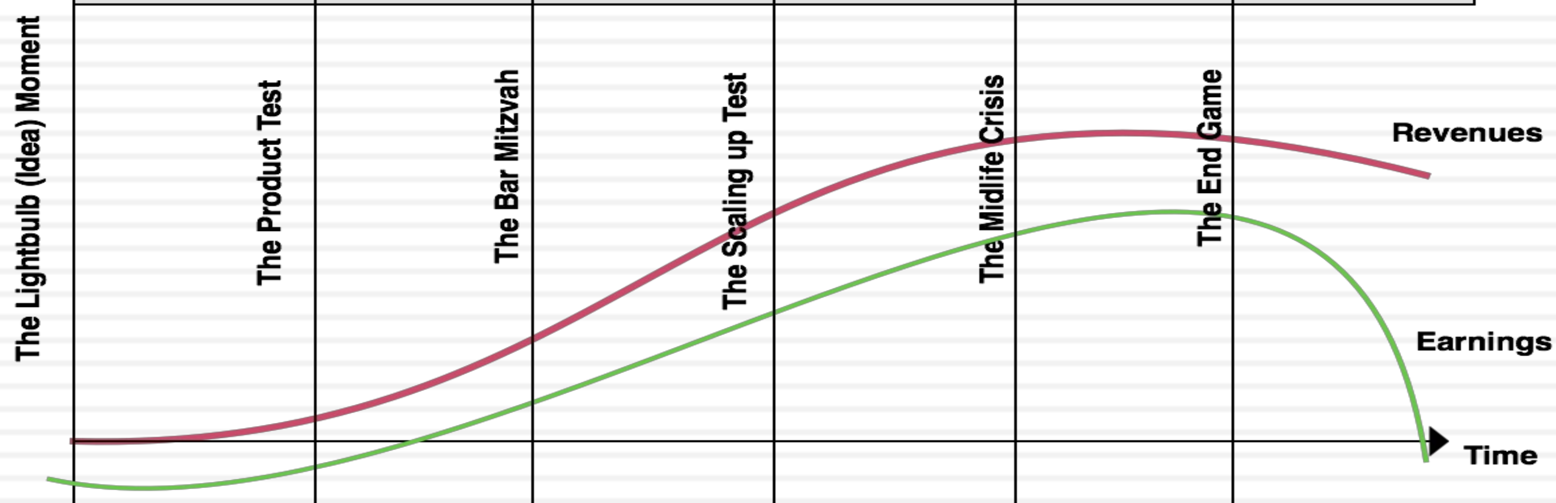
- Many have argued that giving shareholders primacy is bad for companies (separating them from shareholders), unfair to other stakeholders, and bad for society.
  - Those who believe that markets are short term and that companies can create significant untraceable costs to society (externalities) argue that the objective should be to build **the most sustainable (rather than the most valuable) business.**
  - Those who believe that it is unfair to other stakeholders argue that a much better model would be one that **maximizes stakeholder wealth**, and many strategists and even CEOs seem to have bought into that argument.
  - Those who believe that it is bad for society has pushed for a different model, where ”goodness” operates not just as a constraint but is a central objective for businesses. This is the **ESG framework**.

The Myth of Sustainability

Nothing lasts (or should last) forever!

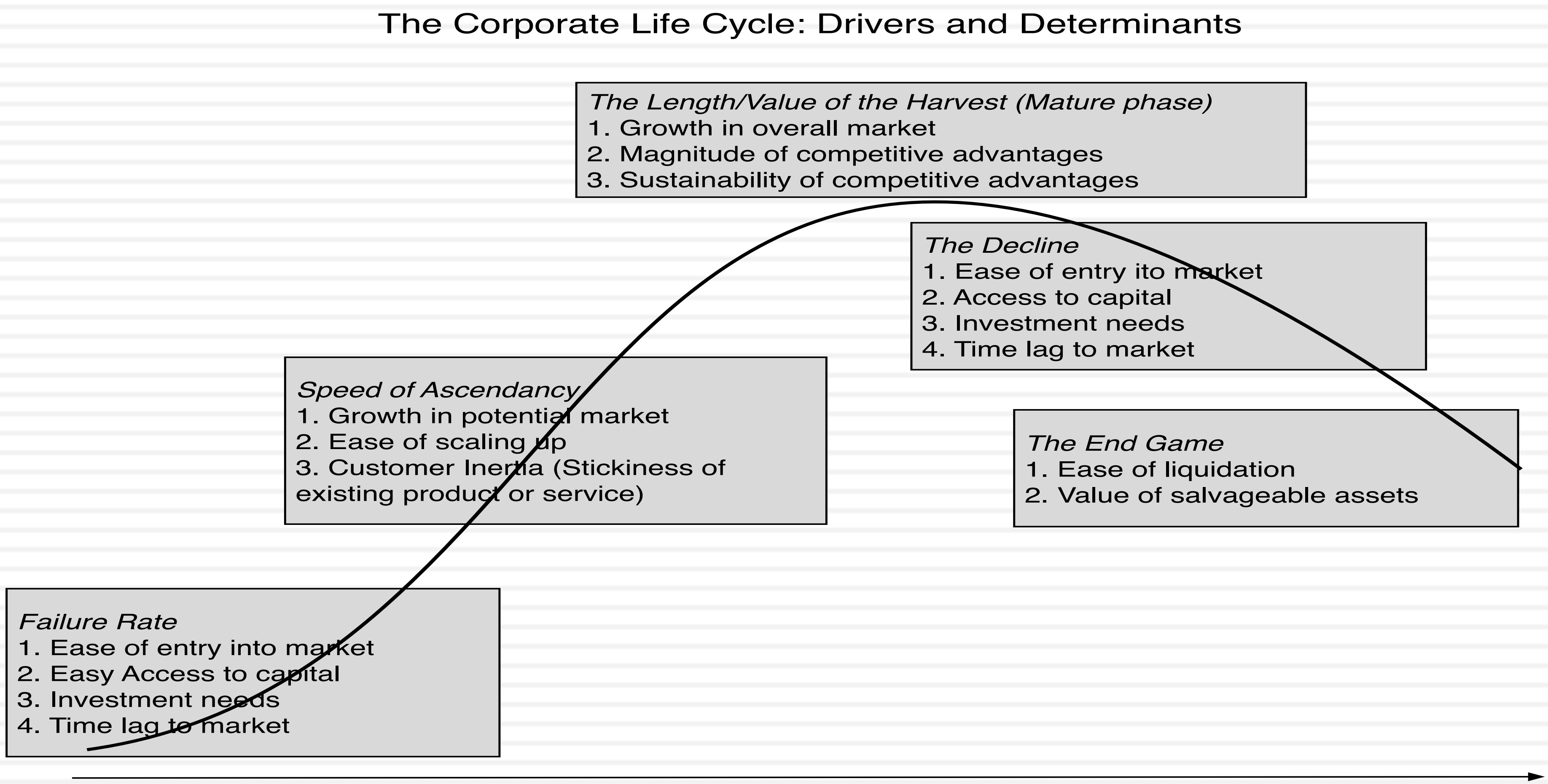
The Corporate Life Cycle

	1. Lime 2. AI	1. Tesla 2. Uber	1. Netflix 2. Nvidia	1. Facebook 2. Google	1. Coca Cola 2. Walmart	1. GE 2. Ford

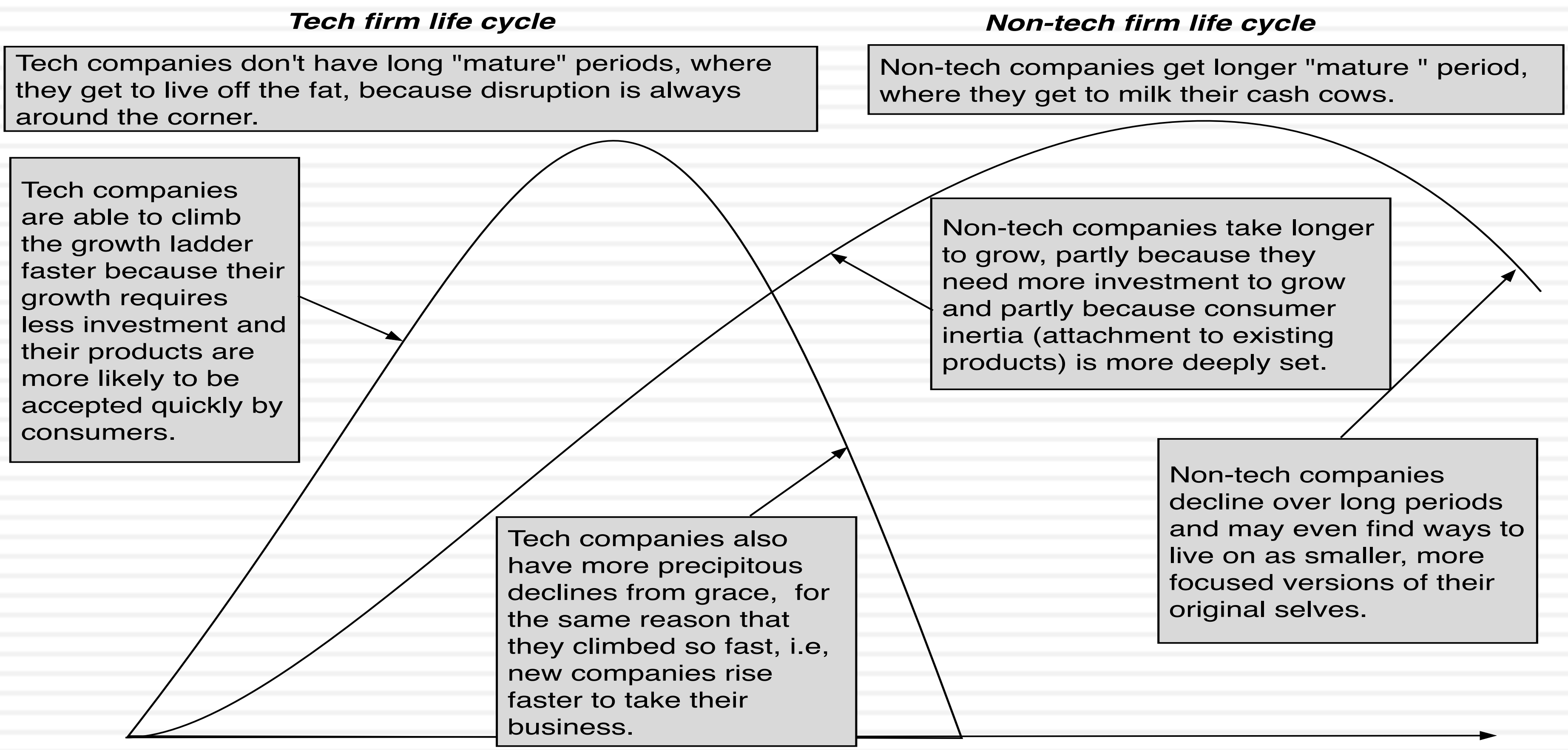


Lifecycle stage	**Start-up**	**Young Growth**	**High Growth**	**Mature Growth**	**Mature Stable**	**Decline**
Description	Have an idea for a business that meets an unmet need in the market.	Create a business model that converts ideas into revenues	Build the business, looking for scaling benefits (moving to profitability)	Grow your business, with revenue growth & higher margins	Defend your business from competitors & find new markets	Scale down your business as market shrinks.

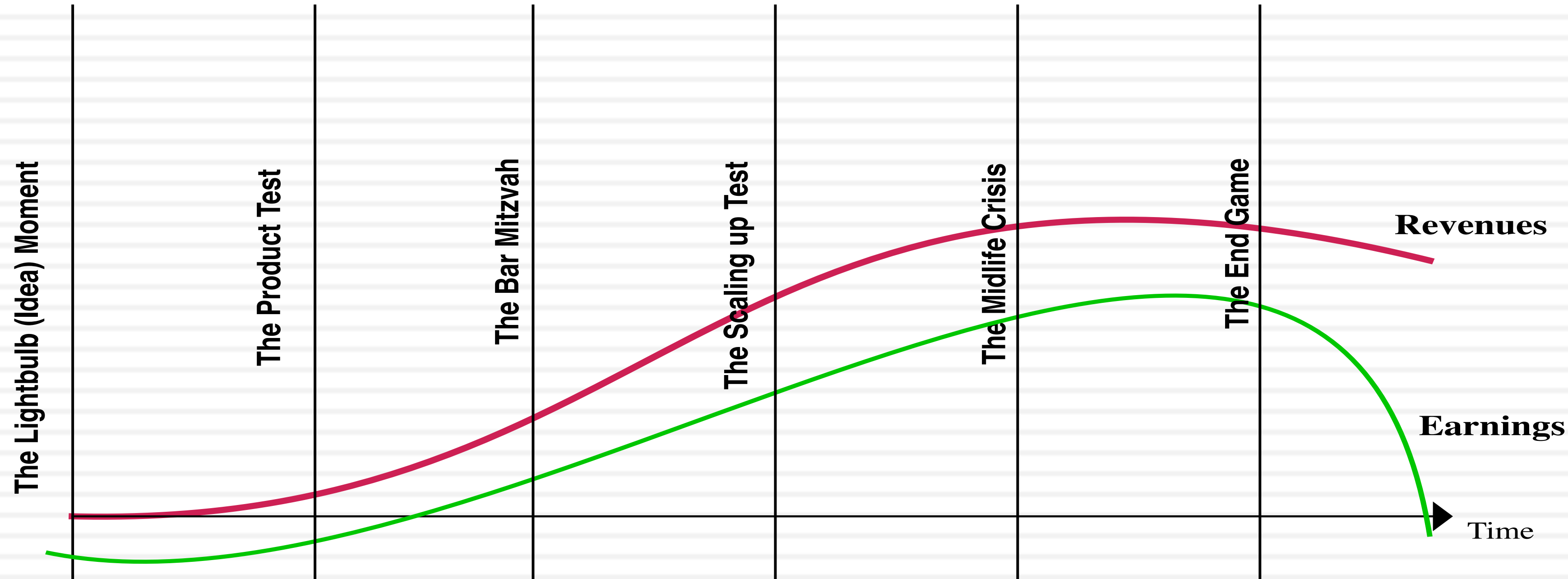
The determinants of the life cycle



Tech versus Non-tech life cycles

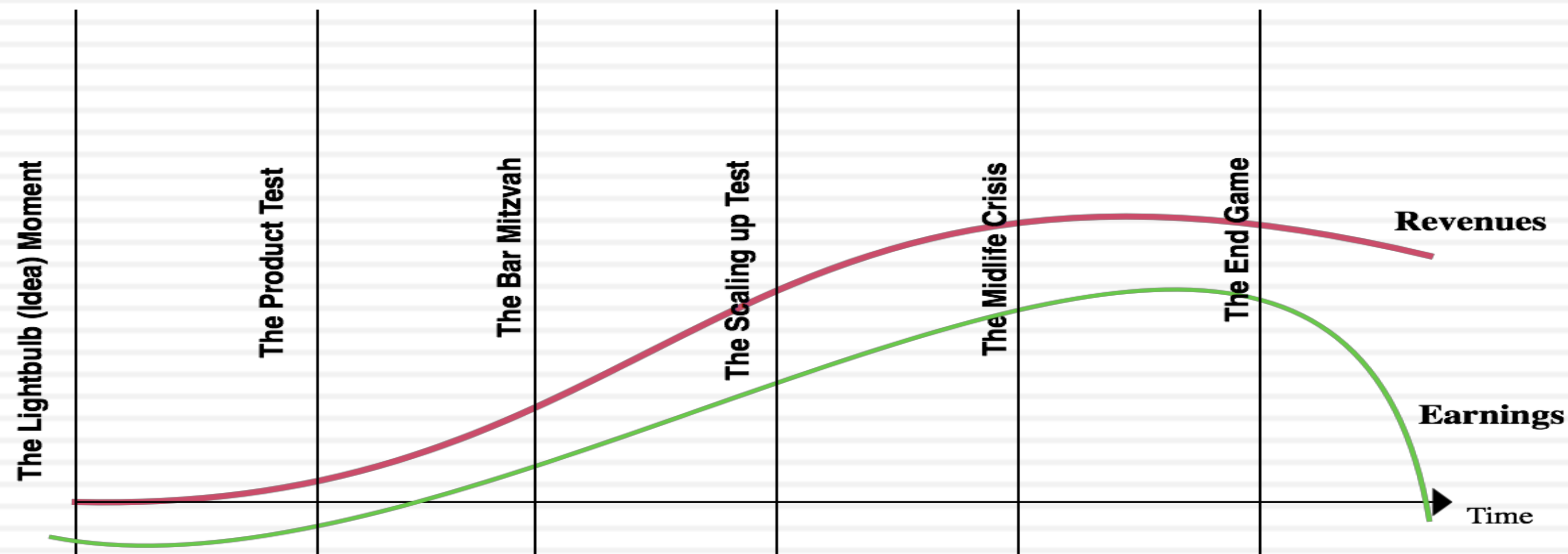


The emphasis in corporate finance shifts..



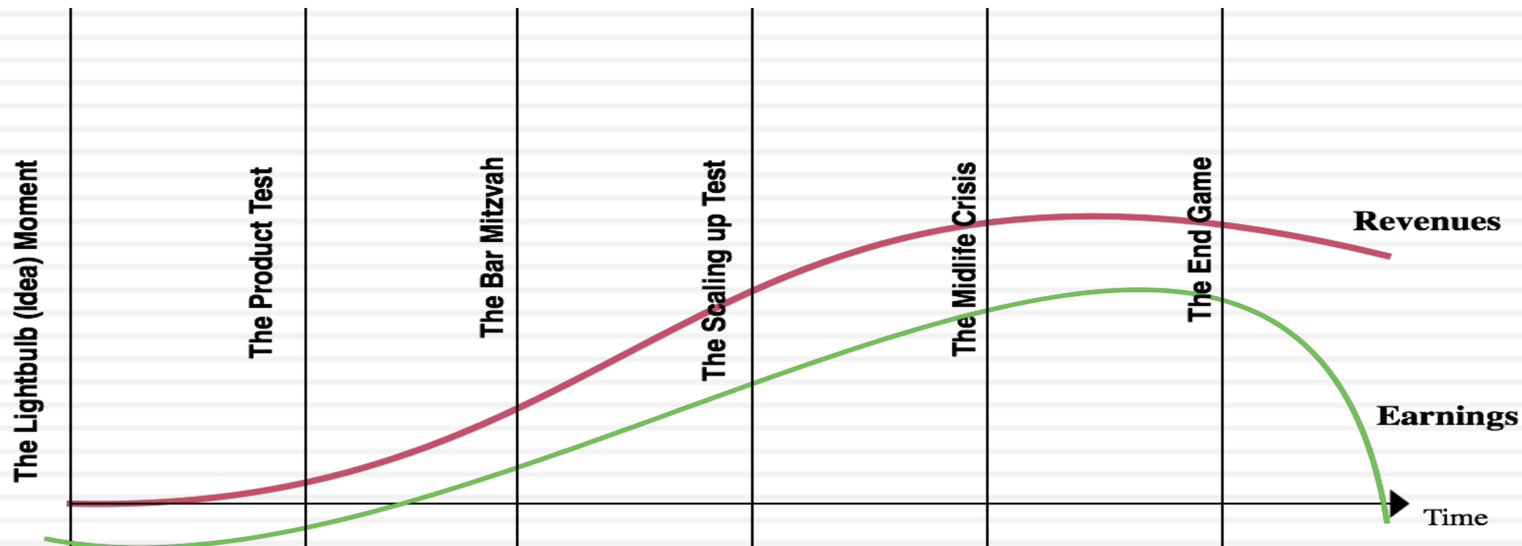
Lifecycle stage	**Start-up**	**Young Growth**	**High Growth**	**Mature Growth**	**Mature Stable**	**Decline**
Investing Policy	New product development	Market testing and build up	Scale up production	Augment capacity + New Products	Maintain capacity + Acquisitions	Reduce capacity
Financing Policy	Equity funding, debt only if desperate	Equity, public market option	Equity mainly, with some debt capacity	Debt capacity increases	Debt capacity maximized	Debt scales down with firm
Dividend Policy	Cash burn, with equity infusions	Cash burn maximized	Beginnings of positive cash flows	Cash buildup, if not returned	Peak cash returns	Cash return from asset divestitures

In value, the emphasis shifts as well, from narrative to numbers…



Lifecycle stage	Start-up	Young Growth	High Growth	Mature Growth	Mature Stable	Decline
Narrative versus Numbers	All Narrative	Mostly narrative	Narrative + Numbers	Numbers + Narrative	Mostly Numbers	All Numbers
Narrative Drivers	How big is the narrative?	How plausible is narrative?	How profitable is narrative?	How scalable is narrative?	How sustainable is narrative?	How happy is the ending?
Narrative Differences	Unconstrained & Large differences	*Constraints mount as numbers build up* / *Differences across investors narrow, as history deepens*				Constrained & Narrow differences

And the focus changes.... And so does the right CEO for the company



Lifecycle stage	Start-up	Young Growth	High Growth	Mature Growth	Mature Stable	Decline
The Game	Tell a compelling & plausible story	Stay consistent with story	Deliver numbers to back story	Keep story in sync with numbers	Adjust story to reflect maturity	Shrink the company
The Right CEO	Steve, the Visionary	Paula, the Pragmatist	Bob, the Builder	Oscar, the Opportunist	Donna, the Defender	Larry, the Liquidator

Companies, act your age!

- For many reasons, companies try to speed up or slow down aging
  - Young companies that borrow money to grow faster, invest without a purpose or with too much focus on short term profits or pay dividends.
  - Mature growth companies that act young and refuse to return cash.
  - Stable companies that try to be growth companies through acquisitions.
  - Declining companies that think they can reverse decline, with new management and a new business plan.

Companies that don’t “act their age” will not only destroy value for their owners but will also be drags on the economy.

The Dream of Reincarnation..

- The dream of mature and declining companies is rebirth, i.e., the possibility that they can rediscover their youth, and become young, growth companies again.
- In every period, there are a few companies that seem to succeed at this venture, and the companies and their CEOs become legendary, with case studies written about them.
  - In some of these companies, it is a combination of great management, luck and timing that allow for this success.
  - In others, the change is cosmetic.
- There is an ecosystem that is built around these “success stories” that markets them to other aging companies.

The Sustainability Siren Song..

- If the sales pitch of sustainability is that managers should make decisions based upon what is good for long term value, rather than stock price, and that businesses should minimize externalities, it is saying nothing new.
  - Milton Friedman would have agreed with that statement, and it is actually at the basis of traditional corporate finance.
  - Sustainability experts are the last people you should be consulting on whether decisions increase value.
- If the end game of sustainability is that companies should focus on “survival” and extending their corporate lives, it has lost its way.
  - There is no glory in growth for the sake of growth, or in survival, for the sake of survival. That is a recipe for “walking dead” or ”zombie” companies.

Four Sustainability Models

- <u>The Enlighted one(s)</u>: In this model, those in charge of sustainability are capable (more so than the mere mortals that surround them at businesses) to see into the future and bring in long term consequences into decisions.
- <u>The Jiminy Cricket model</u>: In this model, those in charge of sustainability acts as the corporate conscience, reminding decision makers of their responsibilities to society and the broader good.
- <u>The Mummy Makers</u>: In this model, decision makers try to make companies live forever, no matter what the cost, and devise strategies to advance towards this end.
- <u>The Checkboxers</u>: In this model, the objective is to check all of the boxes that make up the sustainability to-do list, and ensure that you get labeled as sustainable.

Stakeholder Wealth Maximization

A fair solution or kumbaya moment?

Maximize stakeholder wealth

- A fairness argument: To the extent that shareholder wealth maximization seems to, at least at first sight, put all other stakeholders in the back seat, it seems unfair.
- An Easy Fix? The logical response seems to be stakeholder wealth maximization, where the collective wealth of all stakeholders is maximized. That is the promise of stakeholder wealth maximization.
- Protective response: As corporations have found themselves losing the battle for public opinions, many CEOs and even some institutional investors seem to have bought into this idea.

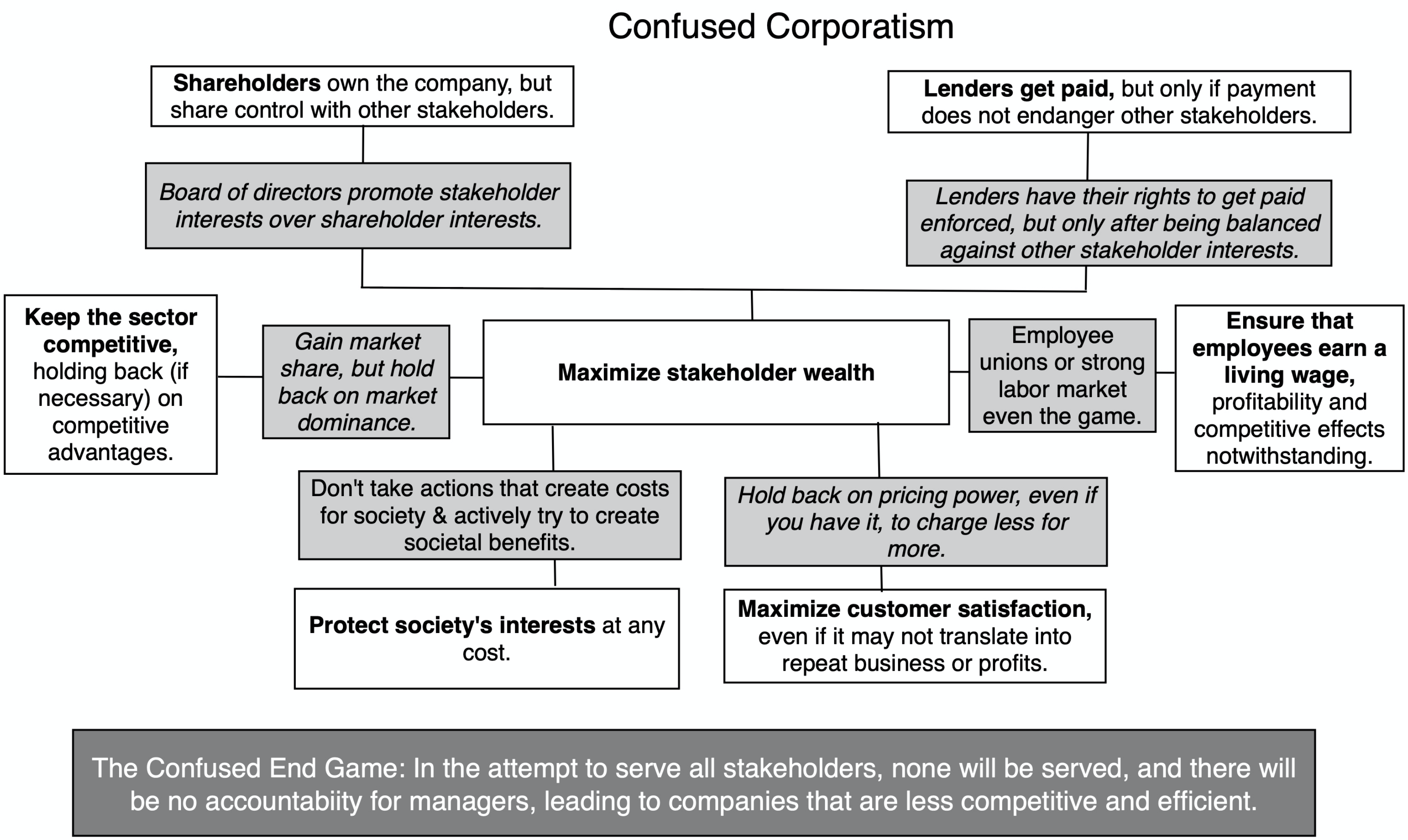
The Business Roundtable's Message..

- *While each of our individual companies serves its own corporate purpose, we share a* ***fundamental commitment to all of our stakeholders****. We commit to:*
  - ***Delivering value to our customers****. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.*
  - ***Investing in our employees****. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.*
  - ***Dealing fairly and ethically with our suppliers.*** *We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.*
  - ***Supporting the communities in which we work****. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.*
  - ***Generating long-term value for shareholders****, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders*

Maximizing stockholder wealth often requires that you take care of other stakeholders…

- Implicit in the stakeholder wealth maximization argument is the belief that what benefits stockholders make other stakeholders worse off. That is not true.
  - Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
    - Employees are often stockholders in many firms
    - Firms that maximize stock price generally are profitable firms that can afford to treat employees well.
  - Maximizing stock price does not mean that customers are not critical to success. In most businesses, keeping customers happy is the route to stock price maximization.
  - Maximizing stock price does not imply that a company has to be a social outlaw.
- There are clearly exceptions, but to use those as the basis for a revolution is foolish.

If you still want to maximize stakeholder wealth, you risk confusion and paralysis…



And if confused corporatism sounds like a good deal, some cautionary notes..

- Government-owned companies: The managers of these companies were given a laundry list of objectives, resembling in large part the listing of stakeholder objectives, and told to deliver on them all. The end results were some of the most inefficient companies on the face of the earth, with every stakeholder group feeling ill-served in the process.
- US research universities: These entities lack a central focus, where whose interests dominate and why shifts, depending on who you talk to and when. The end result is not just economically inefficient operations, capable of running a deficit no matter how much tuition is collection, but one where every stakeholder group feels aggrieved.

The ESG Bandwagon…

Goodness requires sacrifice!

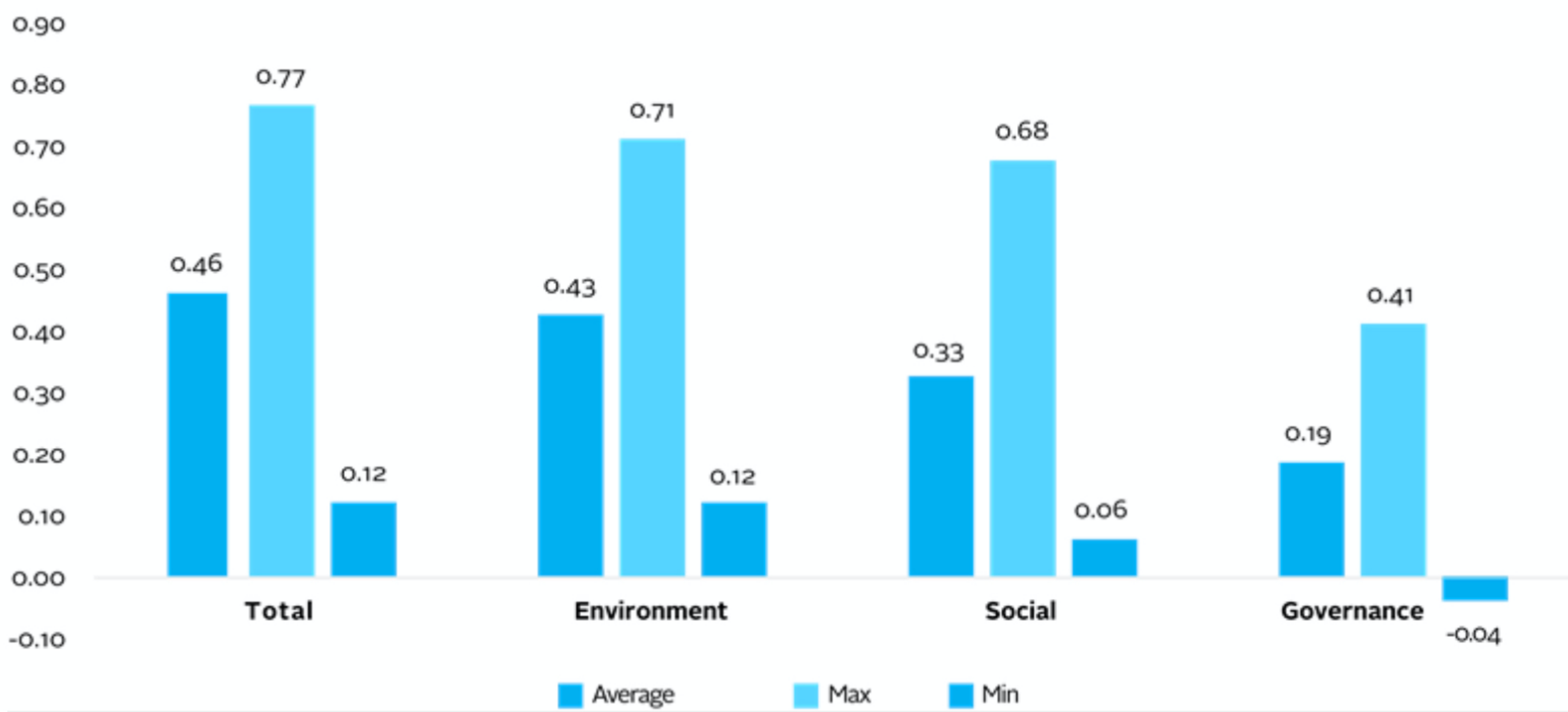
The ESG Promises: Cake for all, with no calories!

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

The Five Big Questions

1. What is ESG and can it be measured?
   - Implicit in ESG is the assumption that there is consensus on what comprises good, and that it can be measured.
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?
   - The pitch is that investors in "good" companies will earn higher returns
   - But that pitch is internally inconsistent and fundamentally incoherent
4. Is society better off, if companies follow the ESG path?
   - The argument is that ESG makes the world a better place, and thus merits acceptance
   - But does it?
5. If you want to make the world a better place (and who does not), what is the alternative to ESG?

1. What does ESG measure? The services don’t seem to know..



Average, minimum, and maximum correlations across providers

Dueling ESG scores for BP…

Refinitiv

BP PLC ESG score:
86/100
Based on BP PLC's self-reported FY 2022 data

Environment	**90**
Emissions	94
Resource Use	98
Innovation	77
Social	**78**
Human Rights	91
Product Responsibility	66
Workforce	79
Community	58
Governance	**94**
Management	100
Shareholders	76
CSR Strategy	96

Sustainalytics

BP Plc

Industry Group: **Oil & Gas Producers**

Identifier: **LON:BP**

BP is an integrated oil and gas company that explores f
produced 1.1 million barrels of liquids and 6.9 billion cu
stood at 7.2 billion barrels of oil equivalent, 56% of whic
+ Show More

Full time employees: **67,600**

ESG Risk Rating COMPREHENSIVE

35.1 High Risk

Negligible	Low	Medium	High	Severe
0-10	10-20	20-30	30-40	40+

Last Full Update: **Jun 26, 2023**
Last Update: **Jul 12, 2023**

S&P

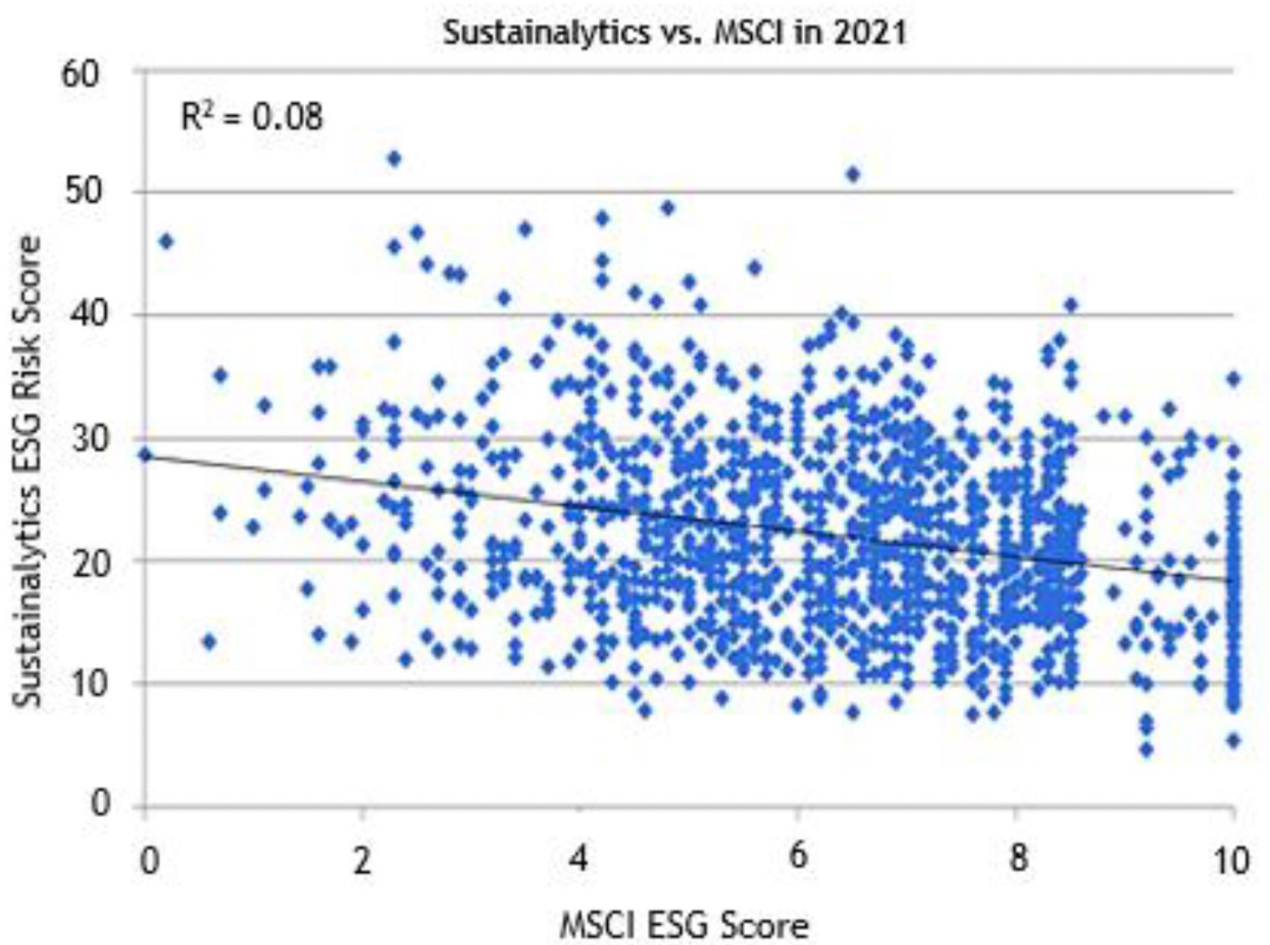
S&P Global ESG Score

50

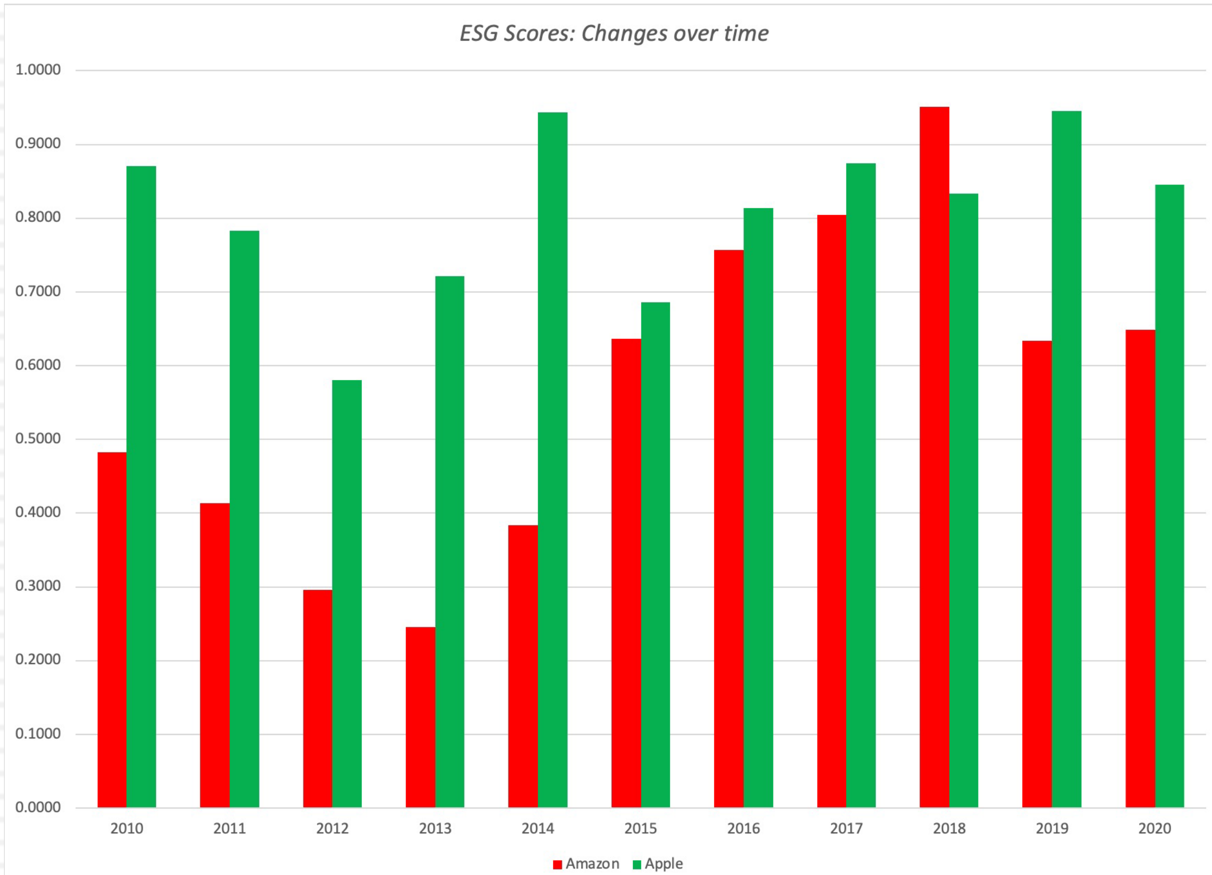
Data Availability : Very High

Methodology Year: 2023
Updated annually or in response to major developments

ESG Services, in the cross section…



ESG scores change over time…



ESG Scores via WRDS do not match scores via Refinitiv

Refinitiv delivers version 1 of ESG to WRDS and uses version 2 on their internal platforms such as Eikon. The two versions use slightly different methodology and the scores will not match exactly. WRDS has requested version 2 but does not have a time frame for this enhancement

ESG score biases: Scores are higher for large market-cap companies…

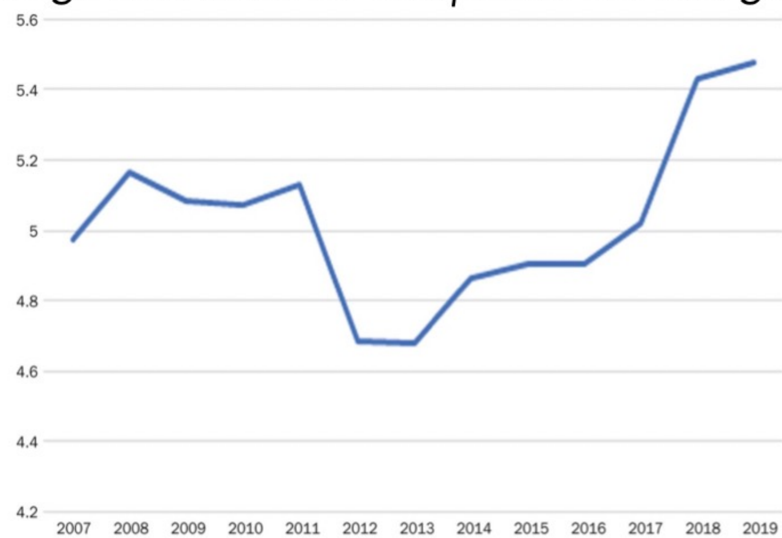
Market Cap Decile	Q1	Median	Q3
Smallest	20.32	28.17	38.19
2nd decile	24.65	33.92	45.67
3rd decile	26.64	37.25	49.93
4th decile	30.20	42.55	56.36
5th decile	31.03	44.08	57.13
6th decile	31.55	46.13	60.30
7th decile	35.26	50.55	63.66
8th decile	38.05	53.23	65.42
9th decile	44.55	59.76	72.49
Largest	49.95	61.72	73.38

And increase with disclosure bulk, and goodness is increasing..

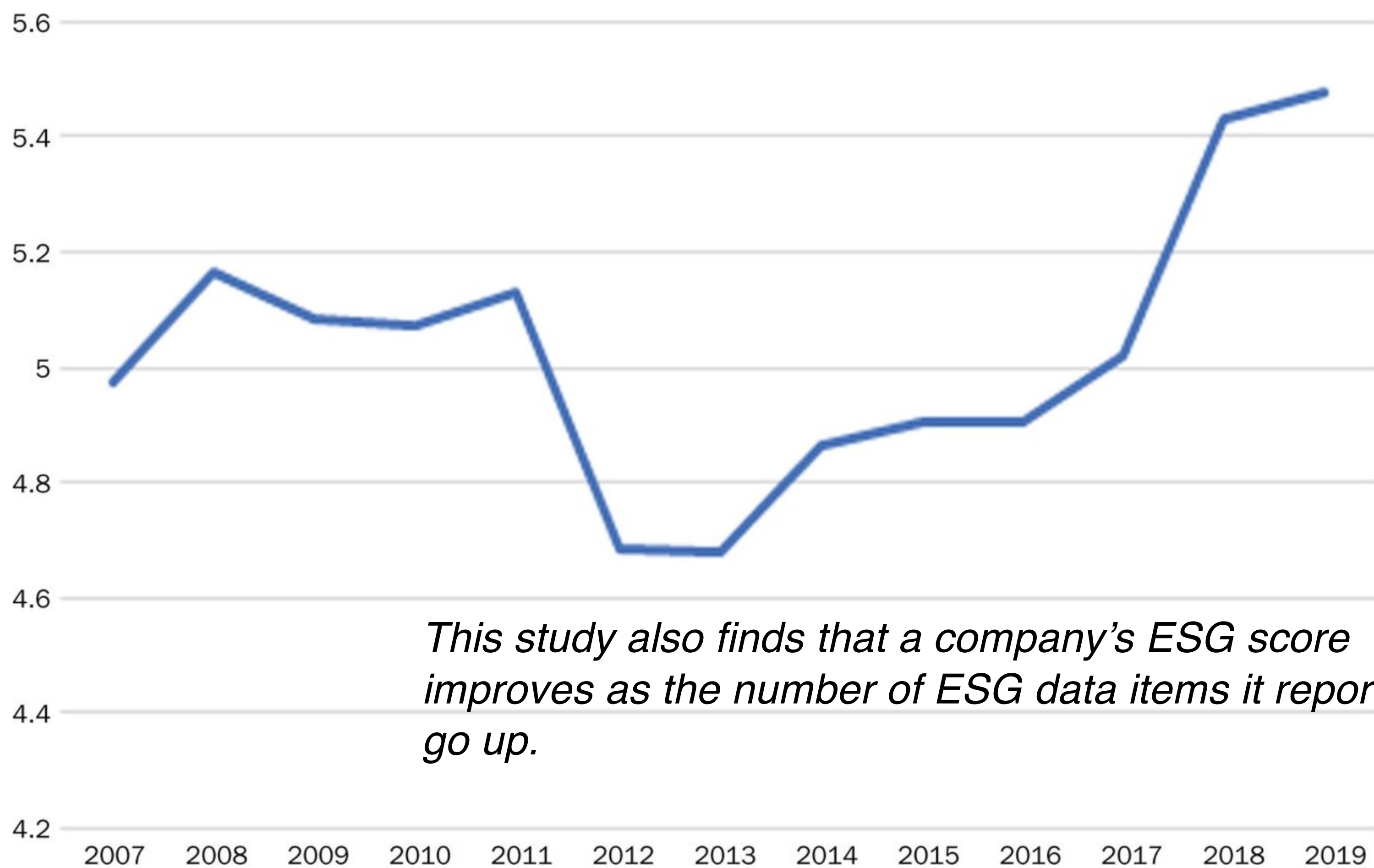
As the number of ESG disclosure items has increased..

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

The average ESG score for companies has also gone up…



Everyone is behaving better (at least according to ESG scores)



This study also finds that a company's ESG score improves as the number of ESG data items it reports go up.

Source: Chen et al, JPM

The Revisionist History of ESG

- Goodness: Born out of a UN document, and packaged by leading financial service companies, ESG was created as a measure that could measure how well companies were **contributing to the planet's well being**.
- Alpha: The ESG salespeople recognized early in the game that goodness by itself did not sell well and swiveled to making it an **instrument of delivering alpha**.
- Risk: After the Russian invasion of Ukraine upended markets, and fossil fuel stocks surged, ESG services changed their tune and argued that **ESG scores were a measure of risk, with better scores translating into lower costs of capital & failure risk.**
- Disclosure of material impact: In the last year, as the pushback against ESG's use by investment managers has mounted, ESG has been reframed as a **mechanism of disclosure of "material" impact**.

a. Measuring Goodness?

- 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.
- Person specific: 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. In fact, we know that people measure goodness very differently, depending on age, culture, religion, nationality ETC.
- 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.

If it is goodness, it certainly generates some odd results…

- Manufacturing versus Service: ESG scores through most of the period that ESG has been around have been skewed away from manufacturing and towards service businesses, perhaps because of the focus on carbon footprint.
- Tangible versus Intangible: Until recently, technology companies were ESG favorites, reflecting the same focus on carbon footprint and an implicit bias towards price momentum in markets. (Just as analysts rush out with buy (sel) recommendations for companies after their stock prices go up (down), ESG scores drift up after stock prices go up for a company, and drift down after they go down).

Goodness is not absolute….

Philip Morris donates 500,000 packs of cigarettes to Ukrainian army

The tobacco company said it's working on options for leaving the Russian market, joining scores of multinationals that are scaling back operations in the country after its invasion of Ukraine

b. If your answer is risk… look again

- In the last three or four years, ESG services seem to have changed their tune about what they are measuring, from "goodness" to "risk".
- At various points, ESG services have claimed that
  - Companies with higher ESG scores have lower costs of capital than companies with lower ESG scores
  - Companies with higher ESG scores have more stable earnings than companies with lower ESG scores
  - Companies with higher ESG scores are less likely to face crises or catastrophic risk
- Each of those statements is misleading, at the very least, and untrue, at its core.

Refinitiv's ESG and Cost of Capital: Is there an ESG link?

Cost of Capital (%): Refinitiv Estimate

		Market Cap Decile										
		Smallest	2	3	4	5	6	7	8	9	Largest	All firms
ESG Score Decile	Lowest	8.22%	8.51%	8.51%	7.89%	7.64%	8.01%	7.13%	7.99%	7.99%	9.02%	8.51%
	2	8.14%	8.44%	8.52%	7.98%	7.71%	7.62%	9.17%	8.07%	8.07%	11.72%	8.73%
	3	8.65%	9.14%	8.80%	8.78%	8.91%	8.58%	8.27%	8.20%	8.20%	7.76%	8.52%
	4	8.26%	8.49%	8.58%	8.12%	7.89%	8.18%	8.22%	8.49%	8.49%	8.94%	8.17%
	5	8.66%	8.79%	8.05%	8.03%	7.64%	8.29%	8.37%	8.18%	8.18%	8.83%	7.92%
	6	8.72%	8.56%	8.64%	7.92%	8.07%	8.09%	7.81%	8.03%	8.03%	8.73%	8.07%
	7	8.05%	8.96%	8.37%	8.08%	8.11%	8.00%	8.11%	7.99%	7.99%	8.55%	8.10%
	8	9.70%	8.65%	8.54%	8.38%	8.36%	7.88%	8.02%	8.15%	8.15%	7.97%	8.07%
	9	9.03%	9.35%	8.56%	8.75%	7.94%	8.00%	7.86%	8.12%	8.12%	7.36%	7.76%
	Highest	7.05%	9.34%	9.69%	8.41%	7.36%	8.70%	7.72%	7.81%	7.81%	7.34%	7.81%
	All firms	8.19%	8.11%	8.74%	8.23%	8.23%	8.23%	8.19%	8.30%	7.85%	7.62%	8.16%
	Bottom 5	8.39%	8.67%	8.49%	8.16%	7.96%	8.14%	8.23%	8.19%	8.19%	9.25%	8.37%
	Top 5	8.51%	8.97%	8.76%	8.31%	7.97%	8.13%	7.90%	8.02%	8.02%	7.99%	7.96%

Number of firms

		Market Cap Decile										
		1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*All firms*
ESG Score Decile	1	308	263	194	165	116	71	41	27	13	3	1201
	2	202	200	188	175	145	116	85	48	30	13	1202
	3	164	160	174	174	137	130	88	92	56	27	1202
	4	105	132	145	137	154	153	125	117	85	48	1201
	5	104	113	150	134	148	141	142	110	92	68	1202
	6	104	115	109	107	149	148	148	144	112	66	1202
	7	91	94	78	114	118	134	157	156	146	113	1201
	8	82	71	78	97	96	132	170	165	170	141	1202
	9	37	38	67	70	88	103	136	175	229	259	1202
	10	4	15	20	28	51	73	110	167	270	464	1202
	All firms	1201	1201	1203	1201	1202	1201	1202	1201	1203	1202	12017

Controlling for the fact that ESG scores tend to be higher for larger firms, there is no correlation between ESG and cost of capital.

As for catastrophic risks, the evidence, at least on the highest profile firms, is to the contrary

- To the extent that ESG is on the side of "goodness", any company that wears the ESG mantle acquires some degree of protection against questioning, not just about ESG actions, but also against legitimate business questions.
  - While the evidence is anecdotal, at least for the moment, there is some backing for the contention that the companies that claim to have the purest of motives often have the most to hide.
  - Materially, any evidence that claims to show that higher ESG scores would have protected you from corporate scandals and scams is based on contorted definitions of what comprises catastrophic risk.

The Runaway Story: ESG as a lubricant

- With a runaway business story, you usually have three ingredients:
  1. Charismatic, likeable Narrator: The narrator of the business story is someone that you want to see succeed, either because you like the narrator or because he/she will be a good role model.
  2. Telling a story about disrupting a much business, where you dislike the status quo: The status quo in the business that the story is disrupting is dissatisfying (to everyone involved)>
  3. With a societal benefit as bonus: And if the story holds, society and humanity will benefit.
- Since you want this story to work out, you stop asking questions, because the answers may put the story at risk. And since it will benefit society, you are reluctant to be churlish enough to ask questions about the basic business models.

The Impossible: The Runaway Story

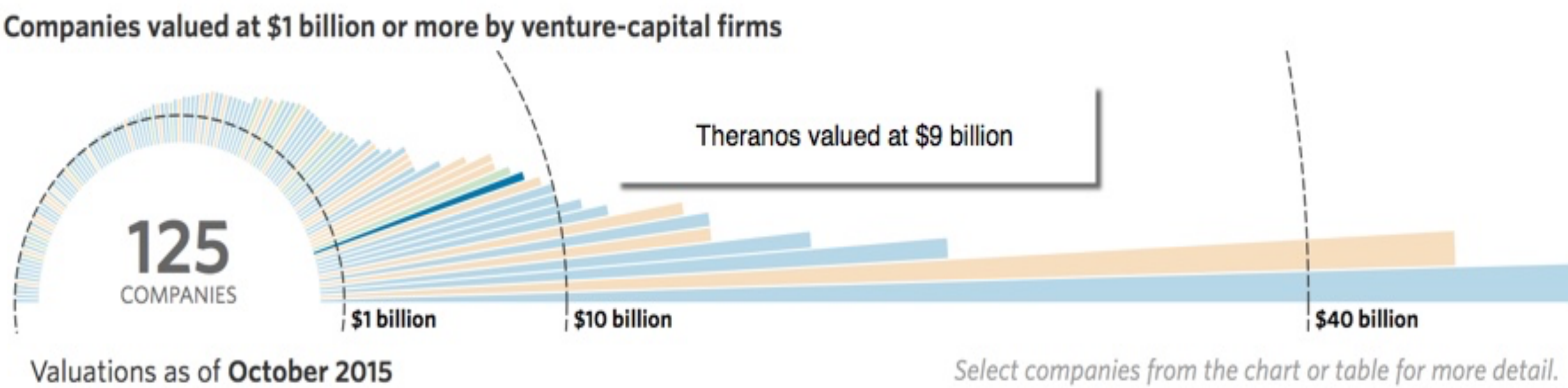
The Story

+

The Checks (?)

Board Member	Designation	Age
Henry Kissinger	Former Secretary of State	92
Bill Perry	Former Secretary of Defense	88
George Schultz	Former Secretary of State	94
Bill Frist	Former Senate Majority Leader	63
Sam Nunn	Former Senator	77
Gary Roughead	Former Navy Admiral	64
James Mattis	Former Marine Corps General	65
Dick Kovocovich	Former CEO of Wells Fargo	72
Riley Bechtel	Former CEO of Bechtel	63
William Foege	Epidemologist	79
Elizabeth Holmes	Founder & CEO, Theranos	31
Sunny Balwani	President & COO, Theranos	NA

+ Money



With more examples…

- FTX

TECHNOLOGY

The do-gooder movement that shielde[d] Sam Bankman-Fried from scrutiny

Effective altruism, backed by Silicon Valley billionaires, now finds itself at a crossroads.

ESG firm raises eyebrows for ranking collapsed crypto giant FTX higher on governance than Exxon Mobil

- Adani Group

Adani Shock Rips Through ESG Funds as Strategy Fails Test

- Adani stocks are spread across large numbers of ESG funds
- ESG fund exposure to fraud risk raises doubts about policies

Too little, too late

https://www.reuters.com › business › sustainable-business

Sustainalytics downgrades three Adani companies ... - Reuters

8 days ago — Among its downgrades this month, Sustainalytics assigned **Adani Green** Energy a "moderate" business ethics controversy score, ...

- It is true that this is anecdotal evidence, but as a challenge, is there a single high-profile firm that you can think of where a low ESG score would have warned you ahead of a crisis?

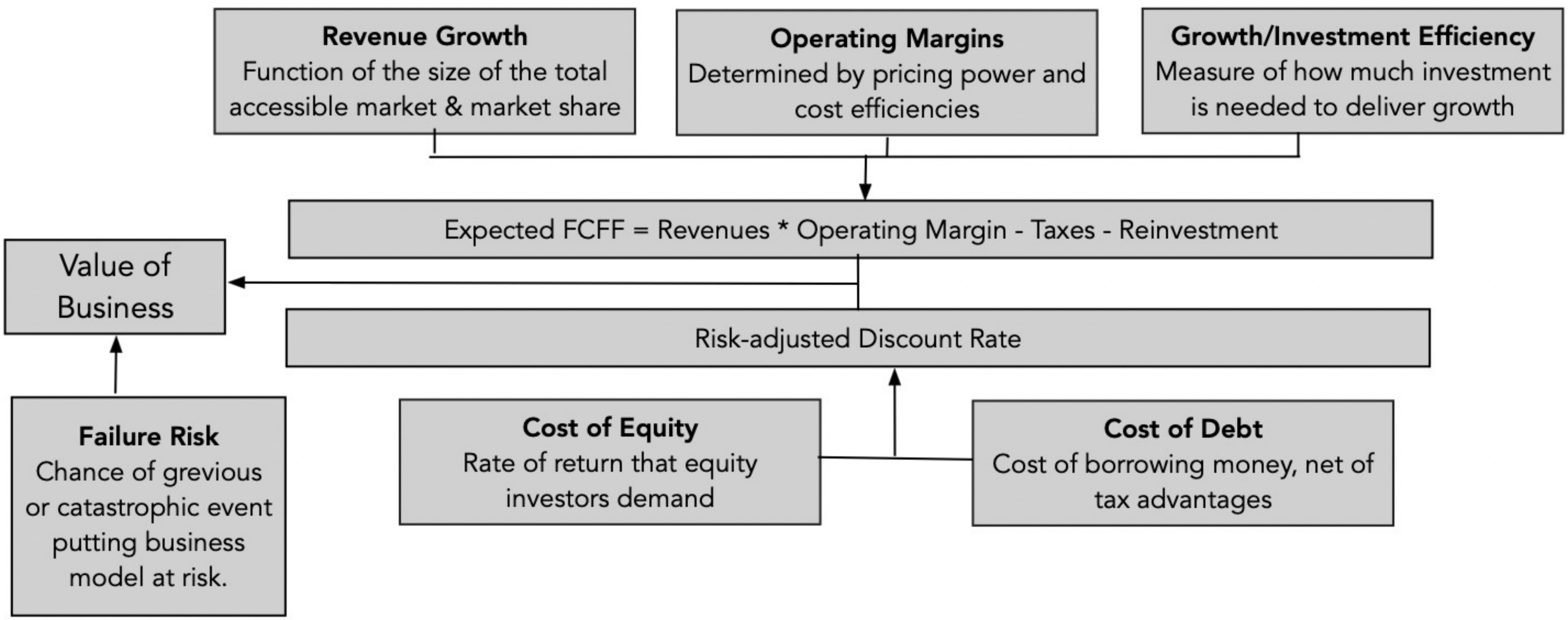
ESG score differences will not only persist…

- 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.*
  - If *there is a consensus that emerges, it will be because ESG services will draw on a small subset of people who have been trained in ESG talk, bring the same mindset and indulge in group think.*
- 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

And the gaming will get worse..

- The nature of any scoring system is that the "scored" will learn (either because it explicitly lays out the components that lead to a high score) or scores can be reverse engineered to figure out what causes high and low scores.
  - The bottom line is that gaming is a feature of any scored system than a bug in the system.
  - As scoring systems mature, the gaming gets easier (not harder) making the scores even less useful.
- Put simply, greenwashing is not a bug in ESG, that if fixed will lead to green heaven, but a feature of ESG, with its reliance on disclosures and scores.

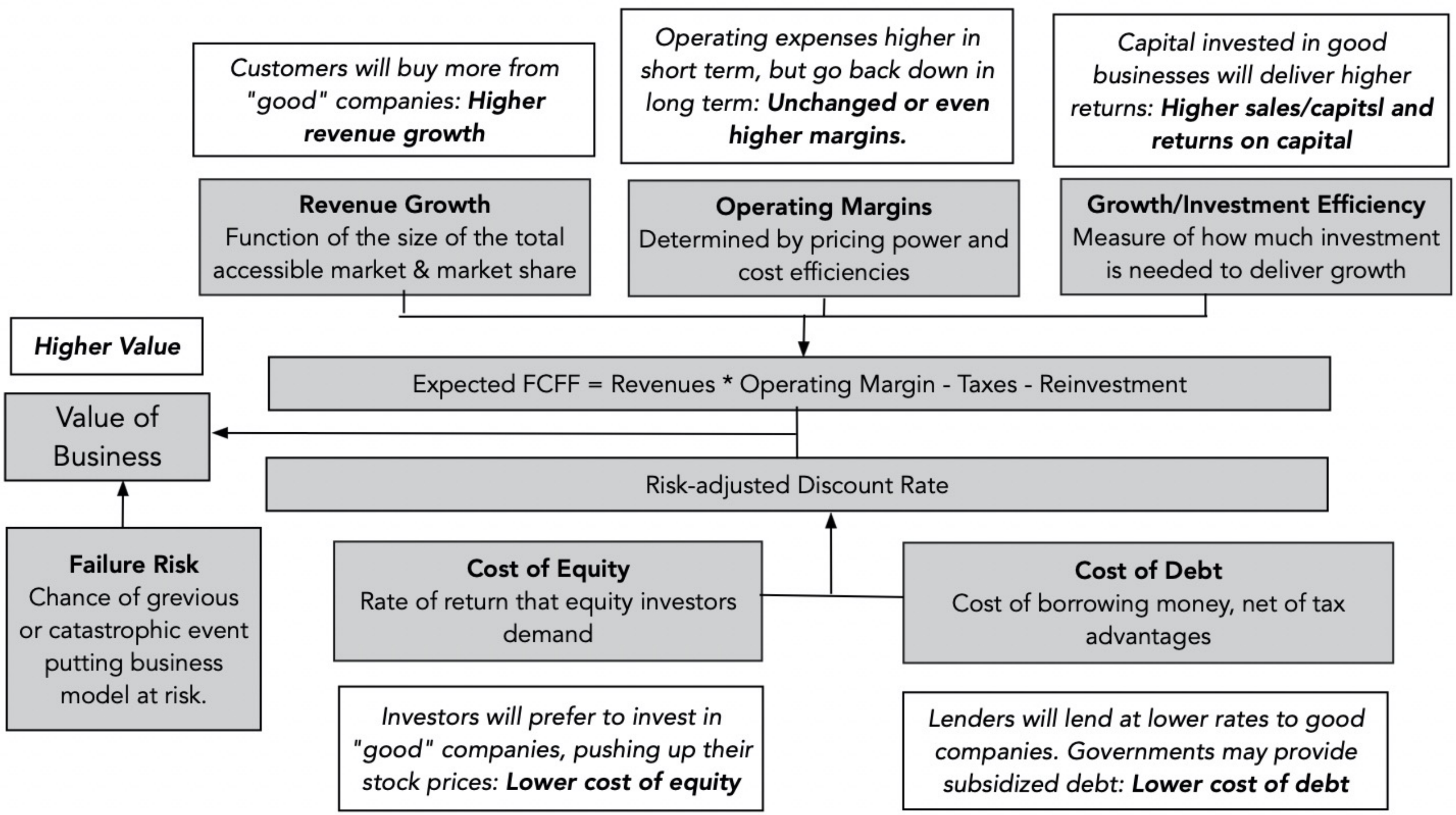
II. ESG and Value



The "It Proposition" applied to ESG: For *ESG to affect value, its practices have to show up in one or more of these inputs.*

The Promise of Heaven : The Good shall be rewarded

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

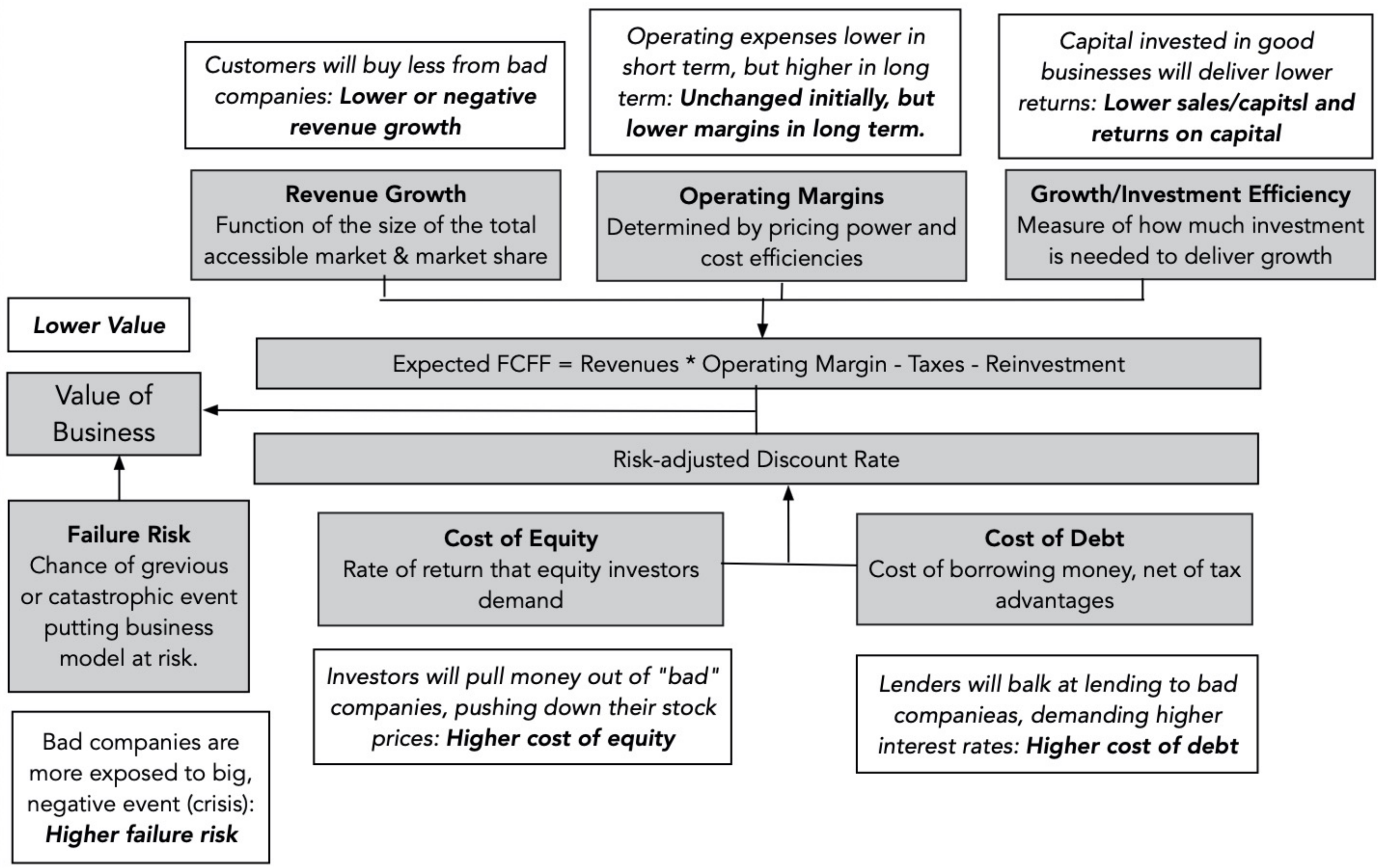


Examples and Counters: Patagonia and Etsy

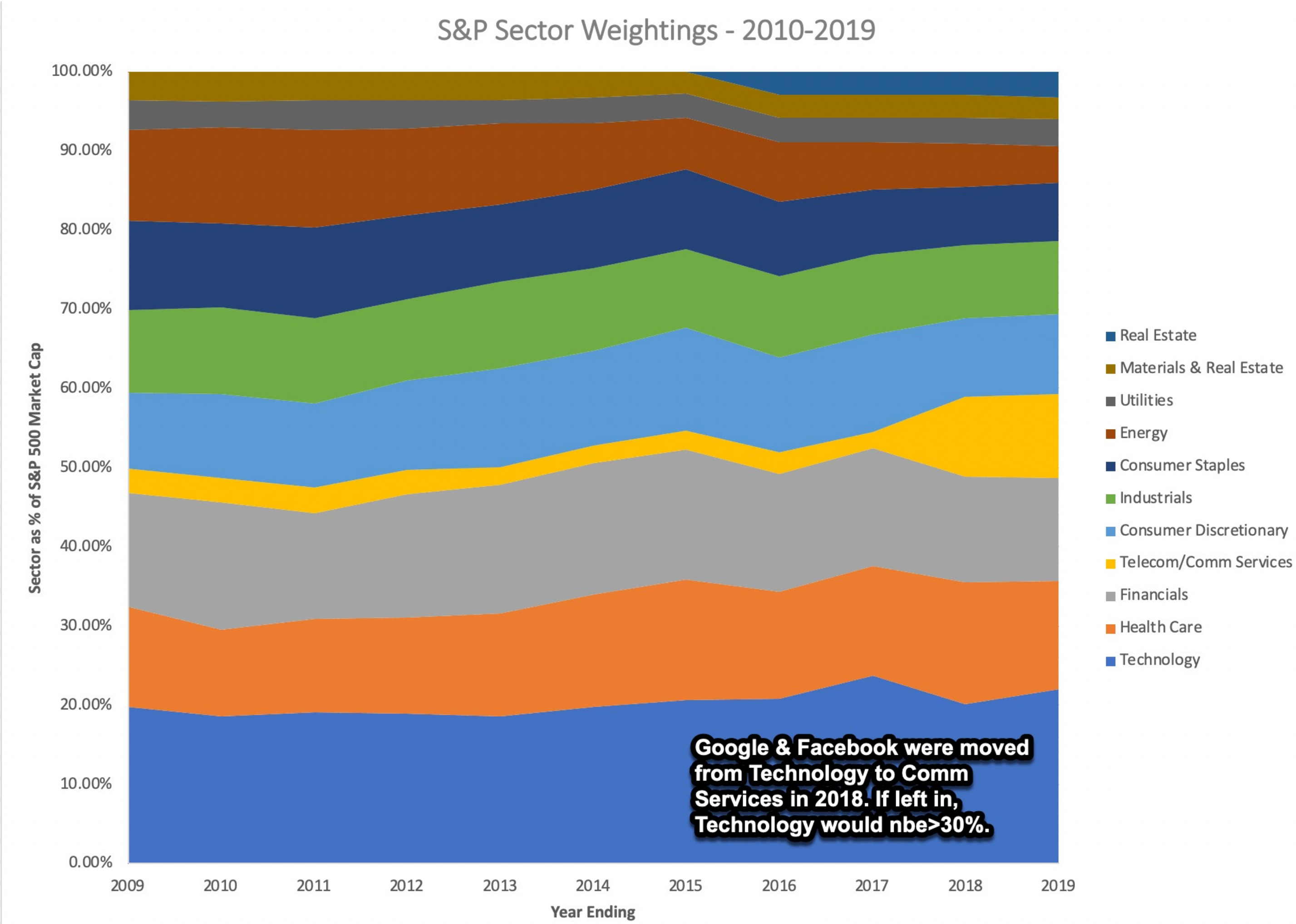
- A company that is often used as an example of “goodness” is Patagonia, and the company has stayed true to its mission by:
  - Remaining an annual benefit corporation, owned by the Chouinard family (Yvon and his children)
  - Being willing to pay to do the “right” thing (at least as it sees them)
  - But is has paid the price (lower revenues, less in profits)
- Etsy went public as a benefit corporation, but that mission clashed with its endgame of being a much larger player in online merchandising. It eventually abandoned its benefit corporation status, so as to be able to access more capital, and is now embroiled in public fights with the craftsmen who provide its merchandise.

The Warning of Hell: The Bad shall be punished

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

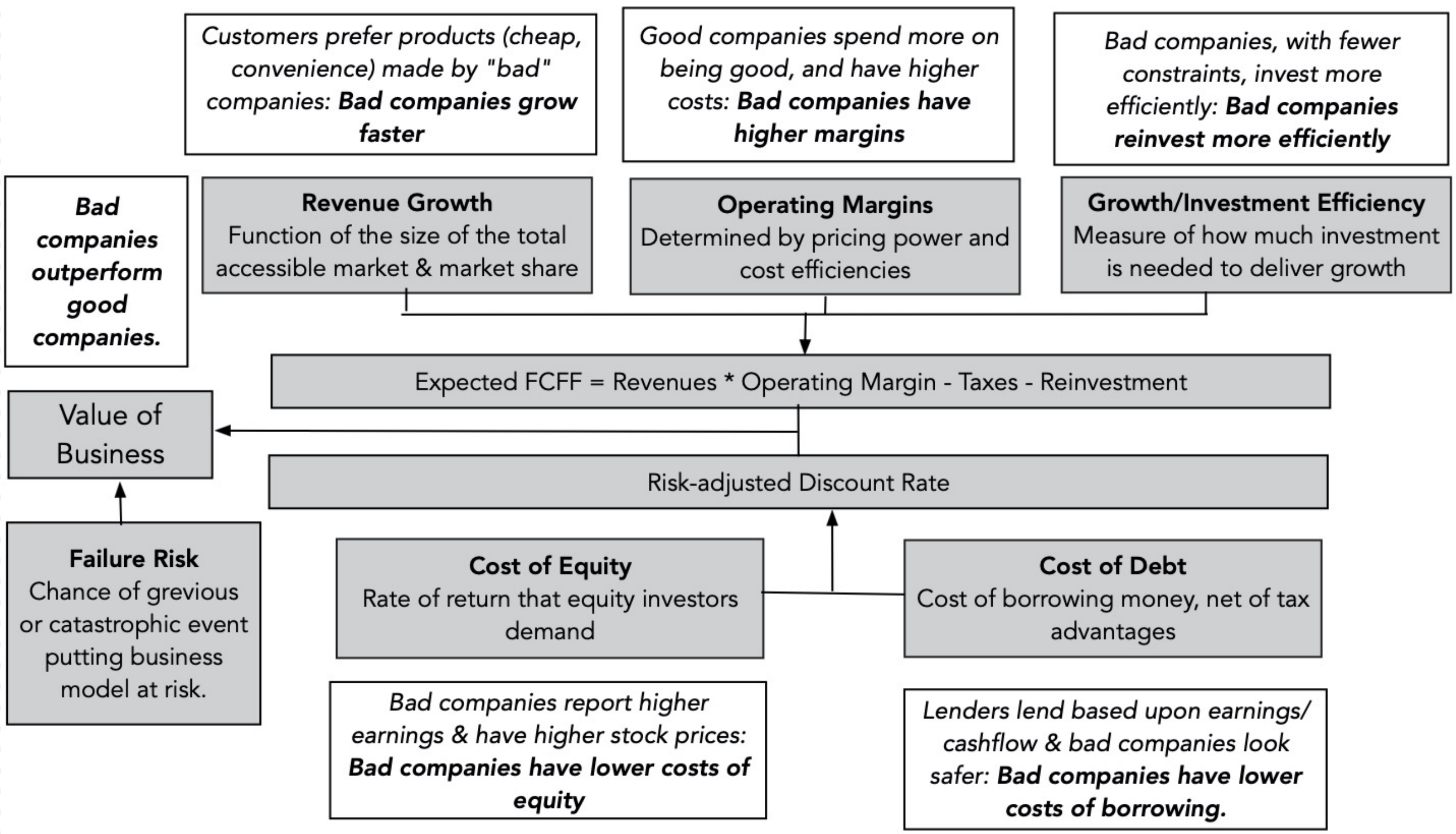


ESG's biggest success? Fossil Fuel..



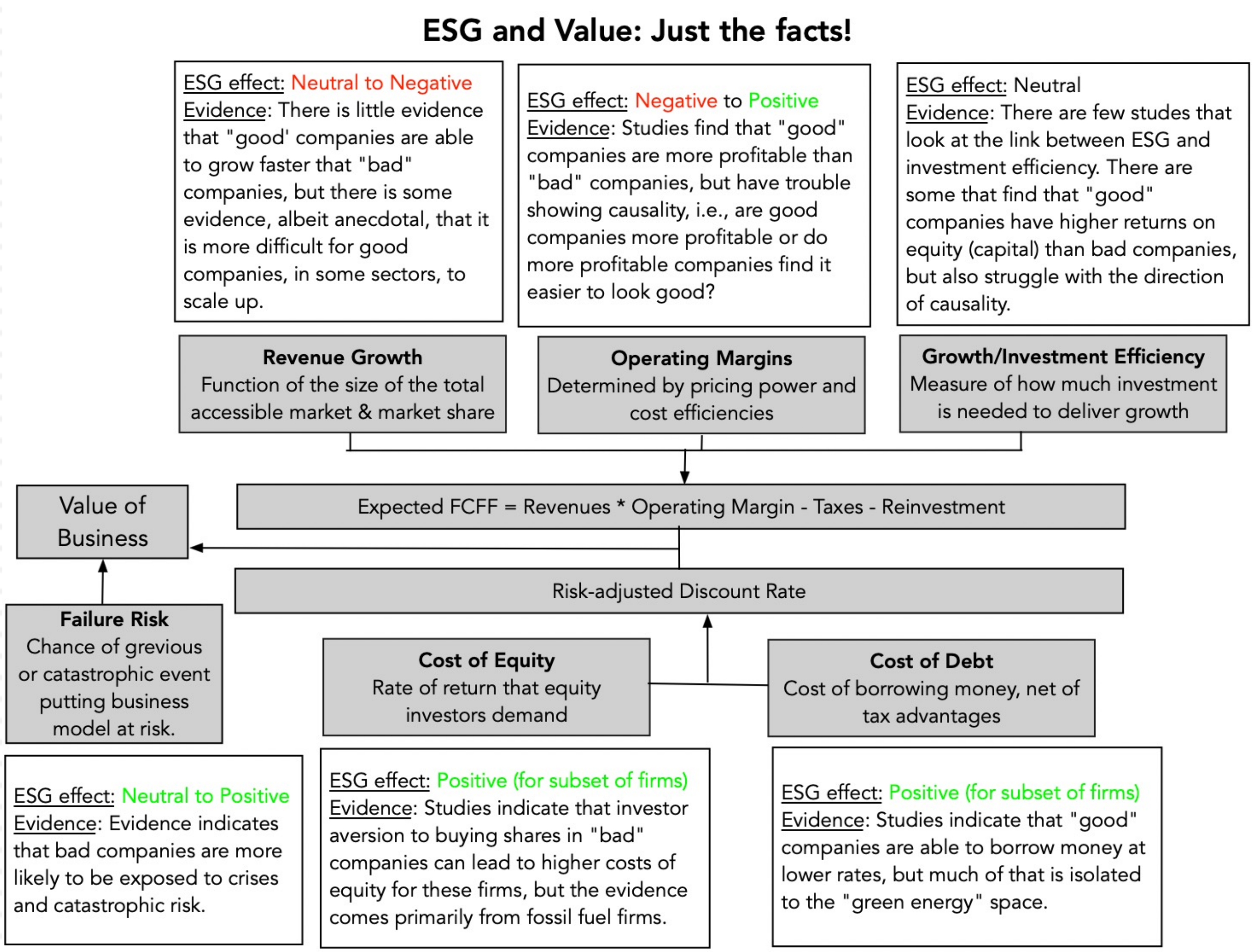
The Bad Guys win: Hell on Earth?

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



Valeant: A Cautionary Tale

The Evidence: Being good will help some firms, hurt others and do others unaffected!



ESG and Profitability: The Causality Question

- There are ESG advocates who point to evidence that firms with high ESG scores have higher profitability (defined as margins or returns on capital), but the findings are statistically flawed for two reasons:
  - The first is that ESG, at least in earlier years, was skewed higher for technology and service firms, which had higher margins well before ESG even showed up.
  - The second is that the disclosure and gaming that has been set in motion by ESG services are expensive and easier to play for profitable firms that have more buffer than for firms that are struggling.
- There is a simple test of causality. If higher ESG scores can improve profitability, increases in ESG scores should lead to increased profitability in subsequent periods, and there is no evidence backing this proposition.

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).

III. 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.

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.

The ESG sales pitch is internally inconsistent and fundamentally incoherent

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.
- Being good has no effect on value, with any benefits being offset by costs.

How is the market pricing ESG?	Long term Returns to ESG investing
Market is **over estimating** the benefits of being good and/or the costs of being bad. →	Investing in bad companies will generate higher risk adjusted returns than investing in good companies
Market is **fairly estimating** the benefits of being good and/or the costs of being bad. →	Investing in good companies will generate similar risk adjusted returns to investing in bad companies.
Market is u**nder estimating** the benefits of being good and/or the costs of being bad. →	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.

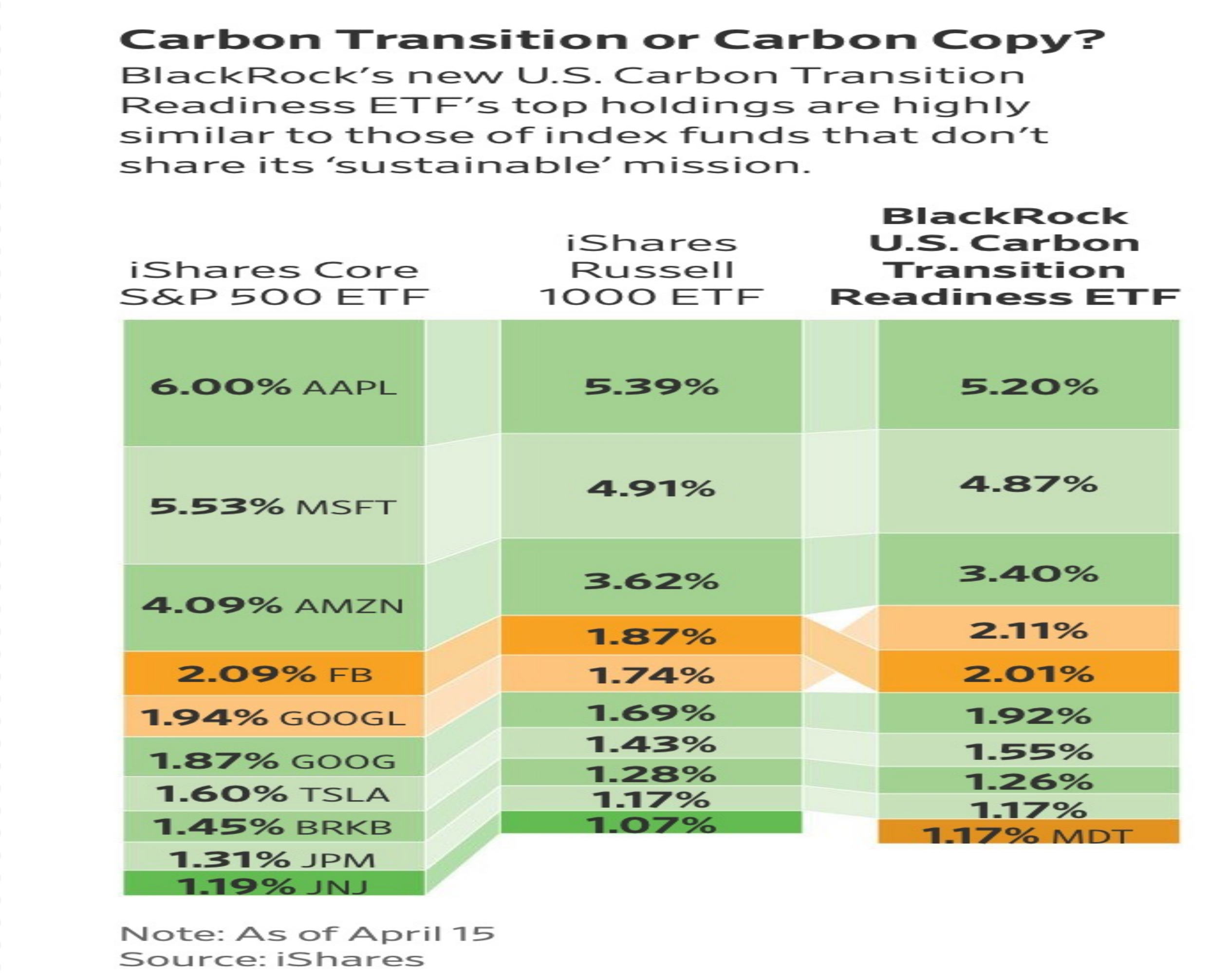
The Pricing Effect

- Put simply, a study that finds a relationship (positive, negative or zero) between ESG and returns is really a test of whether ESG is being priced in correctly and not one of whether ESG is good for investing or bad for investing.
- The only worthwhile conclusion that you can draw is that investing in good companies (or avoiding investing in bad companies) will generate higher returns if the market is underpricing the "positive" effects of being good or the "negative" effects of being bad.
- In fact, if ESG is front and center and investors are rushing into "good" companies and selling "bad" companies, the reverse will be true, i.e., the market will be overpricing the positive effects of being good and the negative effects of being bad. In this world, investing in bad companies will generate higher risk-adjusted returns that investing in good companies.

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

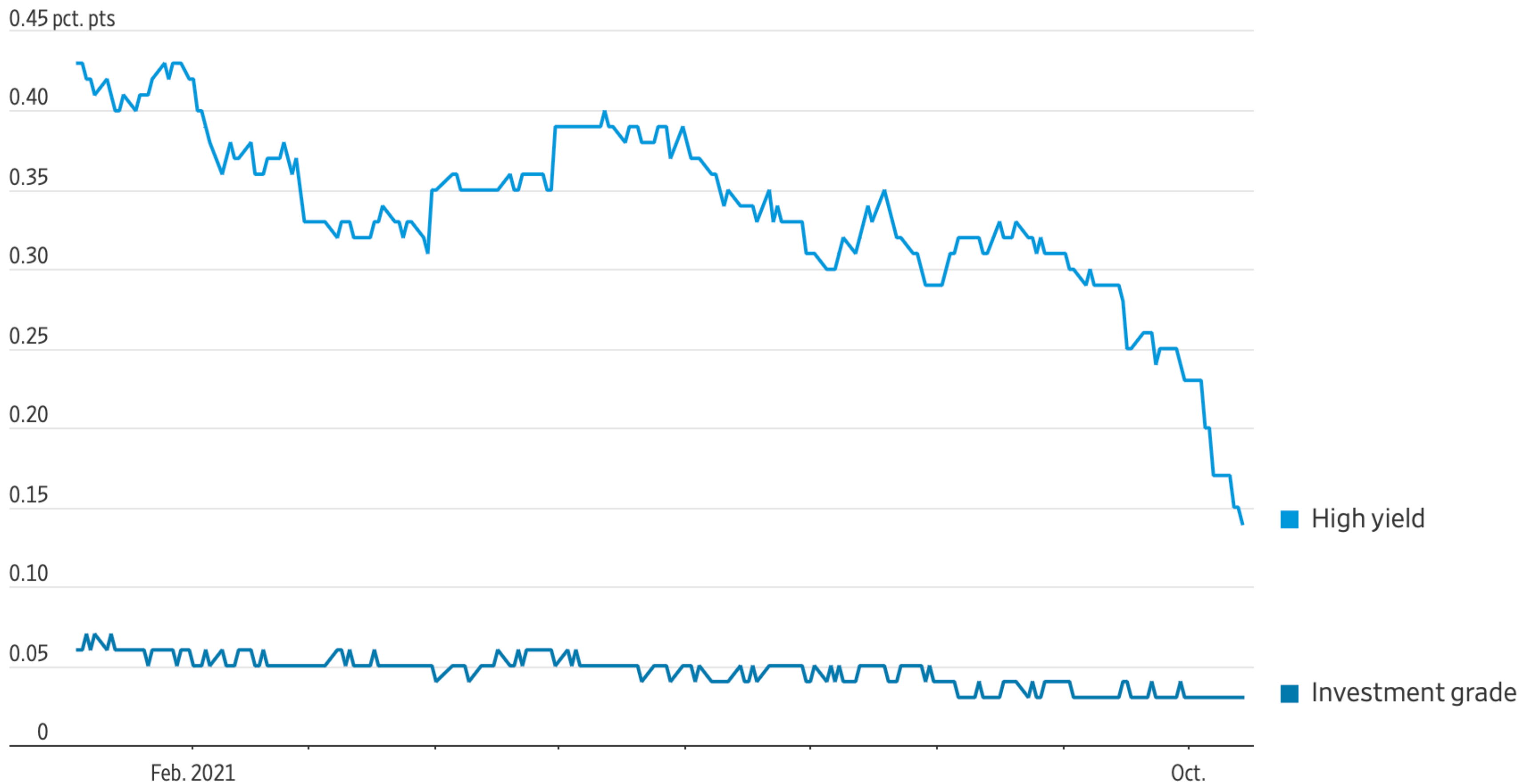
With a caveat…

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

Green Bonds: The Shrinking Premium

Difference between yields, relative to Treasurys, for green bonds versus conventional bonds



Source: ICE

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). They have to adopt a more dynamic strategy built around either *aspects of corporate social responsibility that are not easily measured and captured in scores but also affect value*, or from *getting ahead of the market in recognizing aspects of corporate behavior that will hurt or help the company in the long term.*

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.

IIIa. ESG Disclosure

- If ESG does not add to value, at companies, or to returns, for investors, there are some who argue that the primary benefit of the ESG movement has been increased disclosure.
  - In short, the new push for ESG seems to be that it just a disclosure movement, that is attempting to let investors know about "material" risks that they might be exposed to.
  - Implicit in this argument is the assumption that more disclosure will not only induce better behavior on the parts of the "disclosing" firms, but also allow consumers and investors to make more informed judgments.
- That push has already created results with the EU leading the way on new disclosure requirements, with different interest groups pushing for disclosures on their favorite causes.

The Magic of Materiality

- While there seems to be this consensus that we can define materiality, that is far from true. There are three different definitions of materiality:
  - Accounting materiality: Reflecting the accounting attention to detail and absence of perspective, accounting materiality is designed to mix the small with the big, and expend resources on details that don't matter to anyone other than the accountants (Goodwill impairment).
  - Value materiality: Value materiality focused on items that change the value of a business by having a significant effect on future cash flows, growth and risk.
  - Pricing materiality: Price materiality is built around any item that can cause prices to change substantially, which may or may not overlap with value materiality.
  - Legal materiality: Legal materiality is about disclosing any item, no matter how minor, that if things go wrong could be highlighted as material.

Disclosure as information

- In theory, disclosures should make us more informed as consumers and investors, but here again, there are caveats.
  - Legalese: In an age of litigation and regulation, disclosures seem to be written by lawyers and for lawyers, and there is no reason to believe that ESG disclosures will be any different.
  - Information overload: As we have seen with accounting disclosures, there is a danger that if ESG disclosures become too extensive, they will be ignored even by people who claim to care about the disclosed information.
- It is almost unavoidable that what starts as value materiality will become legal materiality somewhere along the way, especially when there are laws and regulations that will punish firms, with the benefit of hindsight.

Disclosure and Corporate Behavior

- While it is possible that disclosure could lead to better behavior, there are at least two potential problems.
  - Greenwashing and Game Playing: Once the disclosure requirements are set, there will be companies that find ways to play the disclosure game to make themselves look better.
  - Confess and then sin again: A more dangerous problem is that companies may view disclosure as license for the disclosed bad behavior.
- In short, the notion that requiring companies to disclose more will induce better behavior is at odds with the evidence on almost every aspect of disclosure that we have seen so far.
  - Did increased risk disclosures make companies more careful about taking risk?
  - Have corporate governance disclosures, which have exploded over the last two decades, improved corporate governance at companies?

IV. ESG is good 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.

The Law of Unintended Consequences…

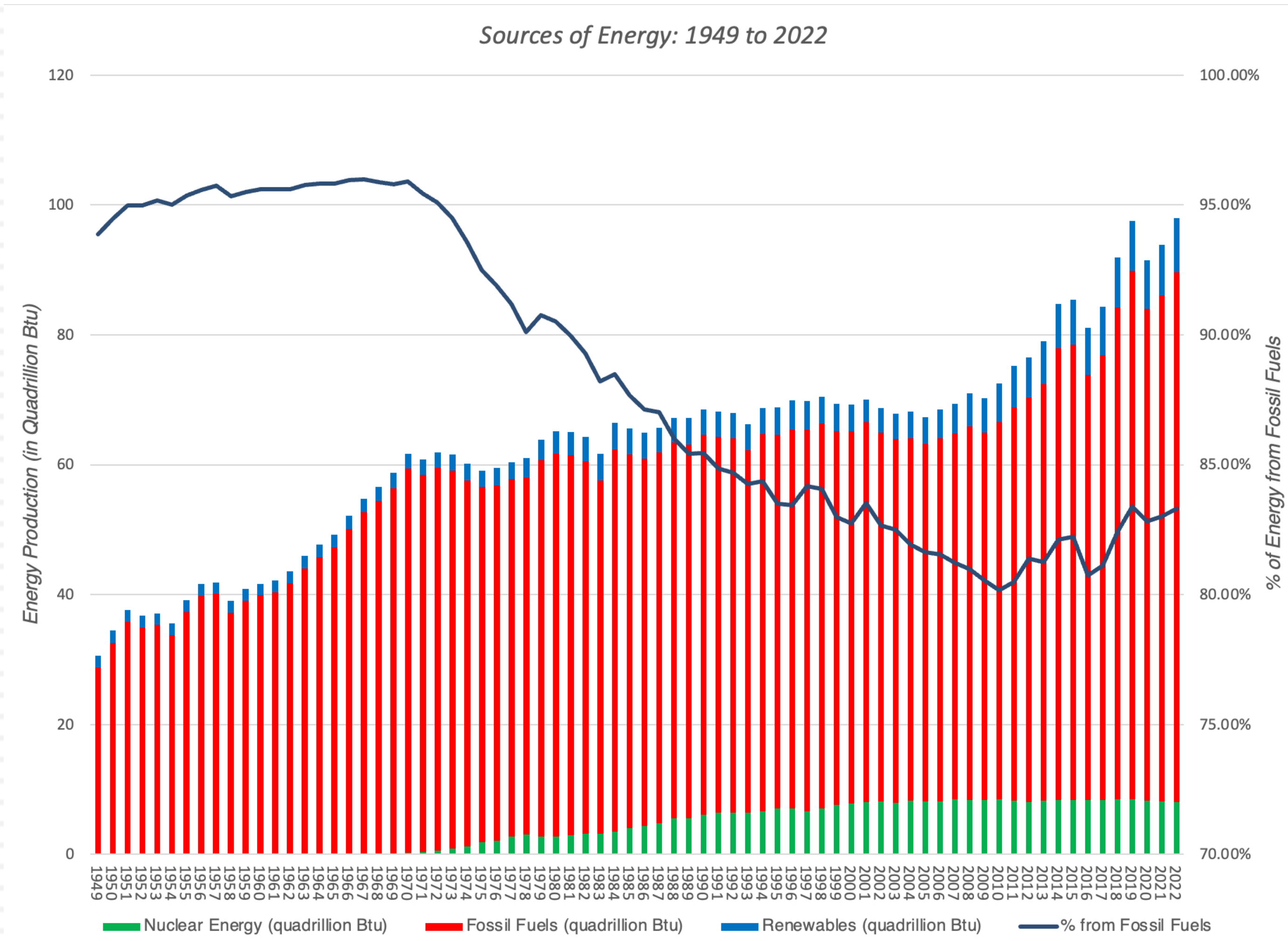
- As publicly traded companies that are exposed to ESG shaming are forced to divest themselves of their "bad" businesses, it is worth remembering that selling or divesting a business does not erase it from the face of the earth, but just transfers it to a different owner, presumably one is less exposed to the ESG shaming.
- In the fossil fuel business, for instance, the pressure on the easily pressured (the big US/European oil companies) has led them to cut back on investments in the fossil fuel space.
  - That absence of investment is and will continue to push up the price of fossil fuels, making their production more profitable.
  - A subset of the investments are now being made by foreign companies (in markets where stockholders has little power) or private equity funds.

Private Equity in Fossil Fuels

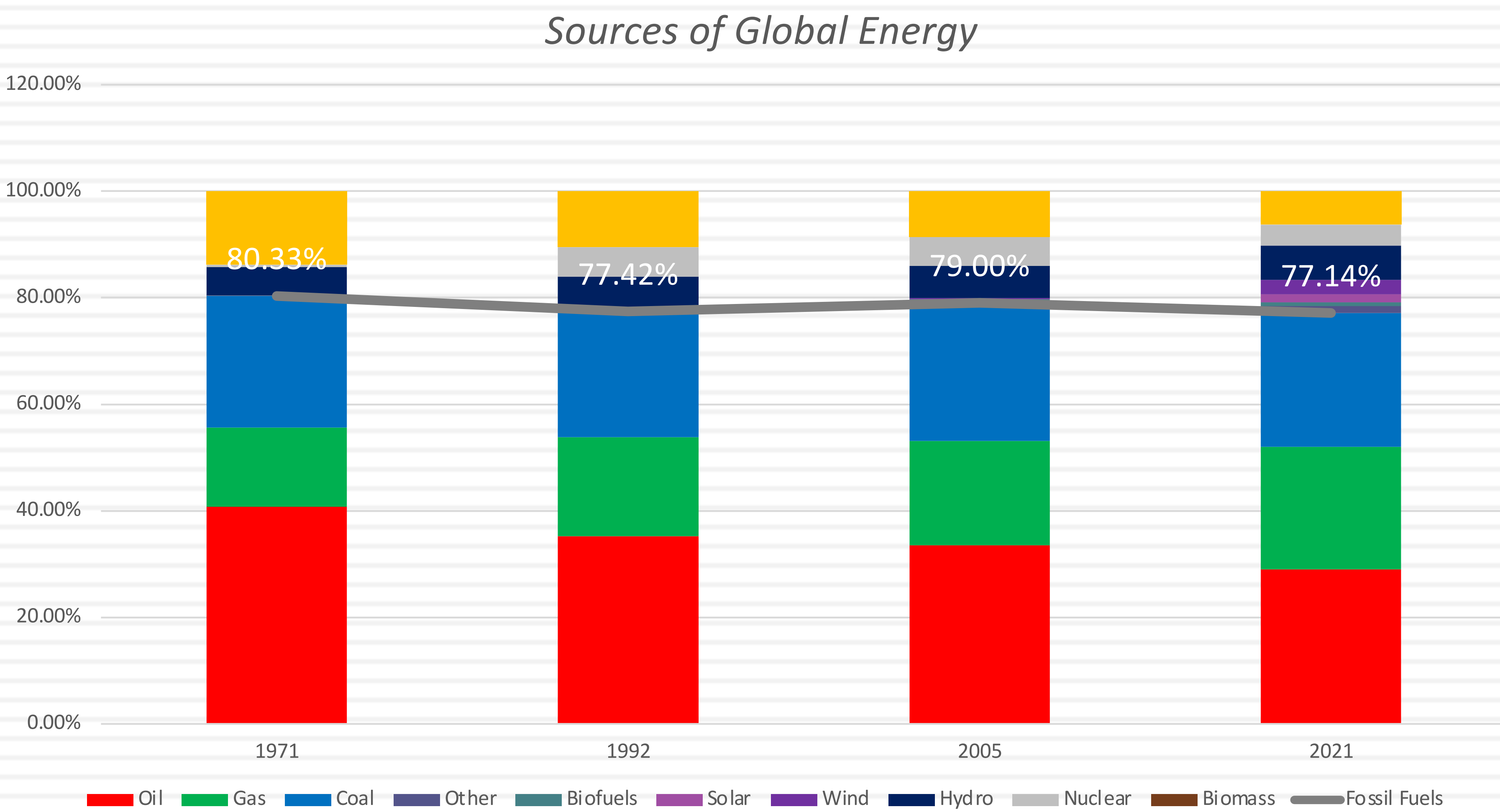
Private Equity Firm	Fossil Fuel Companies Held	Renewable Companies Held	Total Number of Energy Companies
Carlyle/NGP	68	14	82
Brookfield/Oaktree	40	23	63
KKR	28	6	34
Blackstone	25	5	30
Warburg Pincus	28	1	29
Kayne Anderson	23	2	25
Ares	16	3	19
Apollo	14	5	19
TPG	4	2	6
CVC	5	0	5

Between 2010 and 2020, private equity funds have invested a trillion dollars in fossil fuel investments…

And how this plays out… Sources of energy in the US



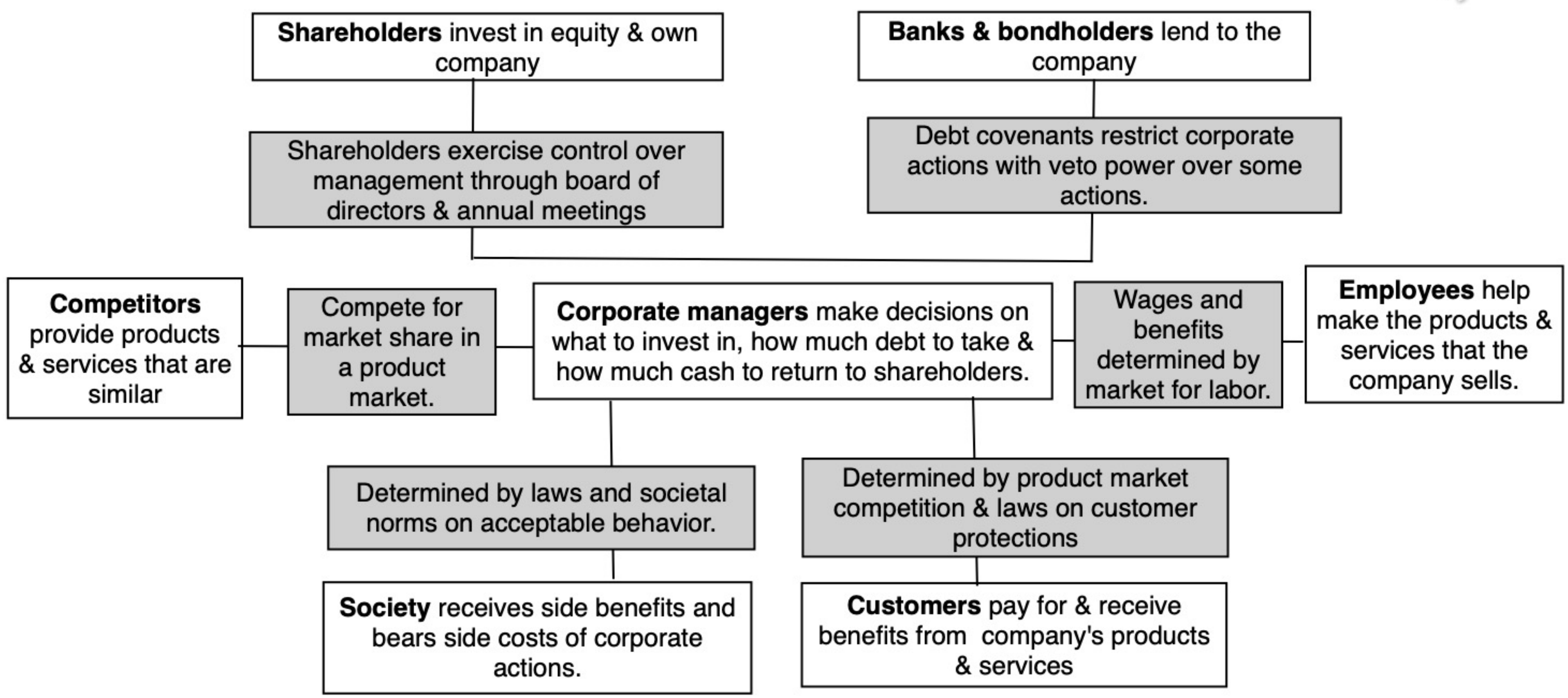
And globally…



V. Wanting to do good for society predates ESG…

- The notion that until ESG came along, companies (and individuals) are businesses operated without a care for society would be comical, if the people pushing it were not so insistent that it is true.
- That is nonsense. People who have wanted to do good have always been able to do so.
  - In privately owned businesses, owners have always been free to share their profits or give away their wealth, to meet whatever societal need they felt most strongly about.
  - In publicly traded companies, that responsibility fell to the owners of its shares, who again were free to share their winnings with society, in any way they though fit.

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



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. Well before ESG came along, good businesspeople have not only made their shareholders wealthy, and also given back to society.
- 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.

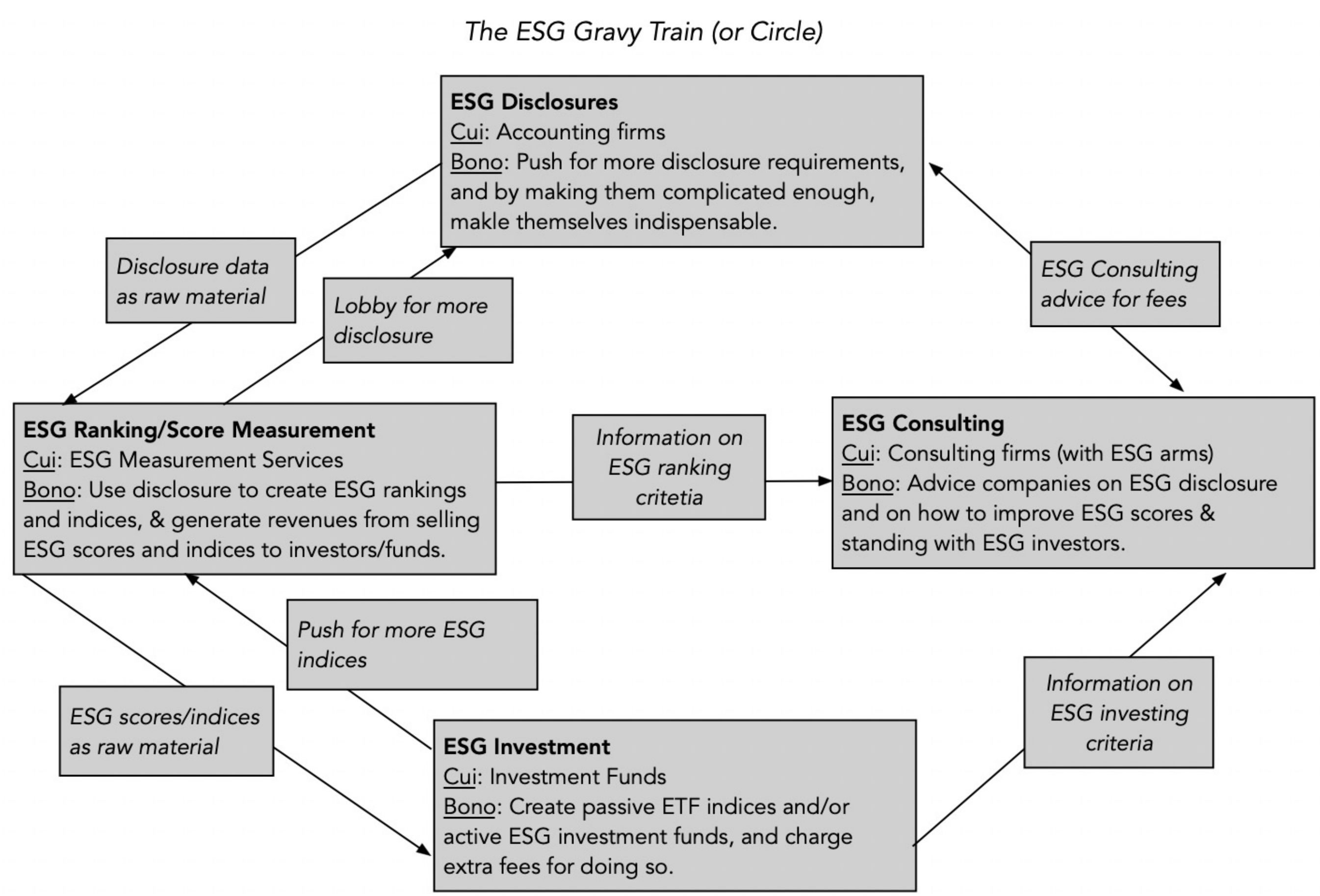
An inside perspective…

- 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.

So, why the hype?

Cui Bono?

The ESG Gravy Train (or Circle)



And why it keeps on rolling..

- 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.

Do you want to do good?

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 you have to bring in your value judgments into your decisions, rather than leave it to ESG measurement services or to portfolio managers.
2. *As a businessperson, be clear on how being good will affect business models and value*: If you own a business, you are absolutely within your rights to bring your personal views on morality into your business decisions, but you should be at peace with the fact that staying true to your values may, and probably will, cost you money.
3. If you are *making decisions at a publicly traded company or at an investment fund*, as an employee, manager or even CEO, you are investing other people's money and if you choose to make decisions based upon your moral code, you have to be open about what your conscience will cost your shareholders and offer them buy in (or out).
4. *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. Goodness requires sacrifice!
5. *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.

Can ESG be rescued? Should it?

- In its current form, and with its existing advocates, the answer is no.
- If corporate action to advance social good is the end game, here is what has to happen:
  - For the (E) environmental mission, the primary drivers have to be laws and regulations that affect everyone, not just the companies that voluntarily toe the lien.
  - On the (S) social mission, pick your fights selectively, don't be holier-than-thou and be clear about how much it will cost the people who are actually paying for your mission.
  - On the (G) governance, accept that it never really belonged in the concept, and that you threw it in there for the same Orwellian reason that East Germany called itself the German Democratic Republic and Beijing anoints China as the "People's Republic of China".
- If corporate disclosure to allow consumers and investors to make more informed judgments is the end game:
  - <u>Less is more</u>: Drowning people in more disclosure will have perverse consequences.
  - <u>One size does not fit all</u>: Disclosures should be tailored to companies.

And 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.