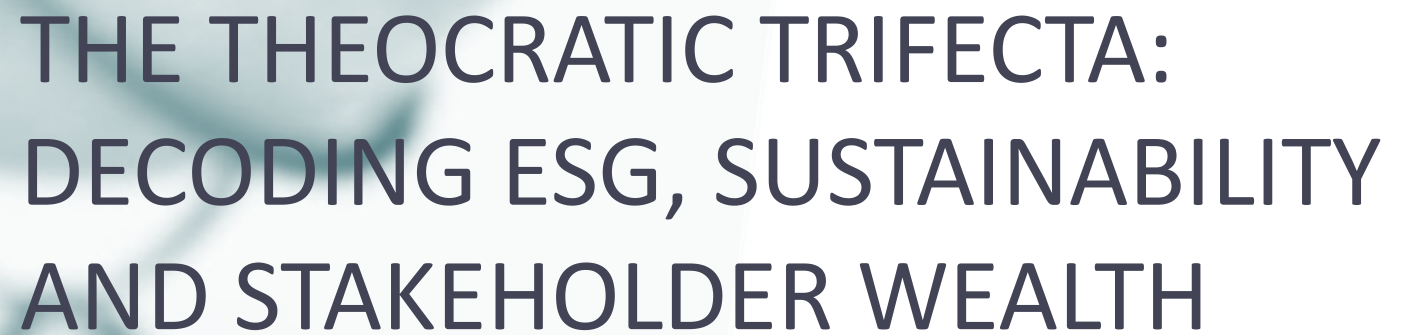


THE THEOCRATIC TRIFECTA: DECODING ESG, SUSTAINABILITY AND STAKEHOLDER WEALTH

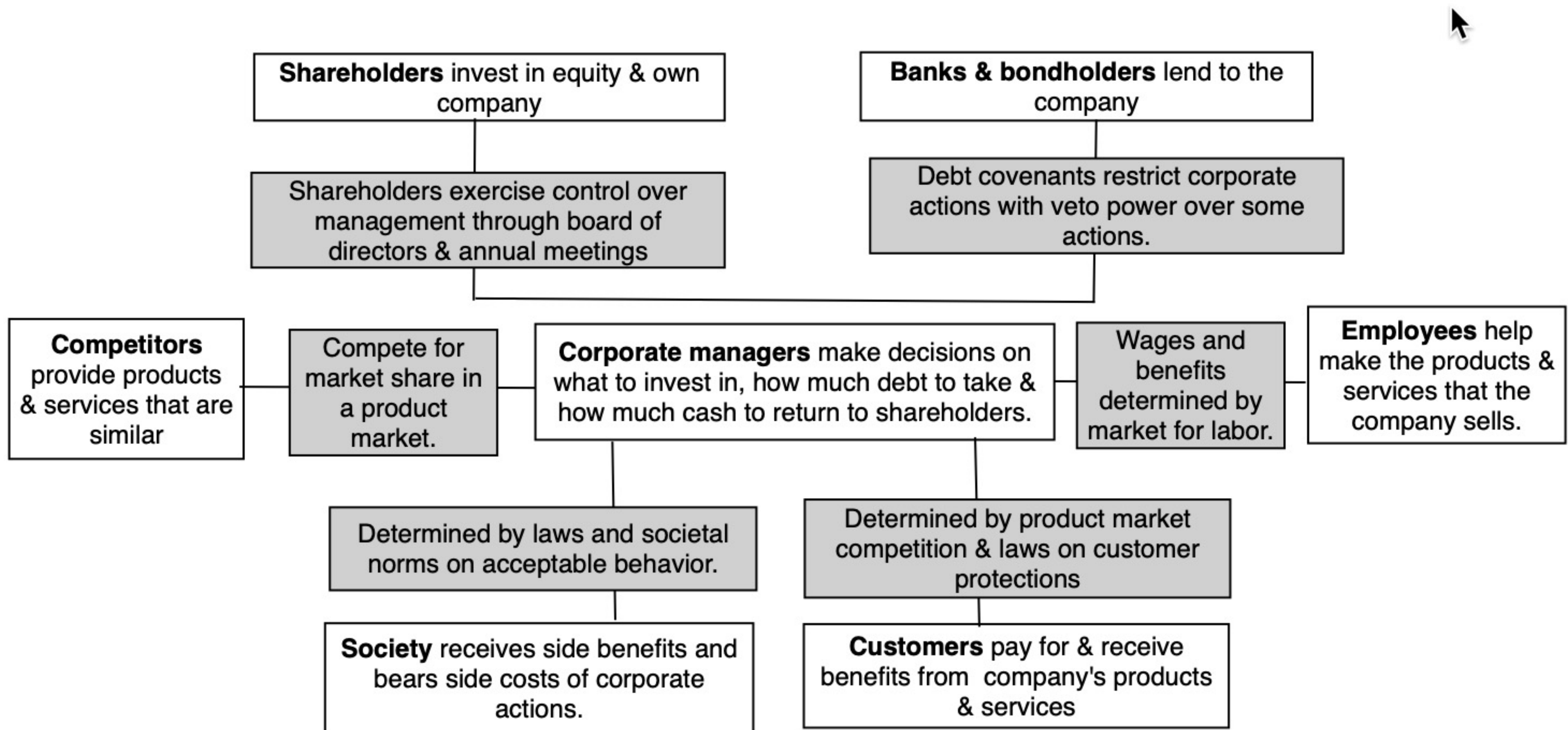
Morality plays in markets!

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

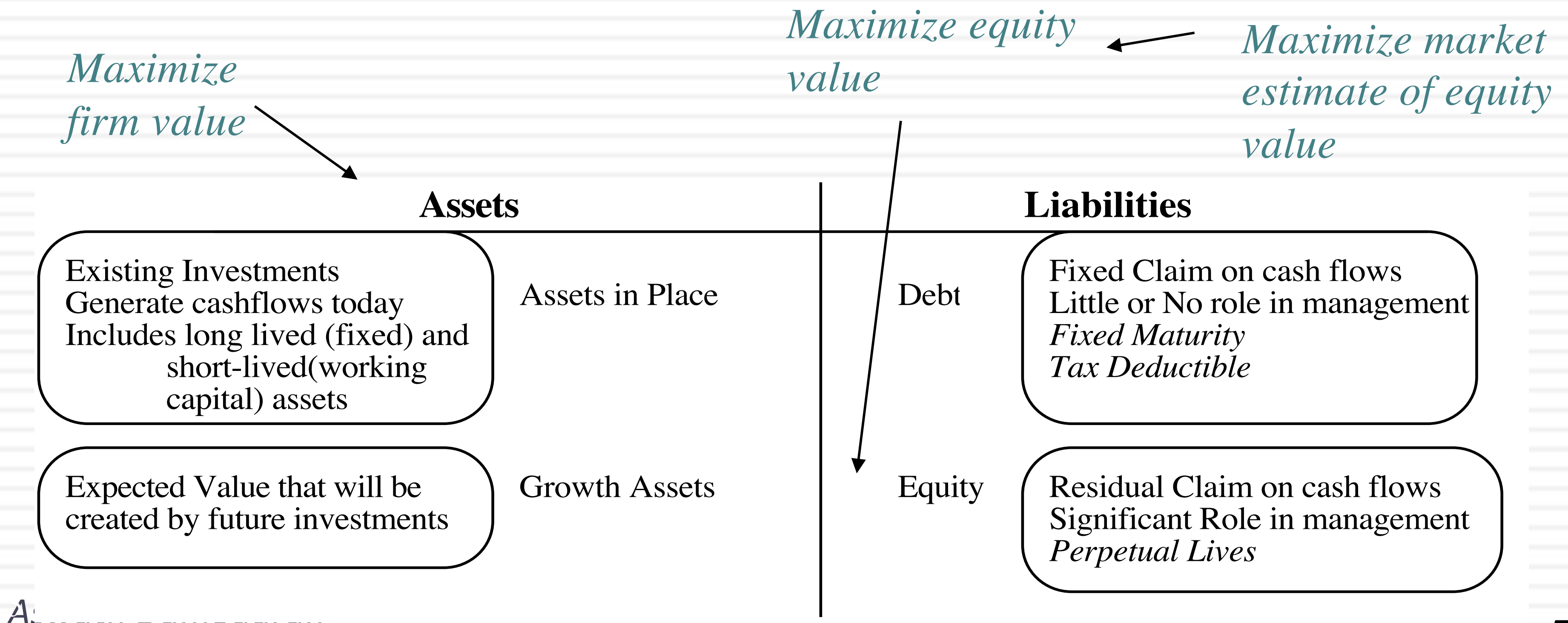
Corporate Finance 101

A business has many stakeholders…

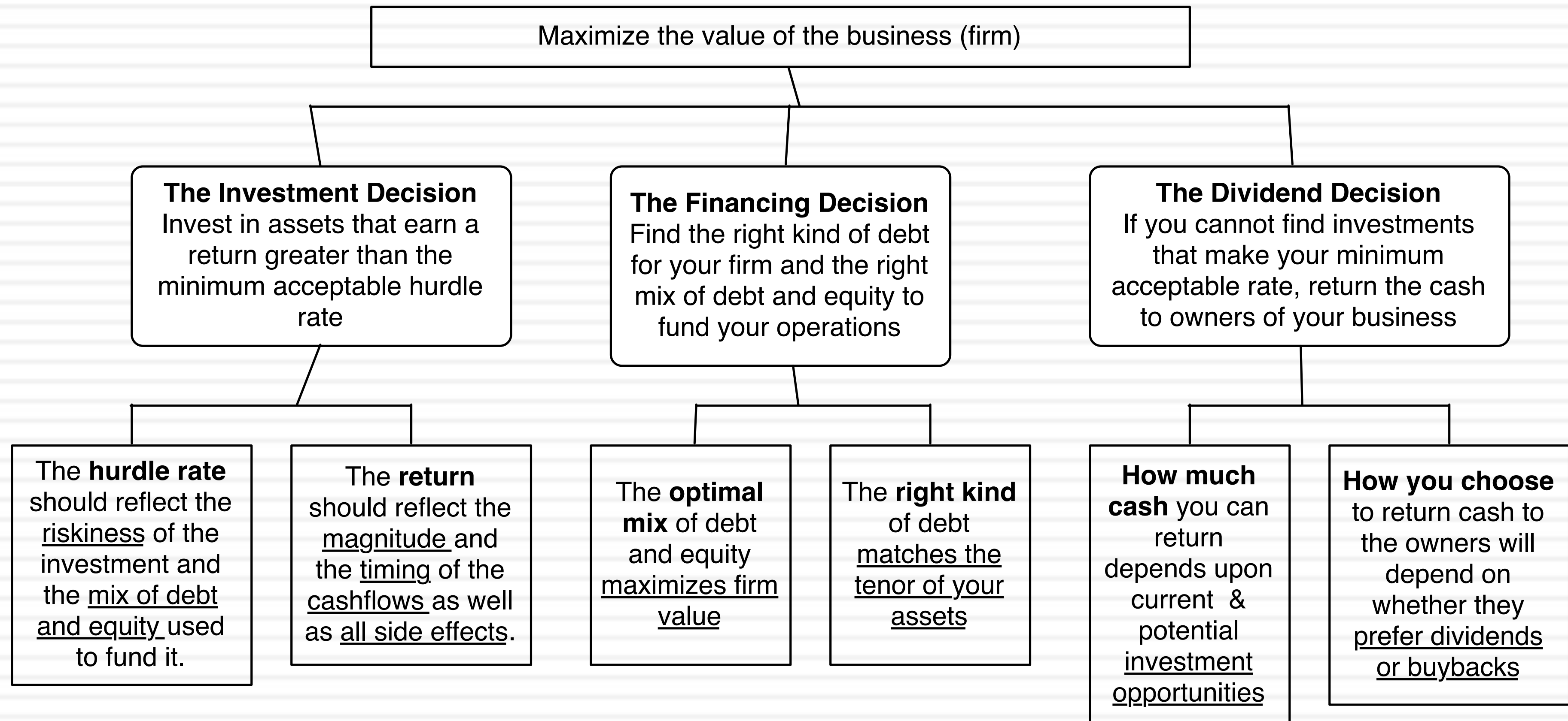


In running a business, one of these stakeholders has to be given primacy…

- 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…



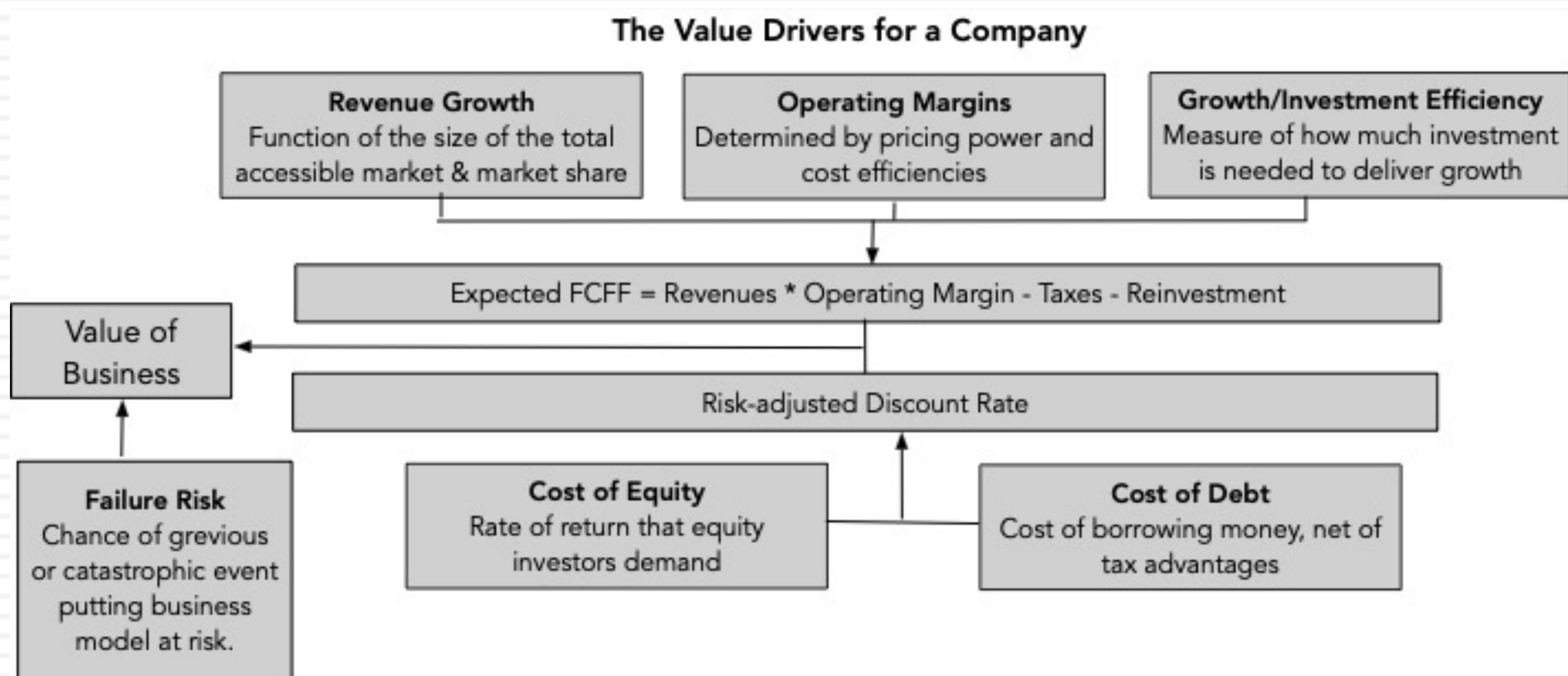
Intrinsic Value 101: Maligned and Misunderstood

- The value of a risky asset can be estimated by discounting the expected cash flows on the asset over its life at a risk-adjusted discount rate:

$$\text{Value of asset} = \frac{E(CF_1)}{(1+r)} + \frac{E(CF_2)}{(1+r)^2} + \frac{E(CF_3)}{(1+r)^3} \ldots\ldots + \frac{E(CF_n)}{(1+r)^n}$$

1. *Value is about cash flows, not earnings:* Though much is made of the games that companies play with earnings, and there are many, value has always been about cash in and cash out, not earnings.
2. *Value is about the long term*: Value comes from looking at cash flows over time. The notion that a company increases value by increasing next year’s cash flows is nonsensical, since if it does so by giving up cashflows in future years, its value will decrease.
3. *Value is risk-adjusted*: While more risky cash flows are valued less than safer cash flows, a business may choose the former, if the payoff in terms of growth offsets risk.
4. *The IT Proposition*: For it (you name it) to affect value, it has to affect either cash flows or risk.

Where is "it"?



Theme 1: Corporate finance is "common sense"

- There is nothing earth shattering about any of the first principles that govern corporate finance.
  - Arguing that taking investments that make 9% with funds that cost 10% to raise seems to be stating the obvious (the investment decision)
  - So is noting that it is better to find a funding mix which costs 10% instead of 11% (the financing decision)
  - And positing that if most of your investment opportunities generate returns less than your cost of funding, it is best to return the cash to the owners of the business and shrink the business.
- Shrewd business people, notwithstanding their lack of exposure to corporate finance theory, have always recognized these fundamentals and put them into practice.

Theme 2: Corporate finance is focused…

- It is the focus on maximizing the value of the business that gives corporate finance its focus. As a result of this singular objective, we can
  - Choose the "right" investment decision rule to use, given a menu of such rules.
  - Determine the "right" mix of debt and equity for a specific business
  - Examine the "right" amount of cash that should be returned to the owners of a business and the "right" amount to hold back as a cash balance.
- This certitude does come at a cost. To the extent that you accept the objective of maximizing firm value, everything in corporate finance makes complete sense. If you do not, nothing will.

Theme 3: Corporate finance is universal…

- Every business, small or large, public or private, US or emerging market, has to make investment, financing and dividend decisions.
- The objective in corporate finance for all of these businesses remains the same: maximizing value.
- While the constraints and challenges that firms face can vary dramatically across firms, the first principles do not change.
  - A publicly traded firm, with its greater access to capital markets and more diversified investor base, may have much lower costs of debt and equity than a private business, but they both should look for the financing mix that minimizes their costs of capital.
  - A firm in an emerging market may face greater uncertainty, when assessing new investments, than a firm in a developed market, but both firms should invest only if they believe they can generate higher returns on their investments than they face as their respective (and very different) hurdle rates.

Theme 4: If you violate first principles, you will pay a price, no matter who you are..

- There are some investors/analysts/managers who convince themselves that the first principles don't apply to them because of their superior education, standing or past successes, and then proceed to put into place strategies or schemes that violate first principles.
  - Sooner or later, these strategies will blow up and create huge costs.
  - Almost every corporate disaster or bubble has its origins in a violation of first principles.

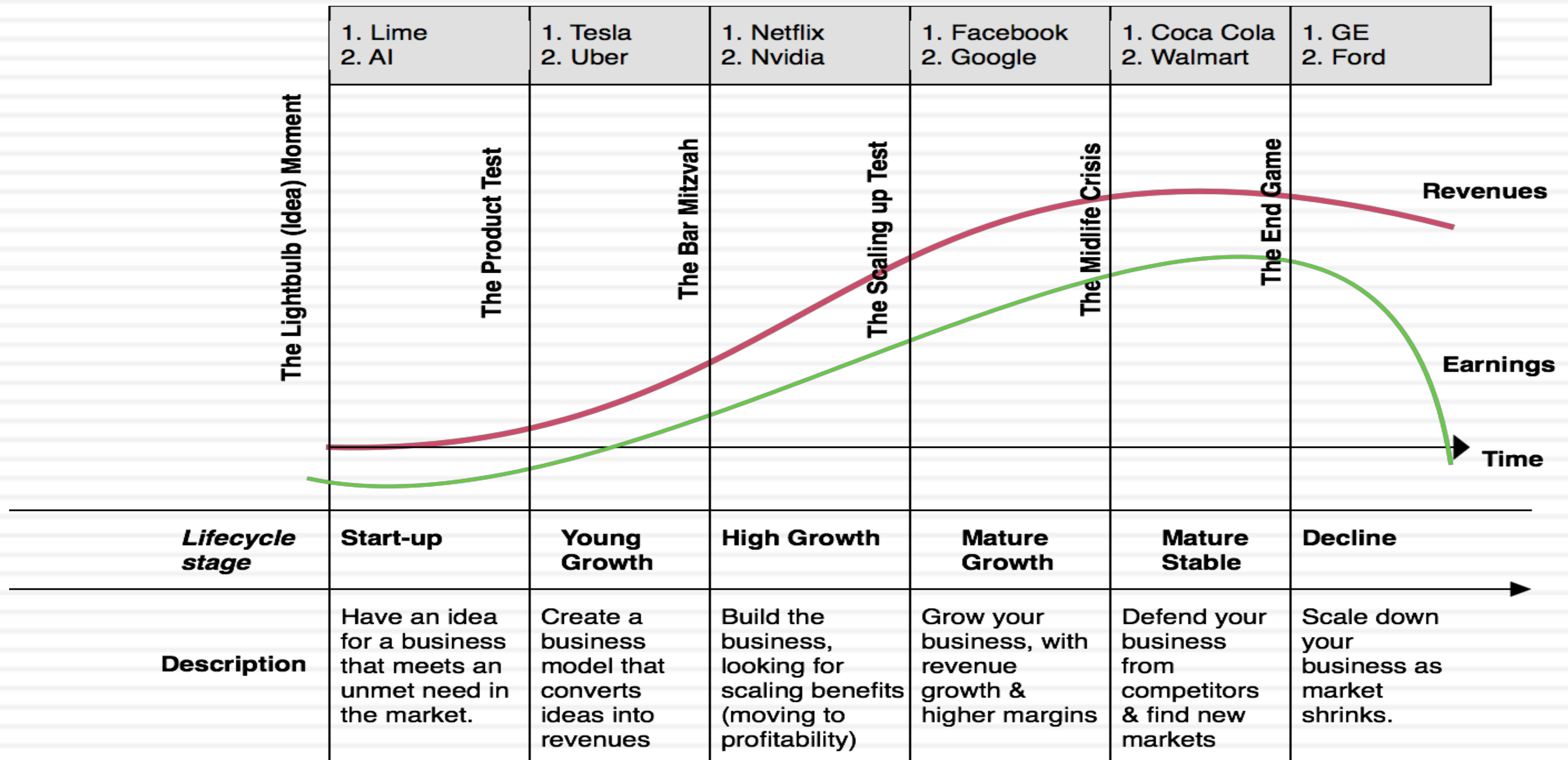
The Pushback..

- 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**.

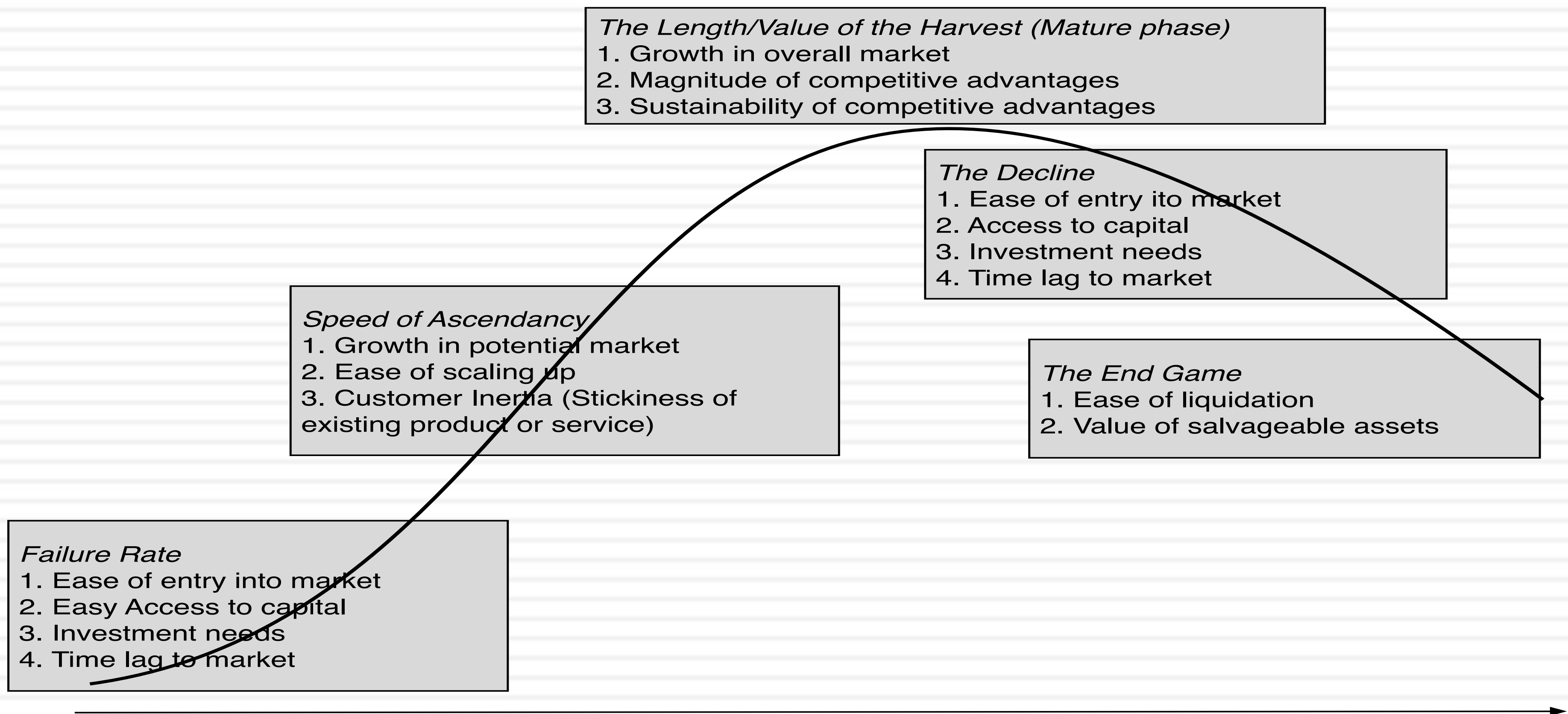
The Myth of Sustainability

Nothing lasts (or should last) forever!

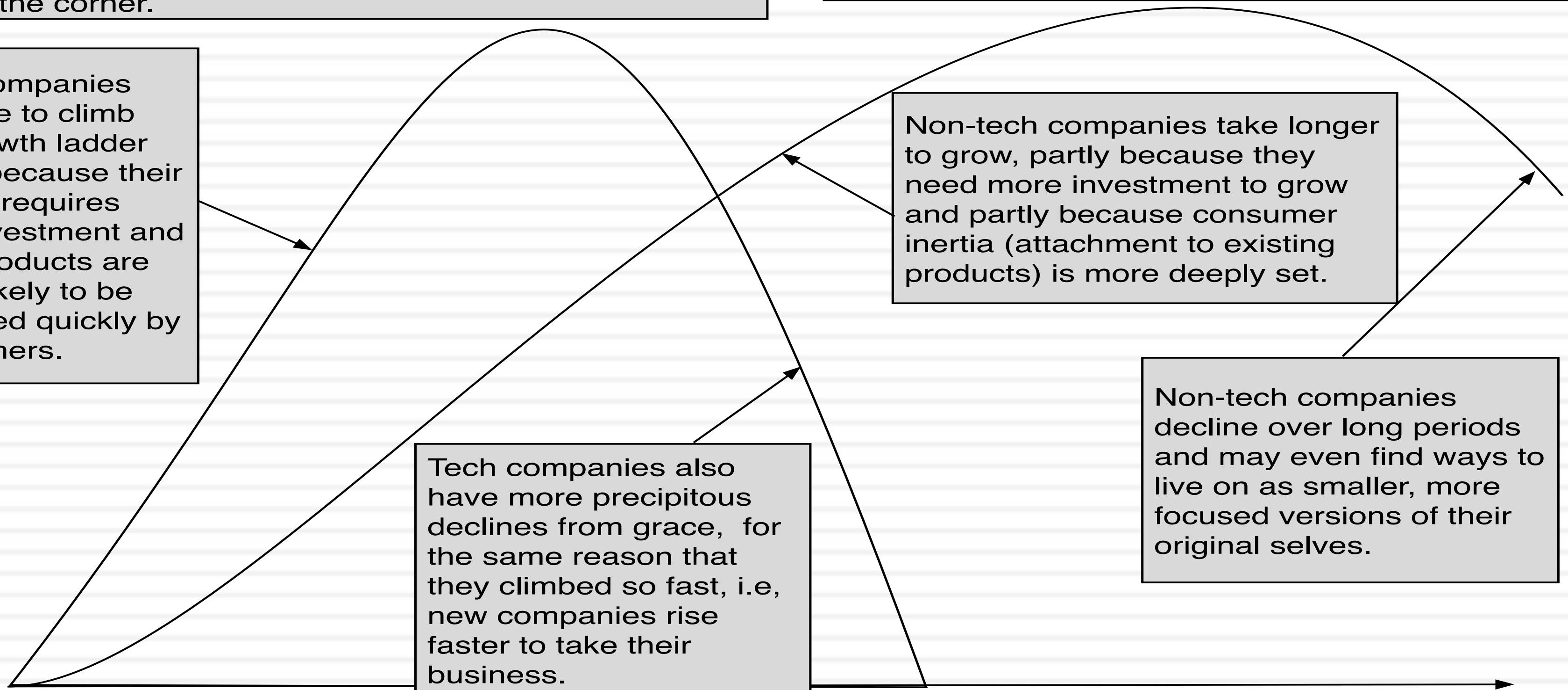
The Corporate Life Cycle



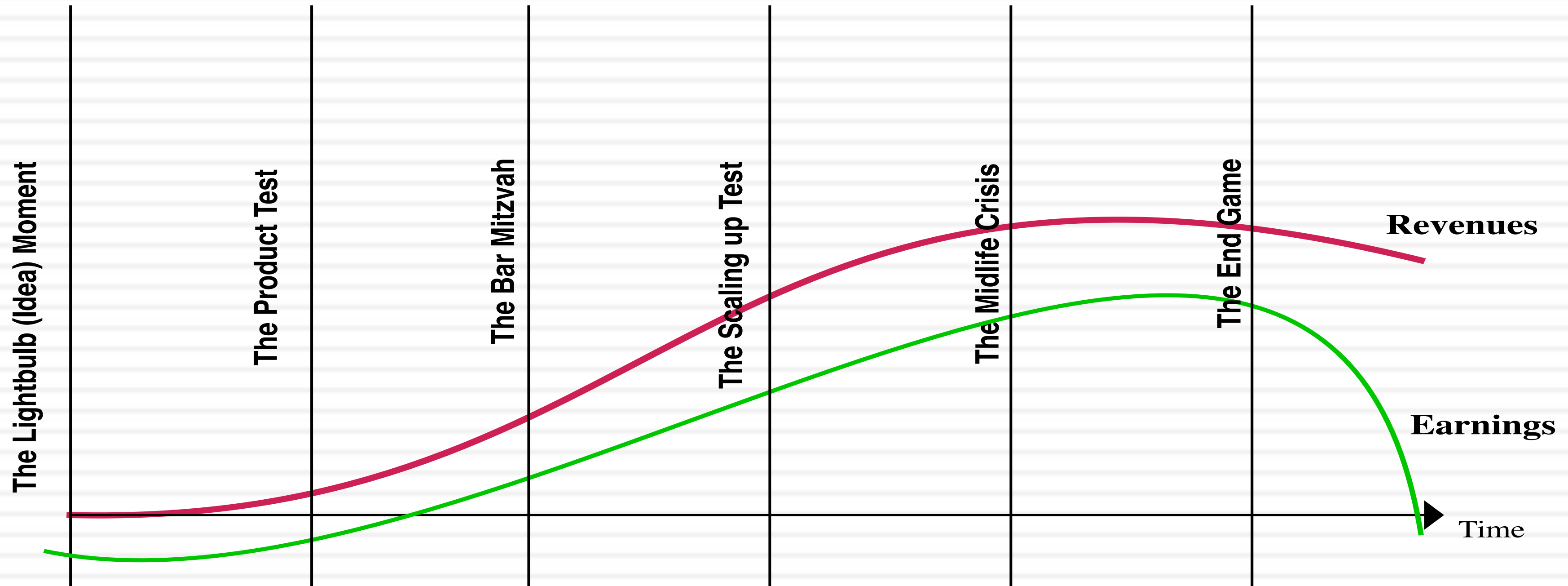
The determinants of the life cycle



Tech versus Non-tech life cycles

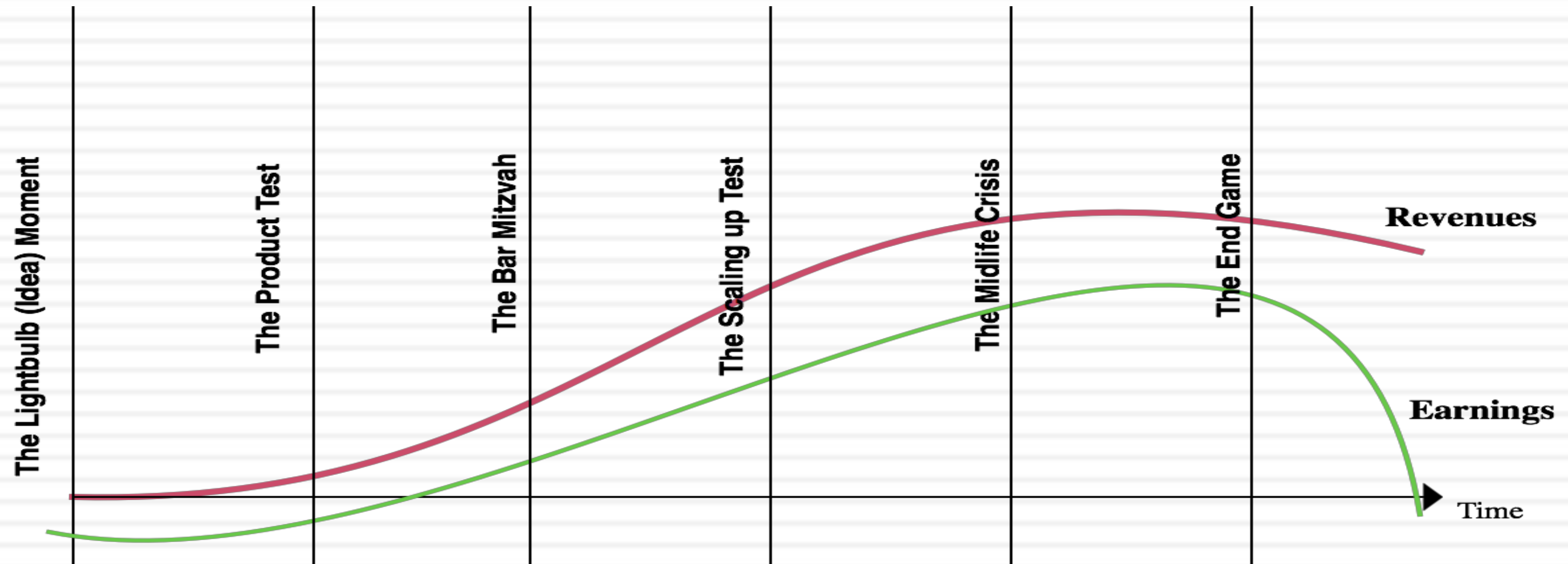


The emphasis in corporate finance shifts..



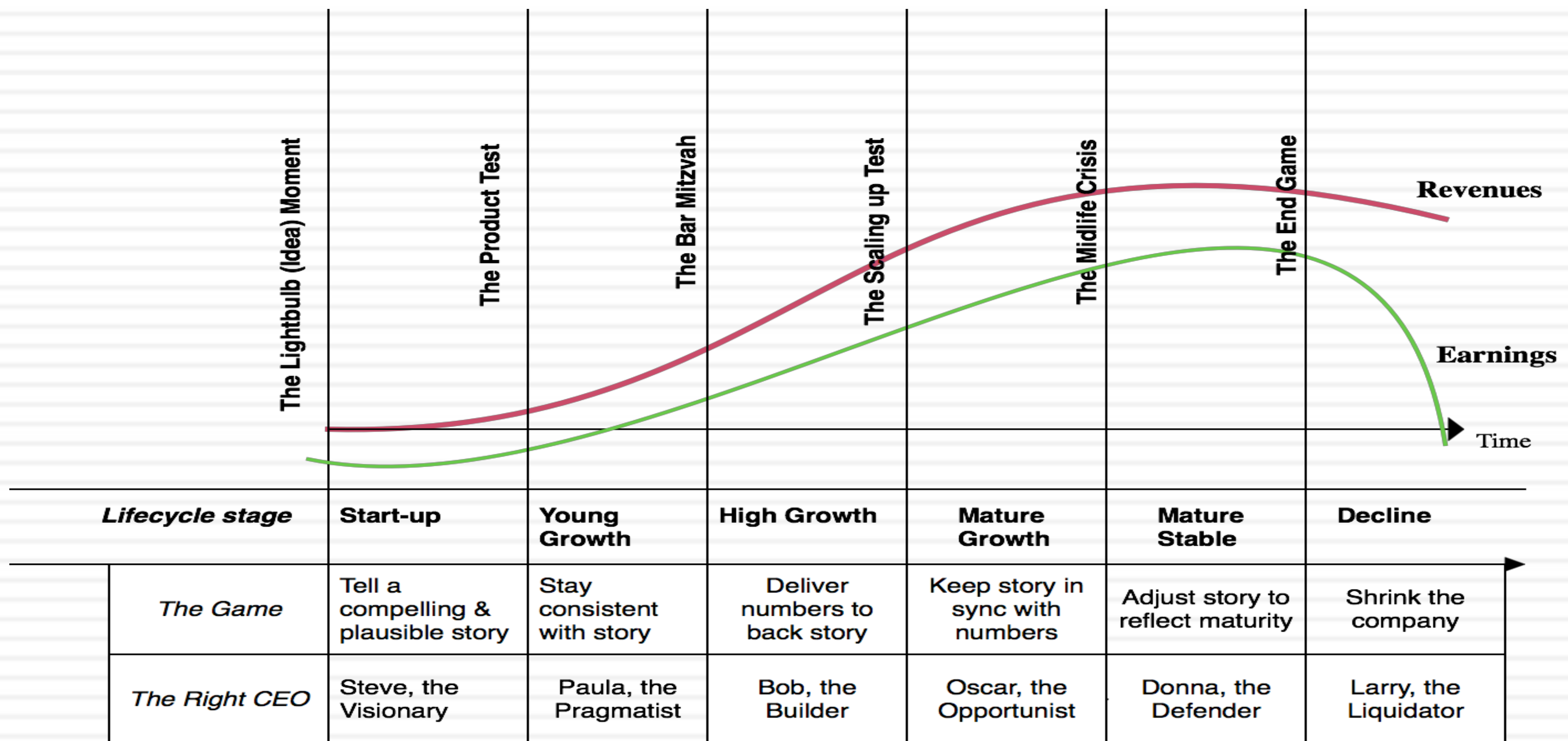
Lifecycle stage	**Start-up**	**Young Growth**	**High Growth**	**Mature Growth**	**Mature Stable**	**Decline**
Investing Policy	New product development	Market testing and build up	Scale up production	Augment capacity + New Products	Maintain capacity + Acquisitions	Reduce capacity
Financing Policy	Equity 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 destroy value not only for their owners, but will drain overall economies.

The Dream of Reincarnation.. And its 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.

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.

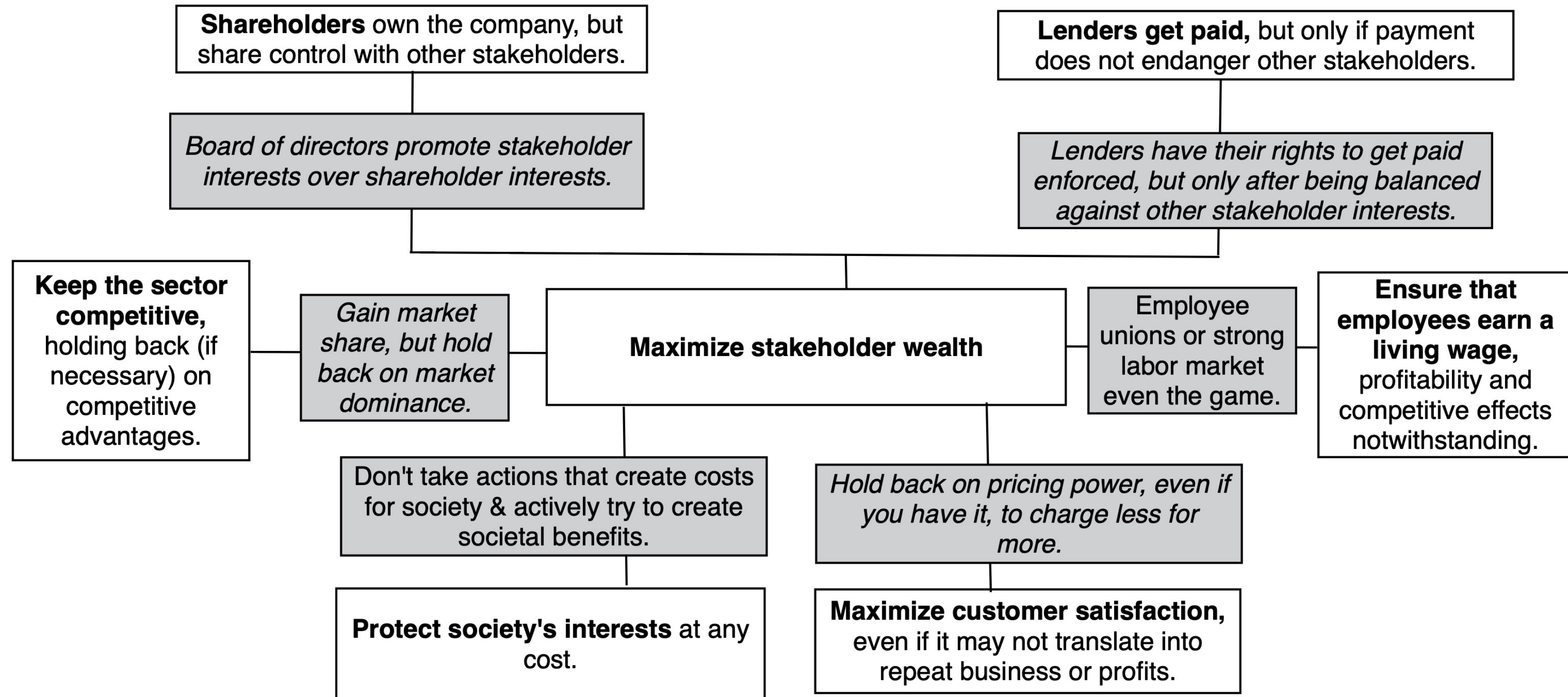
The Business Roundtable's Message..

- *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 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.

Goodness requires sacrifice!

Why now?

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

Measuring ESG: Challenges

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

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What is “goodness”?

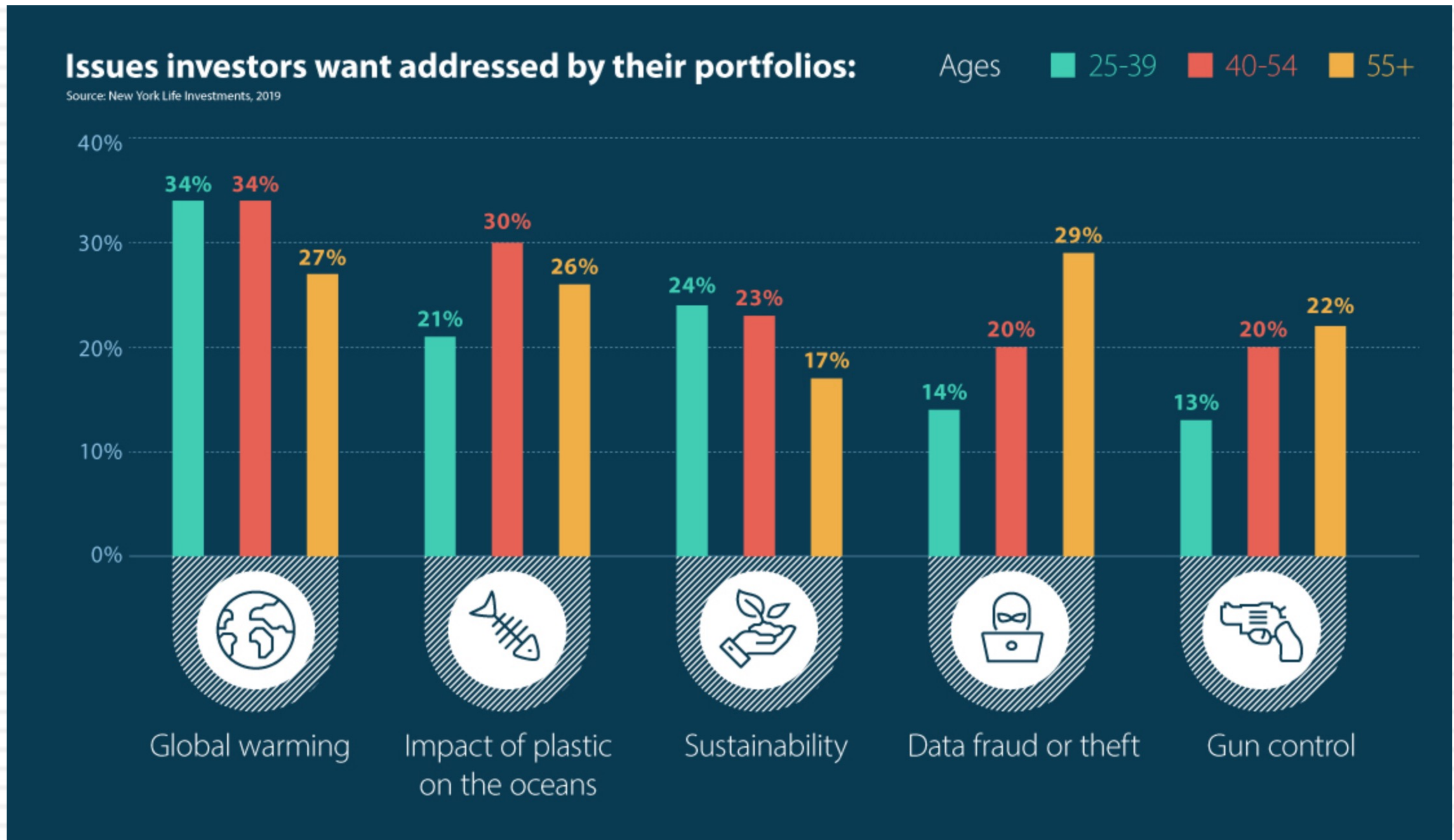
- As an investor, rank the following companies from best to worst purely on goodness:

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

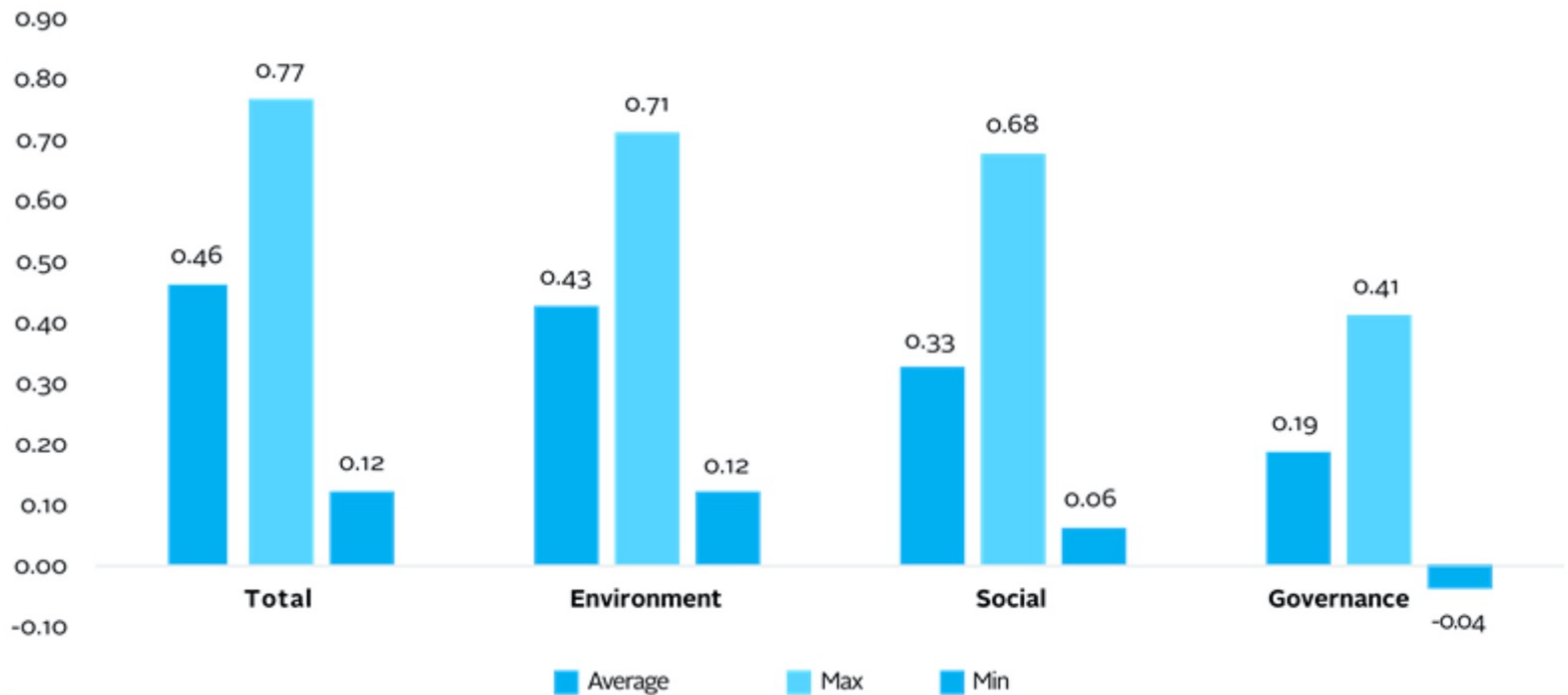
What ESG Services think…

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

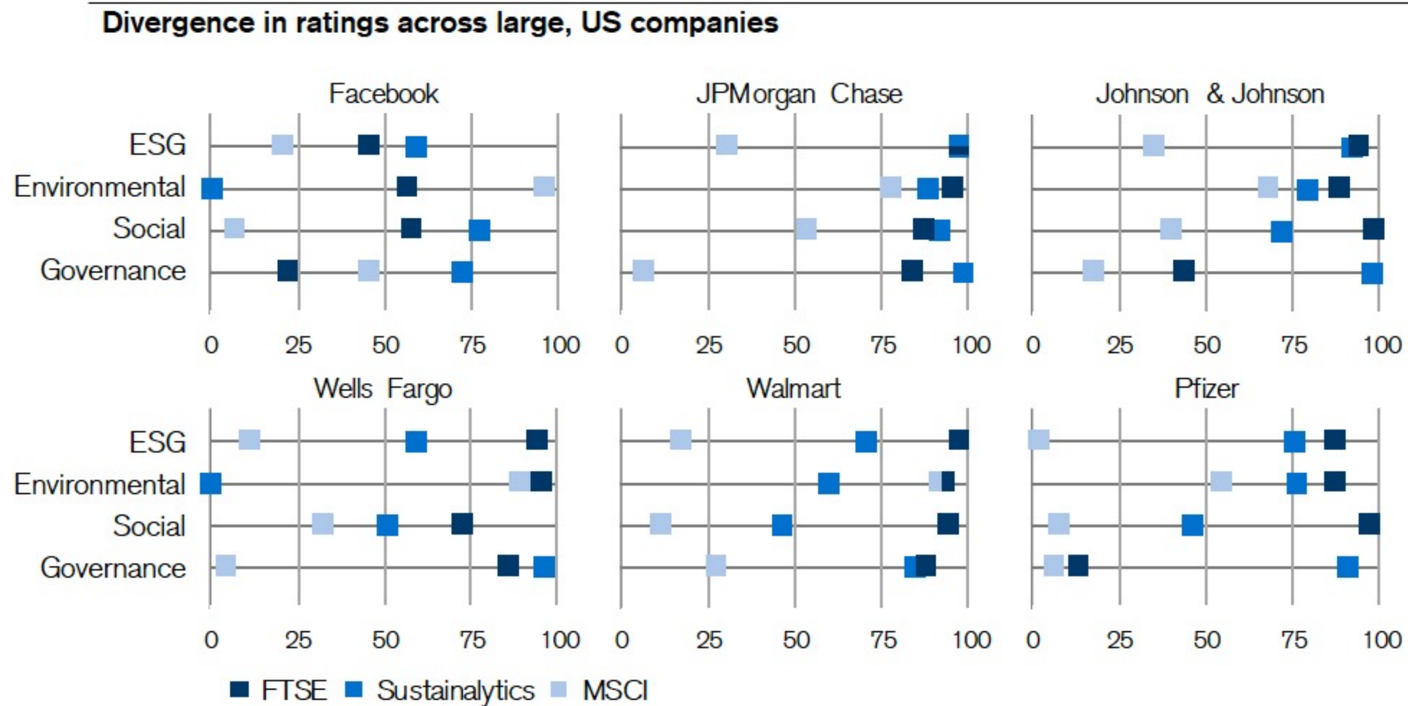


ESG Services disagree…



Average, minimum, and maximum correlations across providers

Even on high profile companies…

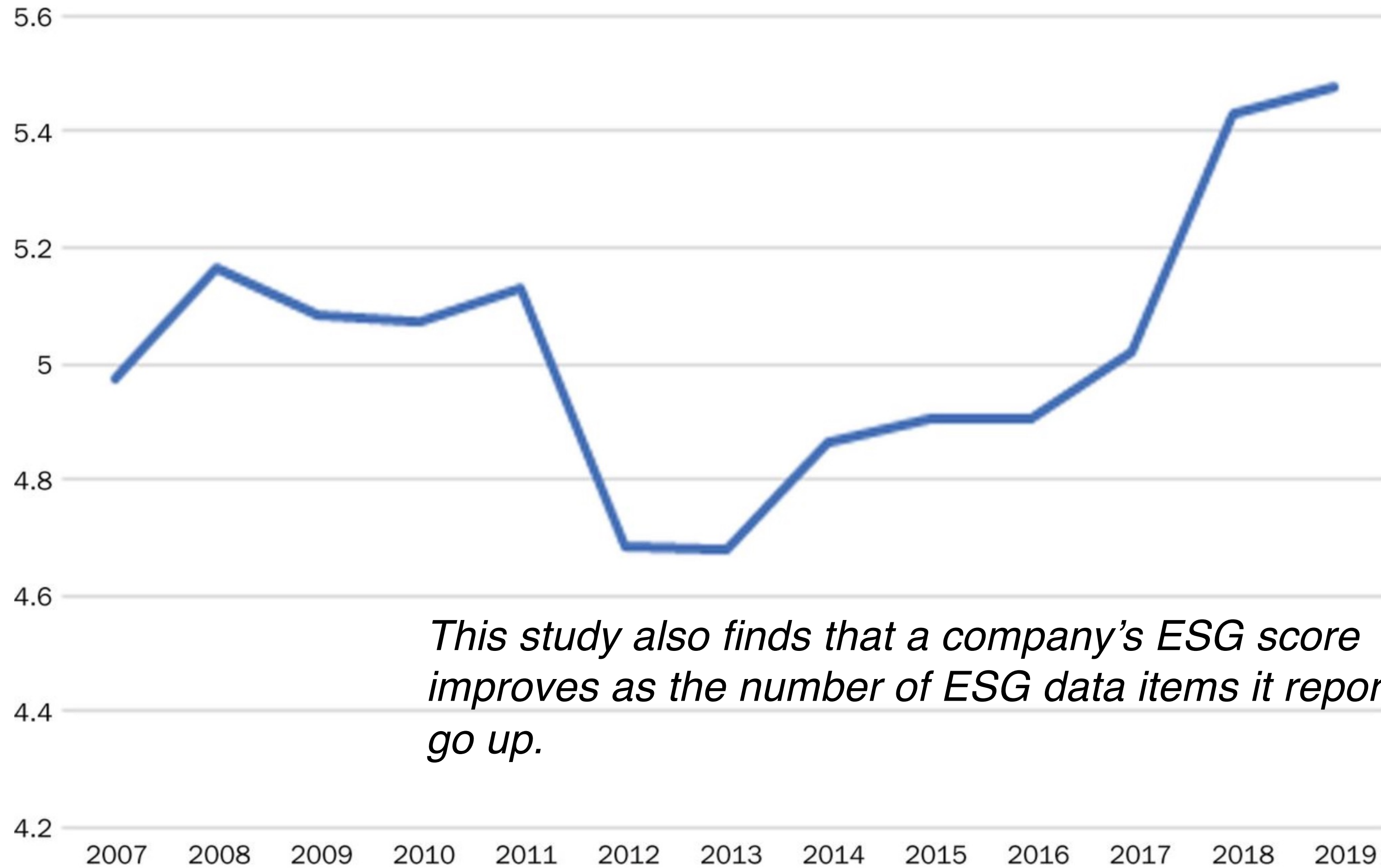


As ESG disclosures increase..

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

Source: Chen et al, JPM

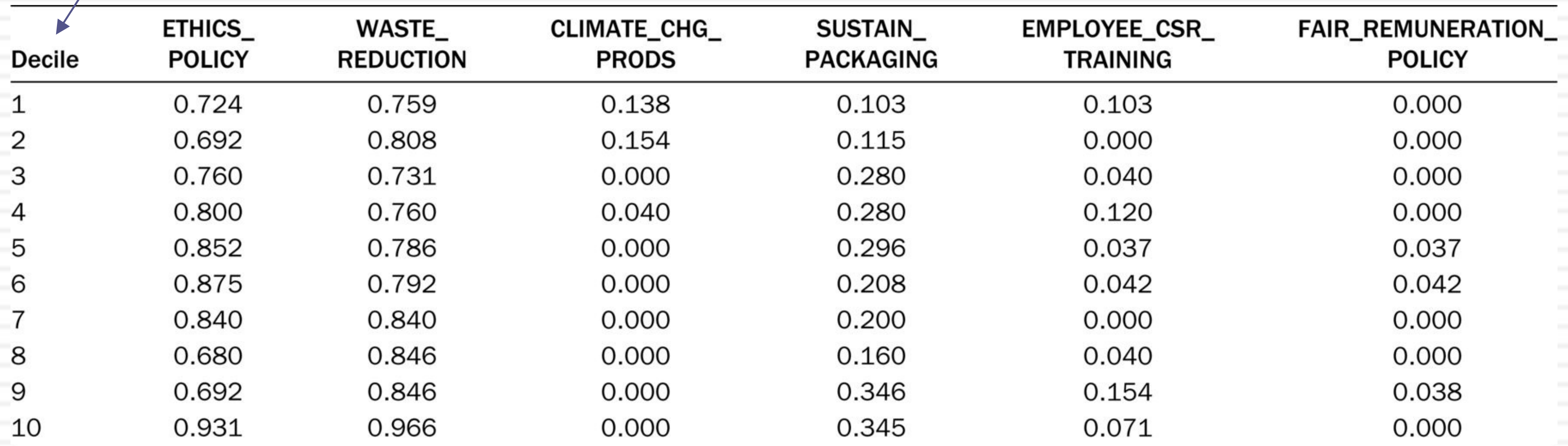
ESG scores are improving across the board…



Source: Chen et al, JPM

But what are these ESG scores measuring?

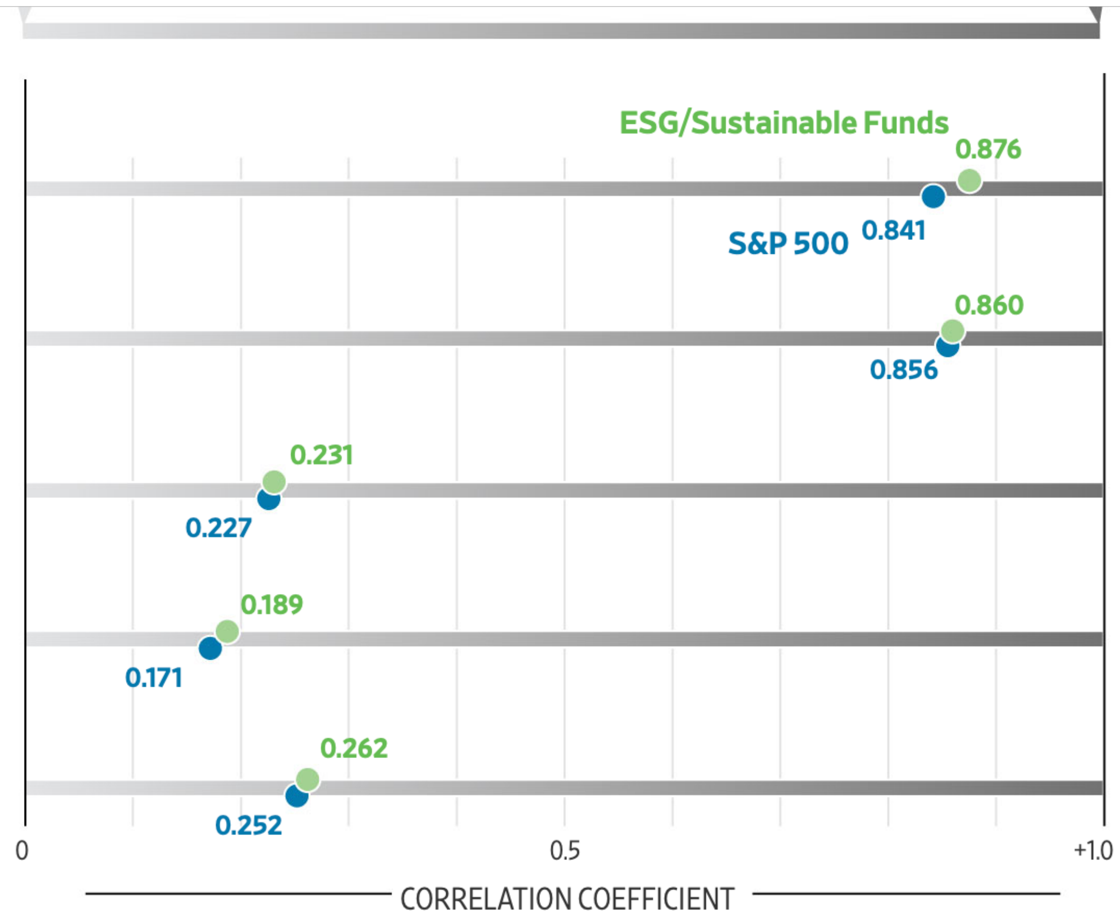
Based upon MSCI ESG score, lowest to highest



Decile	ETHICS_ POLICY	WASTE_ REDUCTION	CLIMATE_CHG_ PRODS	SUSTAIN_ PACKAGING	EMPLOYEE_CSR_ TRAINING	FAIR_REMUNERATION_ POLICY
1	0.724	0.759	0.138	0.103	0.103	0.000
2	0.692	0.808	0.154	0.115	0.000	0.000
3	0.760	0.731	0.000	0.280	0.040	0.000
4	0.800	0.760	0.040	0.280	0.120	0.000
5	0.852	0.786	0.000	0.296	0.037	0.037
6	0.875	0.792	0.000	0.208	0.042	0.042
7	0.840	0.840	0.000	0.200	0.000	0.000
8	0.680	0.846	0.000	0.160	0.040	0.000
9	0.692	0.846	0.000	0.346	0.154	0.038
10	0.931	0.966	0.000	0.345	0.071	0.000

Source: Chen et al, JPM

If your answer is risk… look again



And the differences will persist…

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

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

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

The ESG Questions

The Big Questions on ESG

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

- Increase value by improving profitability and/or reducing risk.
- Reduce value by increasing costs and/or increasing risk.

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

How does the market price the consequences of ESG?

- Price overadjusts to value change.
- Price correctly reflects value change
- Price underadjusts to value change.

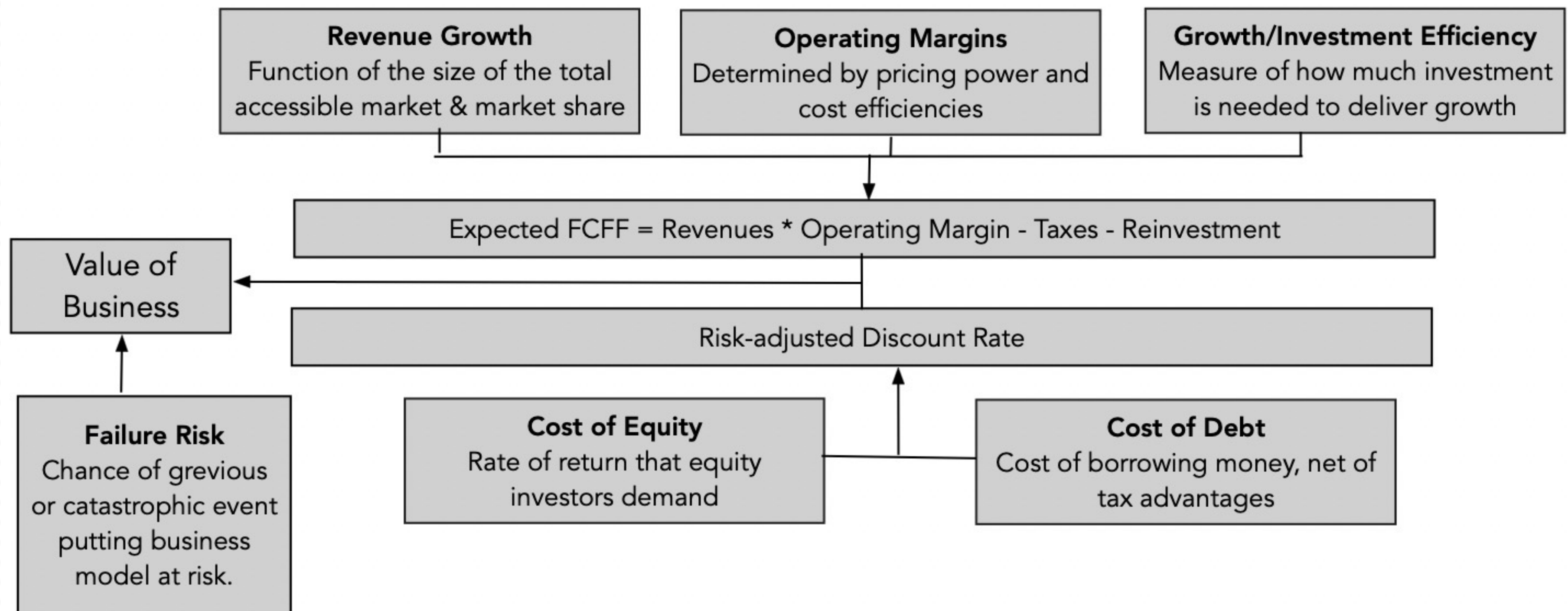
Research on the links between a company's ESG and how its stock is priced (PE, PBV, Tobin's Q or EV multiple)

Do investors make excess returns on ESG stocks

- Investors make positive excess returns
- Investors make "fair rate" of returns
- Investors make positive excess returns

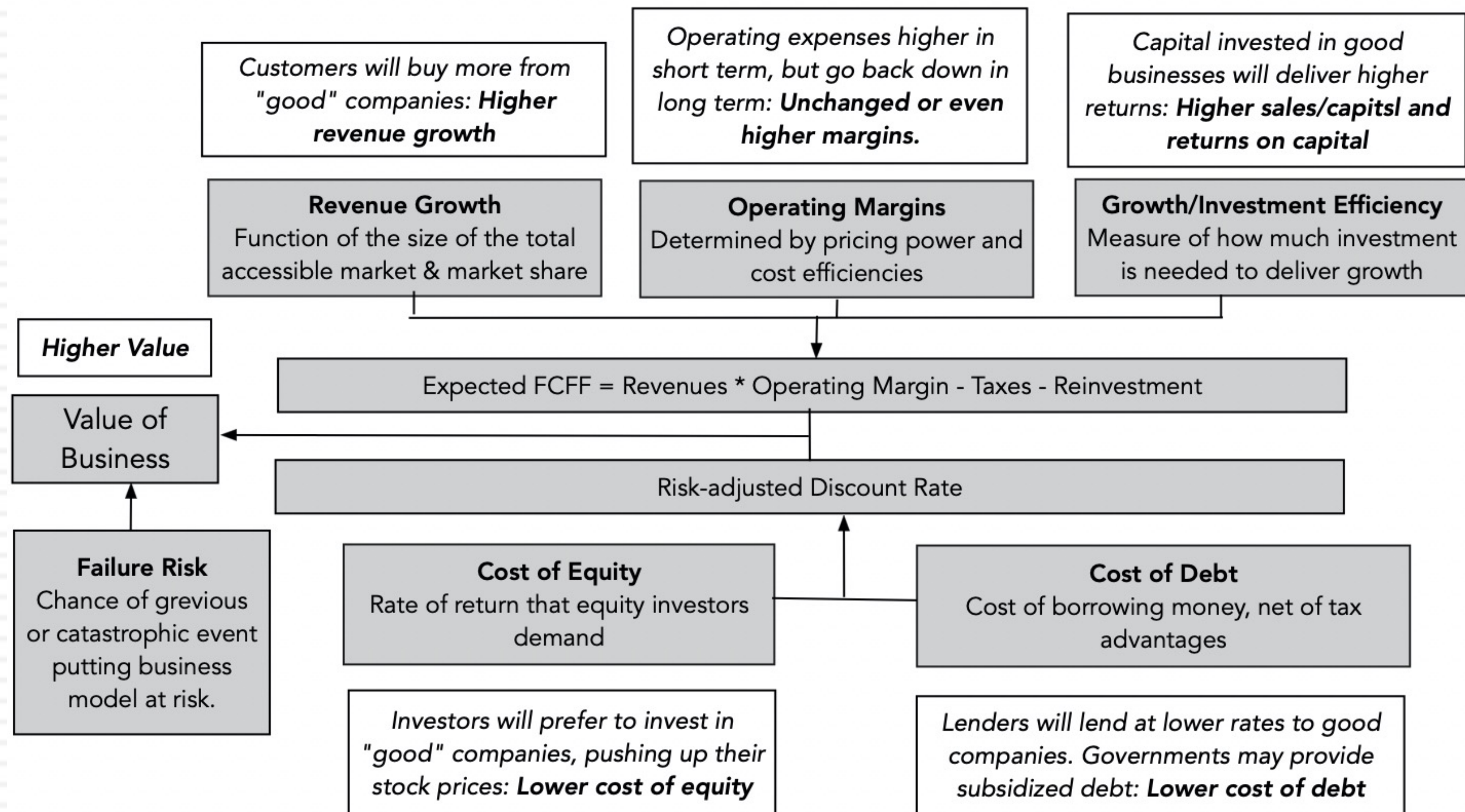
Research on whether stocks that score high on ESG or funds with an ESG focus deliver higher or lower returns than expectd, given risk.

I. 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.*

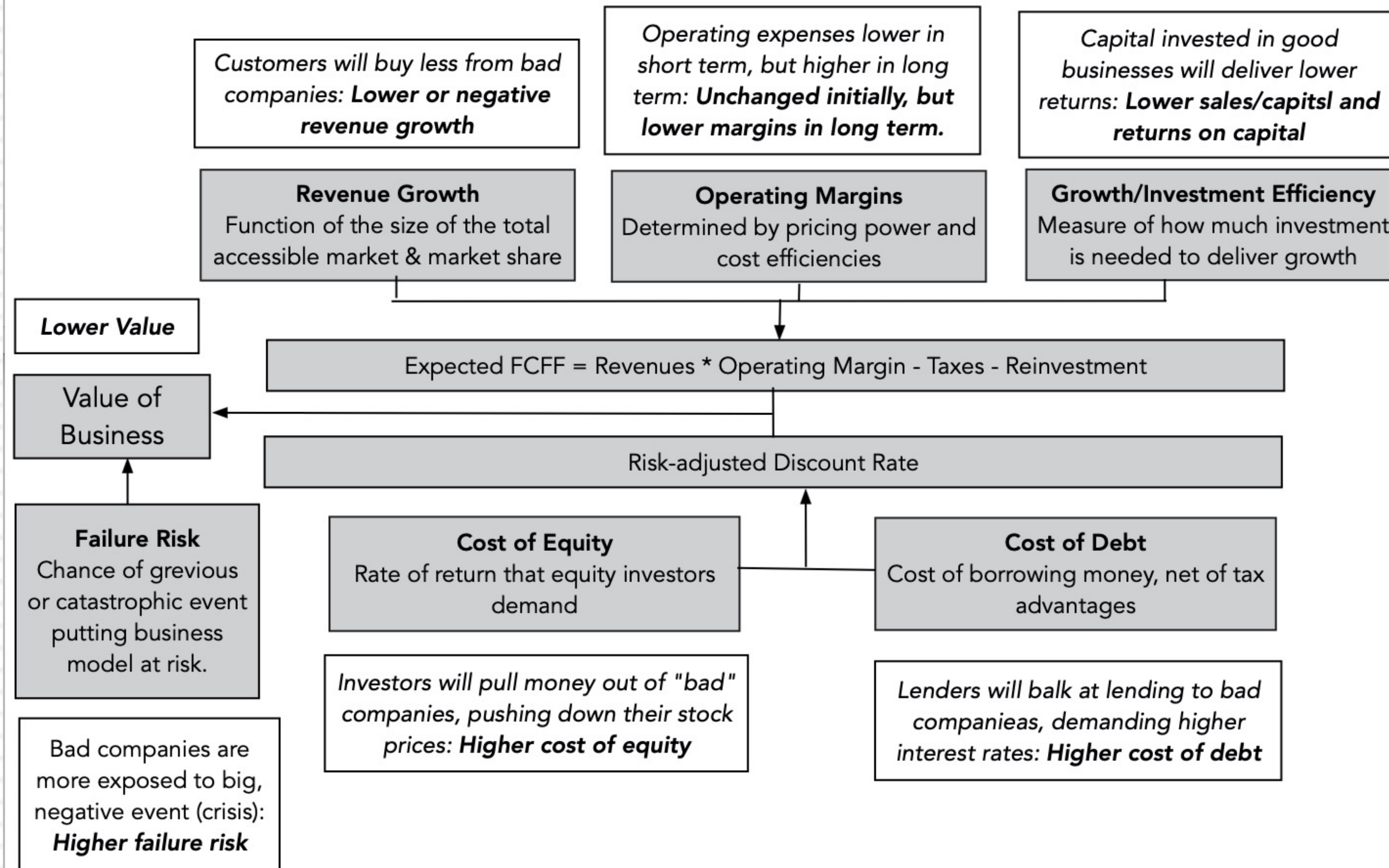
The Promise of Heaven : The Good shall be rewarded



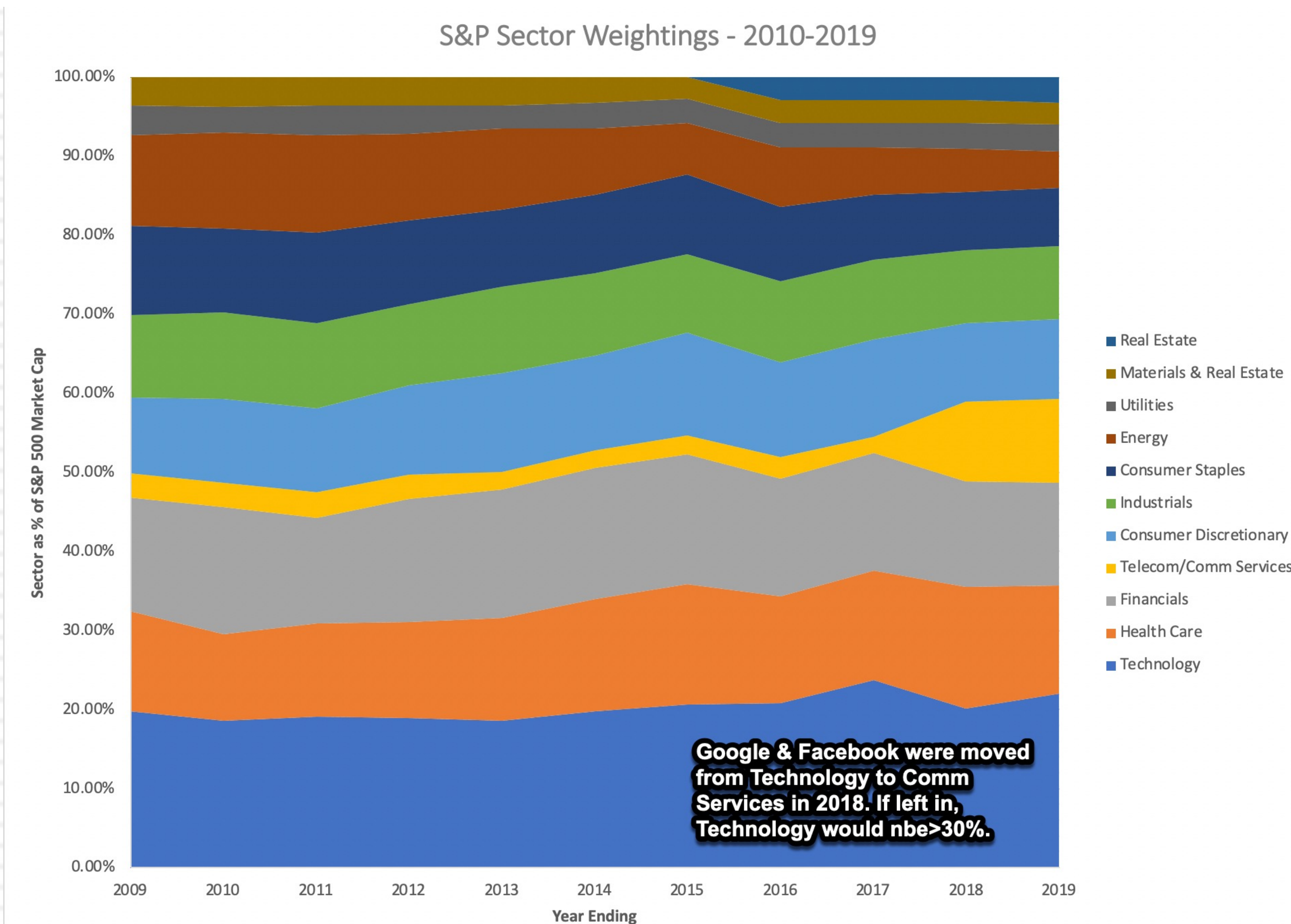
Examples and Counters: Patagonia and Etsy

- 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
  - 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.

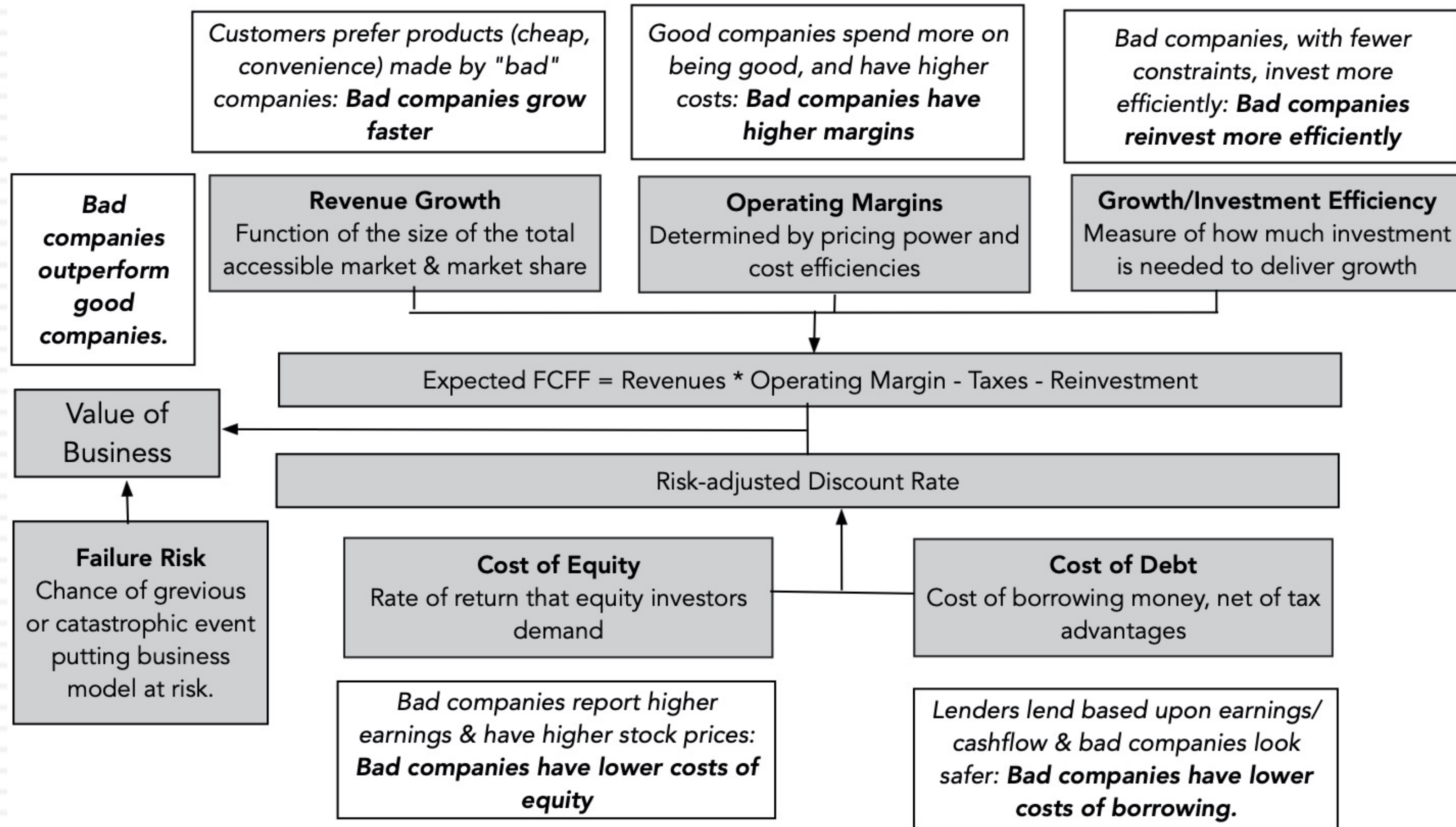
The Warning of Hell: The Bad shall be punished



ESG's biggest success? Fossil Fuel..



The Bad Guys win: Hell on Earth?



ESG and Growth

- There have been very few studies that have looked at the link between ESG and growth. If there is any evidence of a link, it is that it becomes more difficult to wear the goodness cloak, as companies get bigger.
- One simple comparison is between two companies, Patagonia, outspoken about its "purity of purpose" and Nike, accused of being more mushy in its ESG practices.
  - Patagonia has revenues of less than a billion a year, and a focused market (of wealthy millennials).
  - Nike has revenues in excess of $40 billion and has to market its goods to a much wider audience.

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?

And what's with the meta studies?

- ESG backers constantly point to meta studies, which are really an aggregation of studies done on a topic over time.
- While there is a "law of large numbers" reasoning that can be used to back up this practice, it is not a good one for many reasons:
  - Averaging studies that are done at different time periods, with different metrics yield averaging mush.
  - Averaging many studies averages out mistakes, but it does not eliminate bias.
- The cynical way of looking at meta studies is that they point to the absence of studies that can be trusted to stand on their own, either because their findings are specific to the sample that they are studying or the timing of the study (or worse)?

ESG and Employee Satisfaction…

Ford Motor Company

67 | 4.1 ★★★★☆

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BUILD THE FUTURE

Tesla

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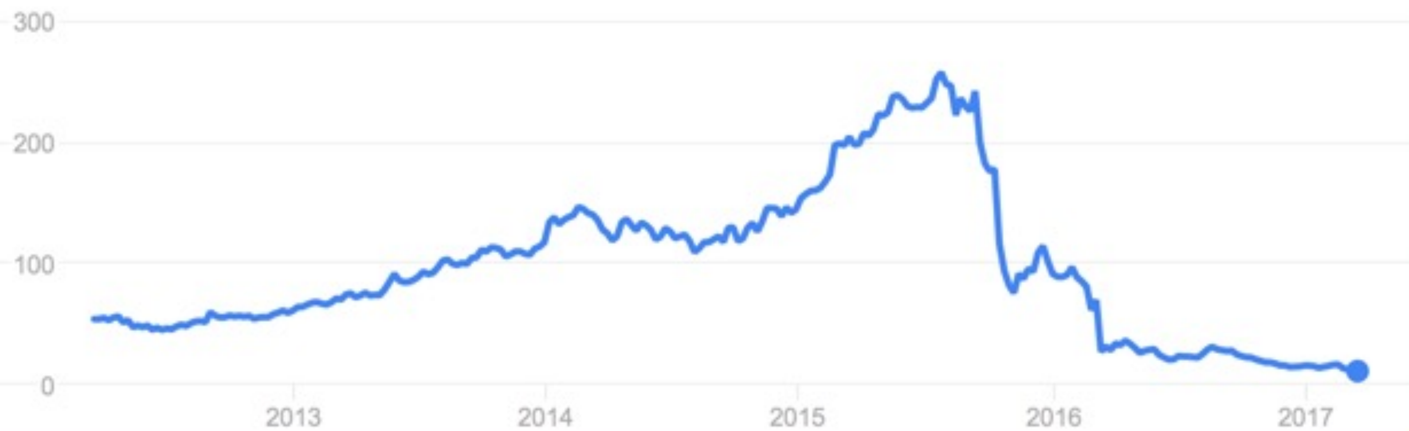
ESG and Funding Costs

- 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.

Valeant: A Cautionary Tale



Valeant

The Story

Valeant is a tainted company in a business where that taint can be a hindrance in operations, reducing pricing power (because of its past history in pricing) in the near term (leading to negative revenue growth & depressed margins). Transitioning from its past status as an acquisitive company to a more conventional mature drug company, with R&D driving a low growth rate, is feasible but will take time and perserverence. Changes in the US tax code will also push up effective tax rates for teh company.

The Assumptions

	Base year	*Years 1-5*	*Years 6-10*		*After year 10*	*Link to story*
Revenues (a)	$ 9,674	-2.00%	→ 3.00%		Terminal year	Declining sales as pricing power muted
Operating margin (b)	35.03%	35.03%	→ 40.69%		40.69%	Margins will stay low for same reason.
Tax rate	20.00%	20.00%	→ 30.00%		30.00%	Tax rate rises as US tax code changes
Reinvestment (c)		Sales to capital ratio =	0.70	RIR =	28.99%	Shift from high growth acquisitions to low growth R&D
Return on capital	7.99%	Marginal ROIC =	111.23%		6.90%	Earn cost of capital in steady state
Cost of capital (d)		9.00%	→ 6.90%		6.90%	High risk from debt in near term

The Cash Flows

	Revenues	*Operating Margin*	*EBIT*	*EBIT (1-t)*	*Reinvestment*	*FCFF*
1	$ 9,481	35.03%	$ 3,321	$ 2,657	$ (276)	$ 2,933
2	$ 9,291	35.03%	$ 3,255	$ 2,604	$ (271)	$ 2,875
3	$ 9,105	35.03%	$ 3,190	$ 2,552	$ (265)	$ 2,817
4	$ 8,923	35.84%	$ 3,198	$ 2,559	$ (260)	$ 2,819
5	$ 8,745	36.65%	$ 3,205	$ 2,564	$ (255)	$ 2,819
6	$ 9,007	37.46%	$ 3,374	$ 2,632	$ 375	$ 2,257
7	$ 9,277	38.27%	$ 3,550	$ 2,698	$ 386	$ 2,312
8	$ 9,555	39.08%	$ 3,734	$ 2,763	$ 398	$ 2,366
9	$ 9,842	39.89%	$ 3,926	$ 2,826	$ 410	$ 2,417
10	$ 10,137	40.69%	$ 4,125	$ 2,888	$ 422	$ 2,466
Terminal year	$ 10,340	40.69%	$ 4,208	$ 2,945	$ 854	$ 2,092

The Value

Terminal value	$ 42,688		
PV(Terminal value)	$ 19,113		
PV (CF over next 10 years)	$ 17,222		
Value of operating assets =	$ 36,335		
Adjustment for distress	$ 1,817	Probability of failure =	10.00%
- Debt & Mnority Interests	$ 30,301		
+ Cash & Other Non-operating assets	$ 543		
Value of equity	$ 4,759		
- Value of equity options	$ -		
Number of shares	347.80		
Value per share	$ 13.68	Stock was trading at =	$12.00

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).

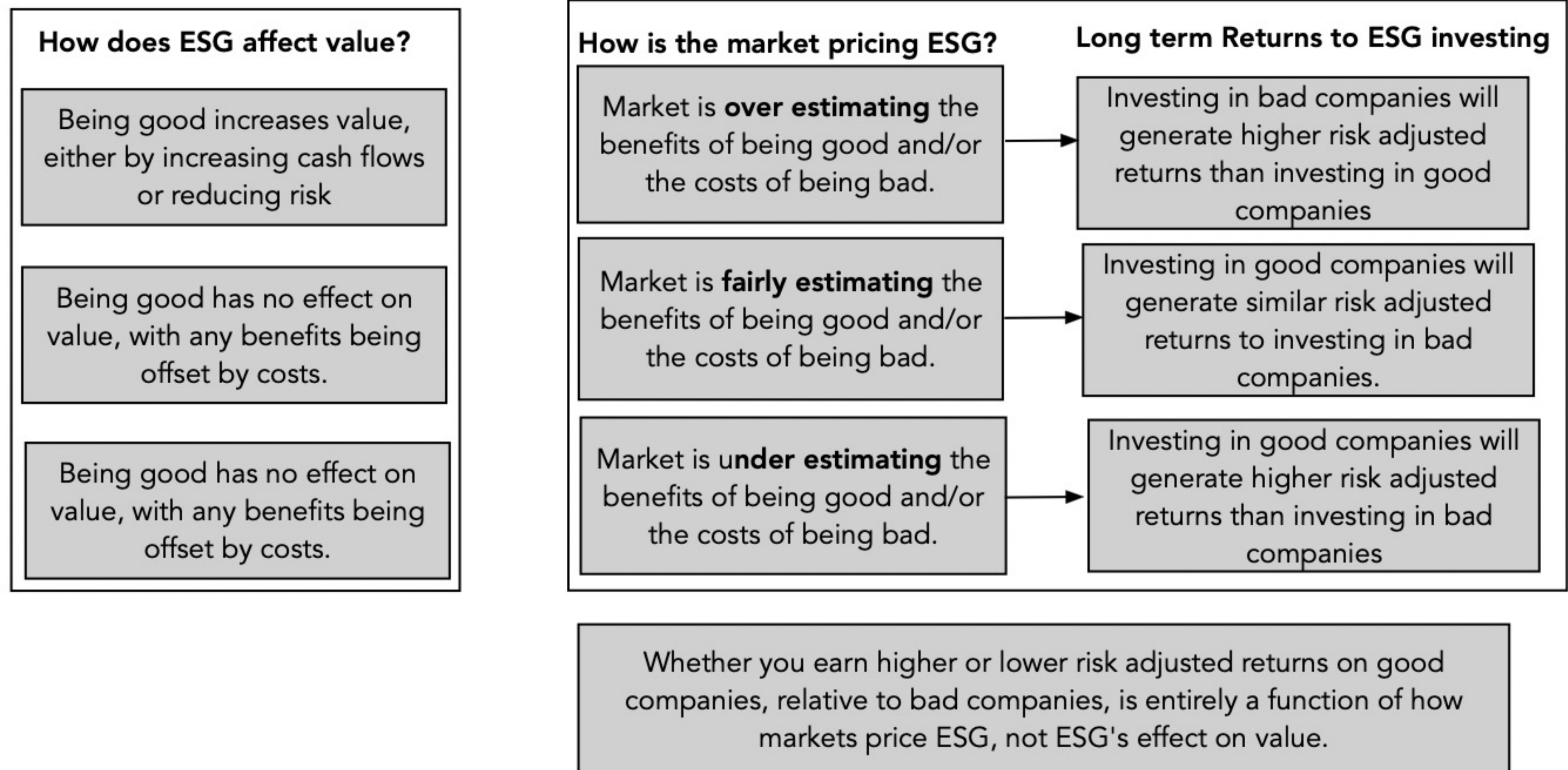
II. ESG and Returns

- 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.

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.

Why returns to ESG are tough to read…



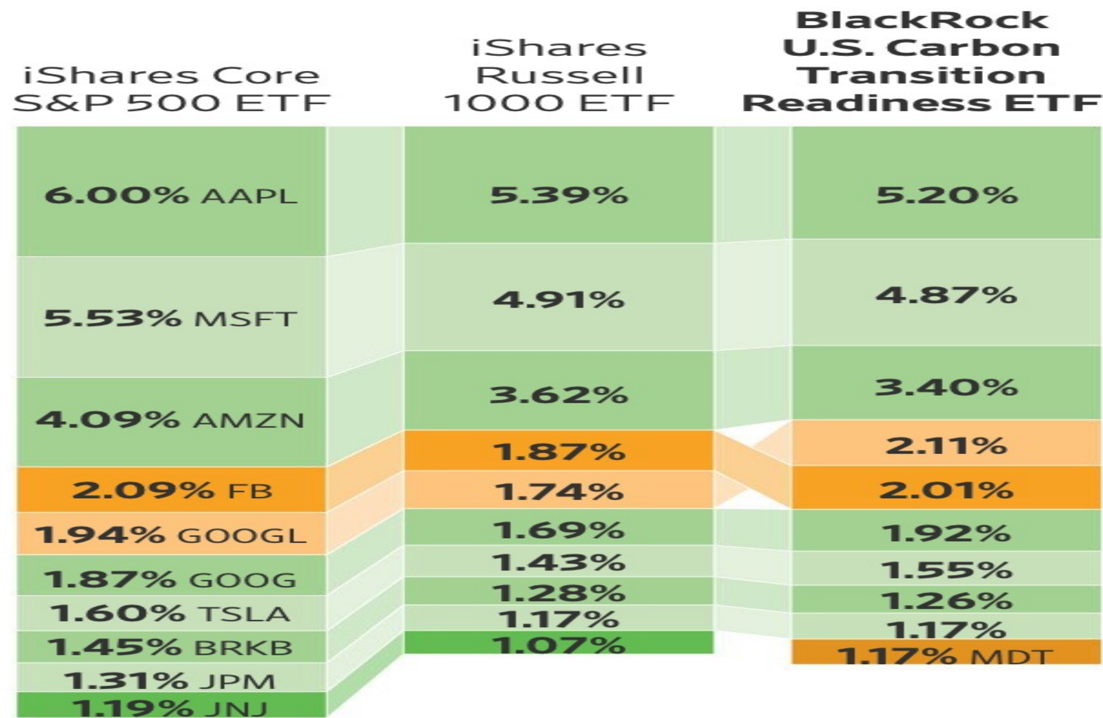
The Pricing Effect

- 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.

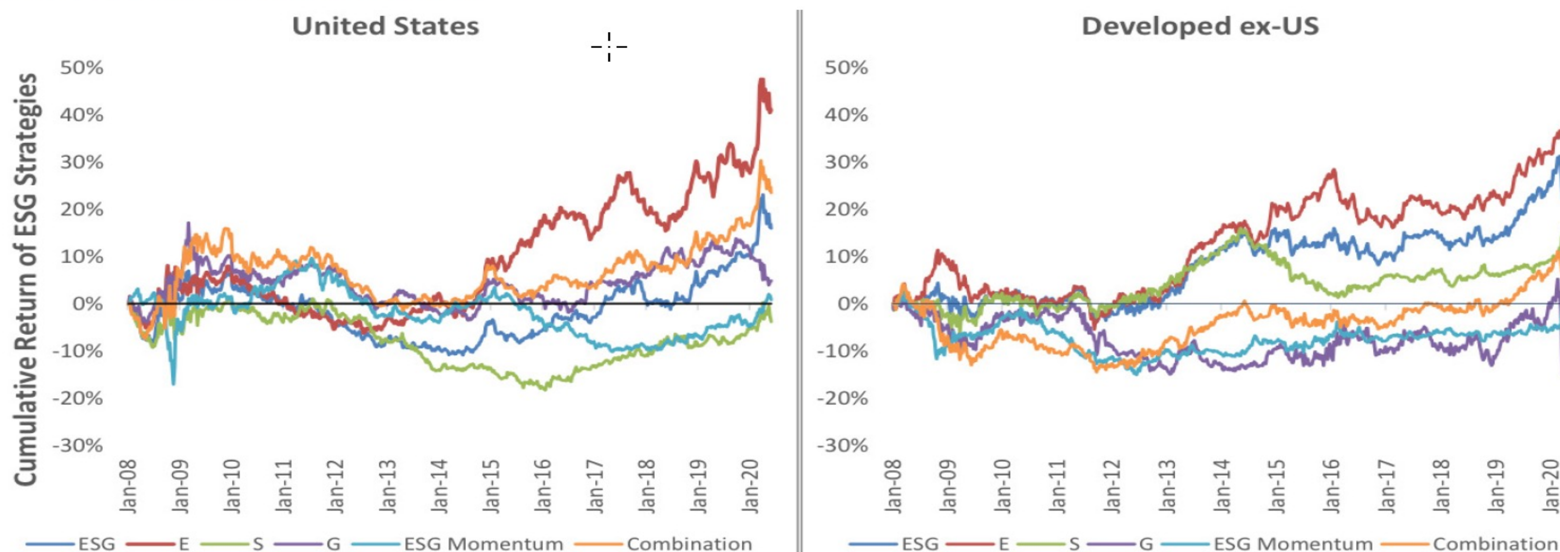
Fake ESG? BlackRock's Carbon Transition ETF



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

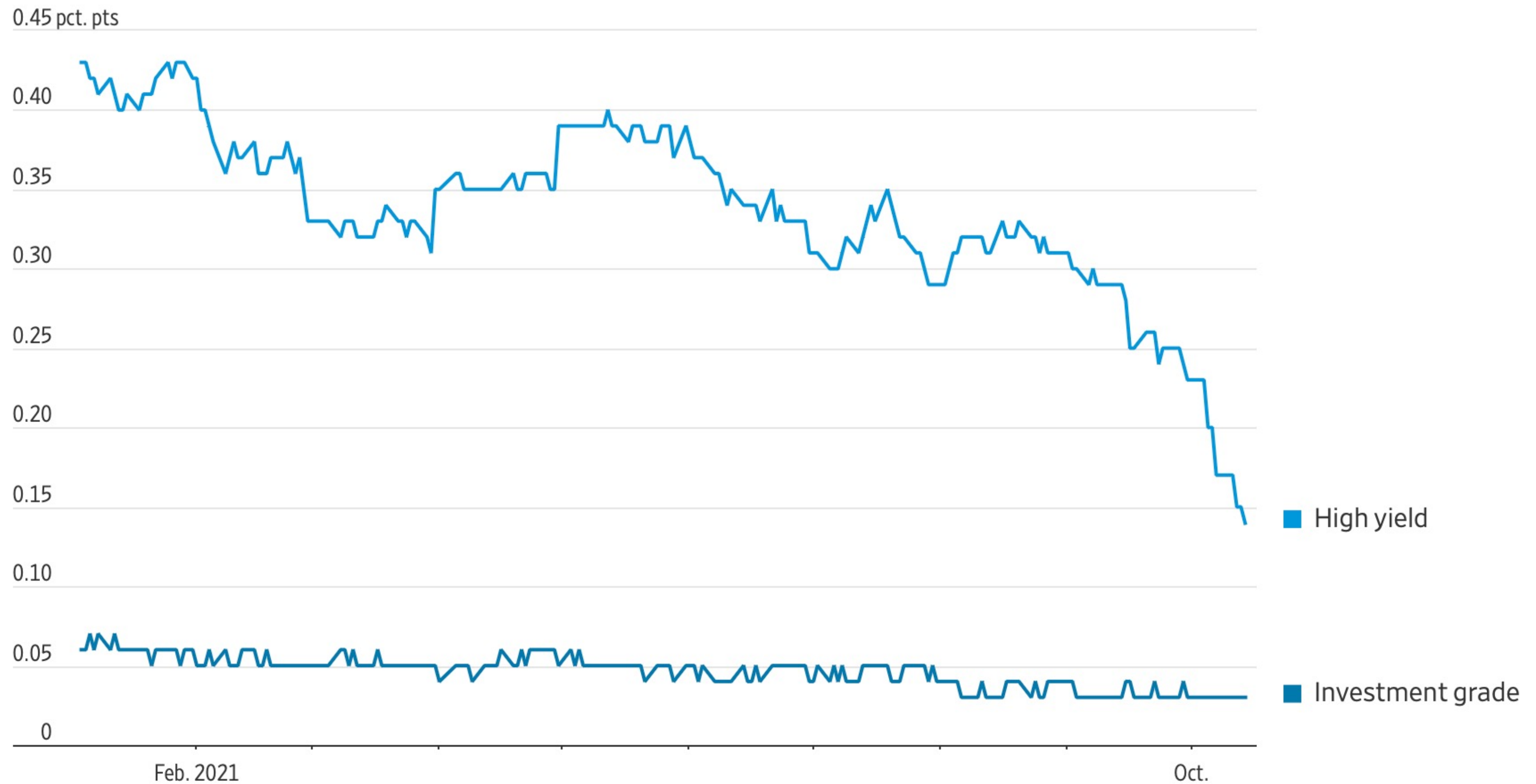
Source: Honey, I shrunk the ESG alpha

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



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.*

The Investing Bottom Line

- If success in active investing is defined as attracting investor money, ESG has had a successful run, 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 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.

III. 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.
- 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.

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?

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.

Goodness as a shield…

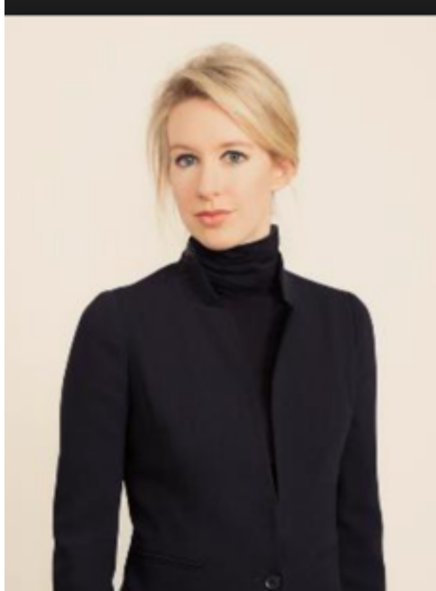
- To the extent that ESG is on the side of "goodness", any company that wears the ESG mantle acquires some degree of protection against questioning, not just about ESG actions, but also against legitimate business questions.
- While the evidence is anecdotal, at least for the moment, there is some backing for the contention that the companies that claim to have the purest of motives often have the most to hide.

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



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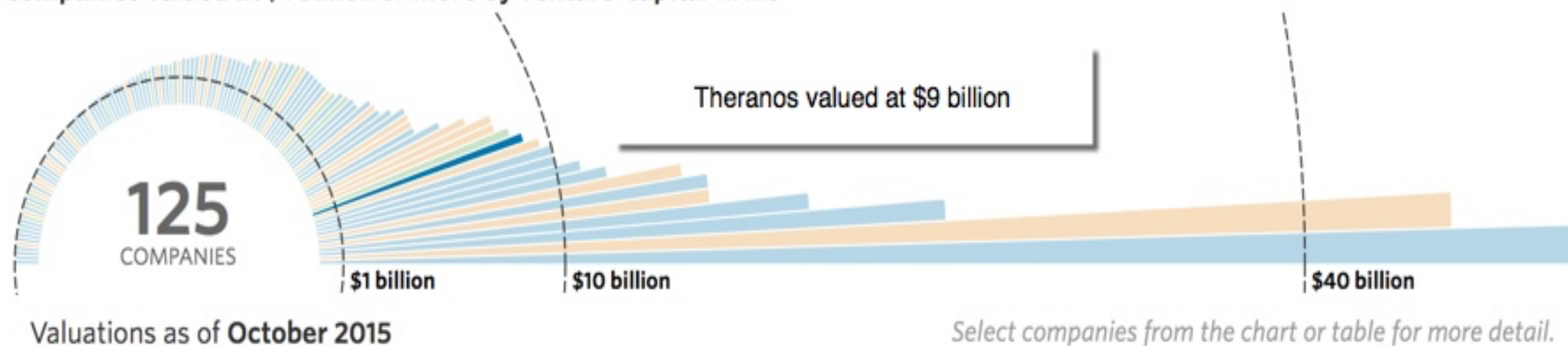
The Checks (?)

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

Companies valued at $1 billion or more by venture-capital firms



IV. 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.

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…

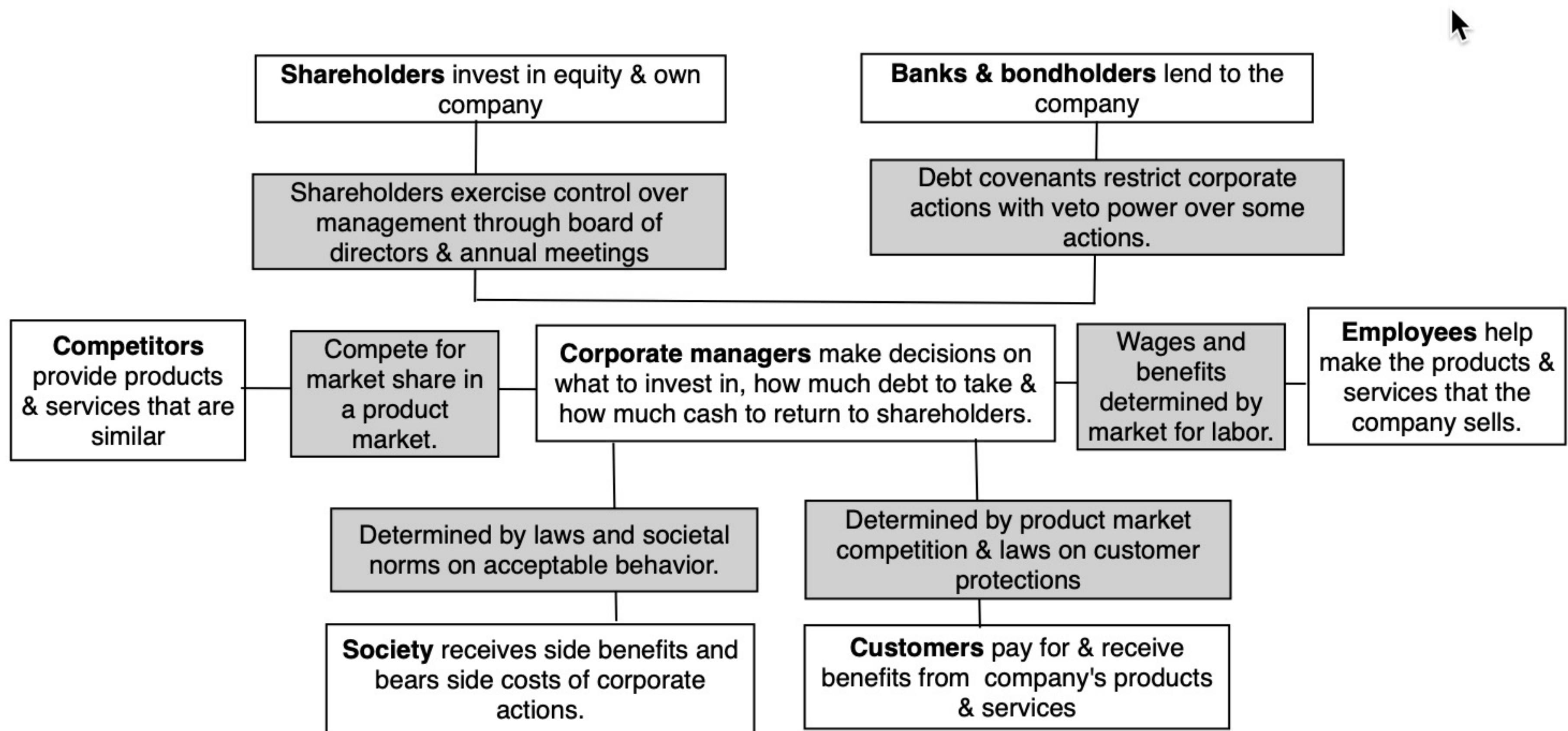
Rising costs of fossil fuel…

- As ESG pressures amp up on publicly traded fossil fuel companies, especially in the US and Europe, to reduce exploration and production of fossil fuels, the laws of demand and supply have created a predictable consequence, which is higher prices for these fossil fuels (gas and oil).
- While ESG advocates may view this as a win, it is worth remembering that 80% of global energy still comes from fossil fuels, and that the people who are most exposed to price increases are not the well off, urban advocates of ESG but the people who are least well off (within countries and across countries).

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?



V. Outsourcing your conscience is a salve, not a solution!

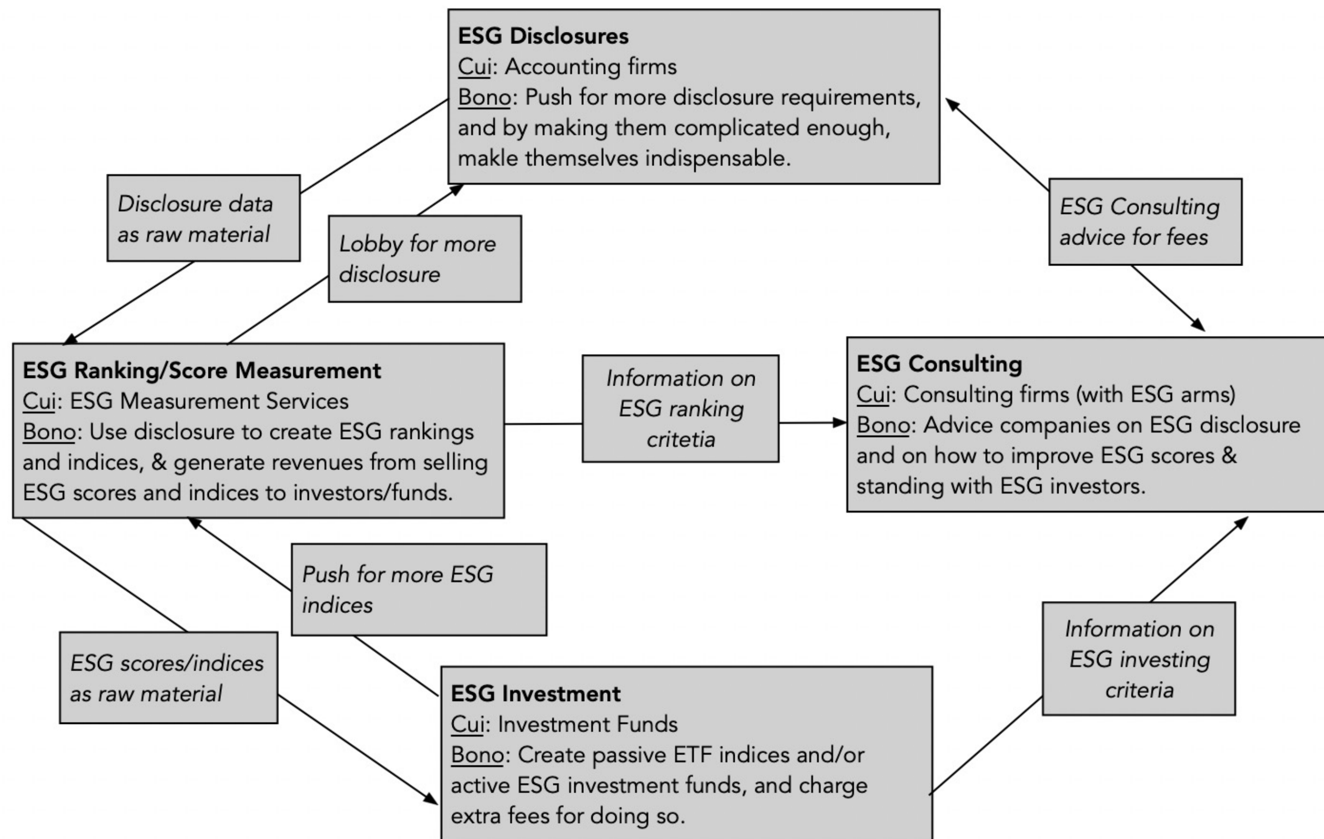
- The ESG movement has given each of us an easy way out of having to make choices, by outsourcing these choices to corporate CEOs and investment fund managers, asking them to be "good" for us, while not charging us more for their products and services (as consumers) and delivering above-average returns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

So, why the hype?

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 business person, 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. 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 moral code, you have 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. Goodness requires sacrifice!
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.

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.