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…

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 **under 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.

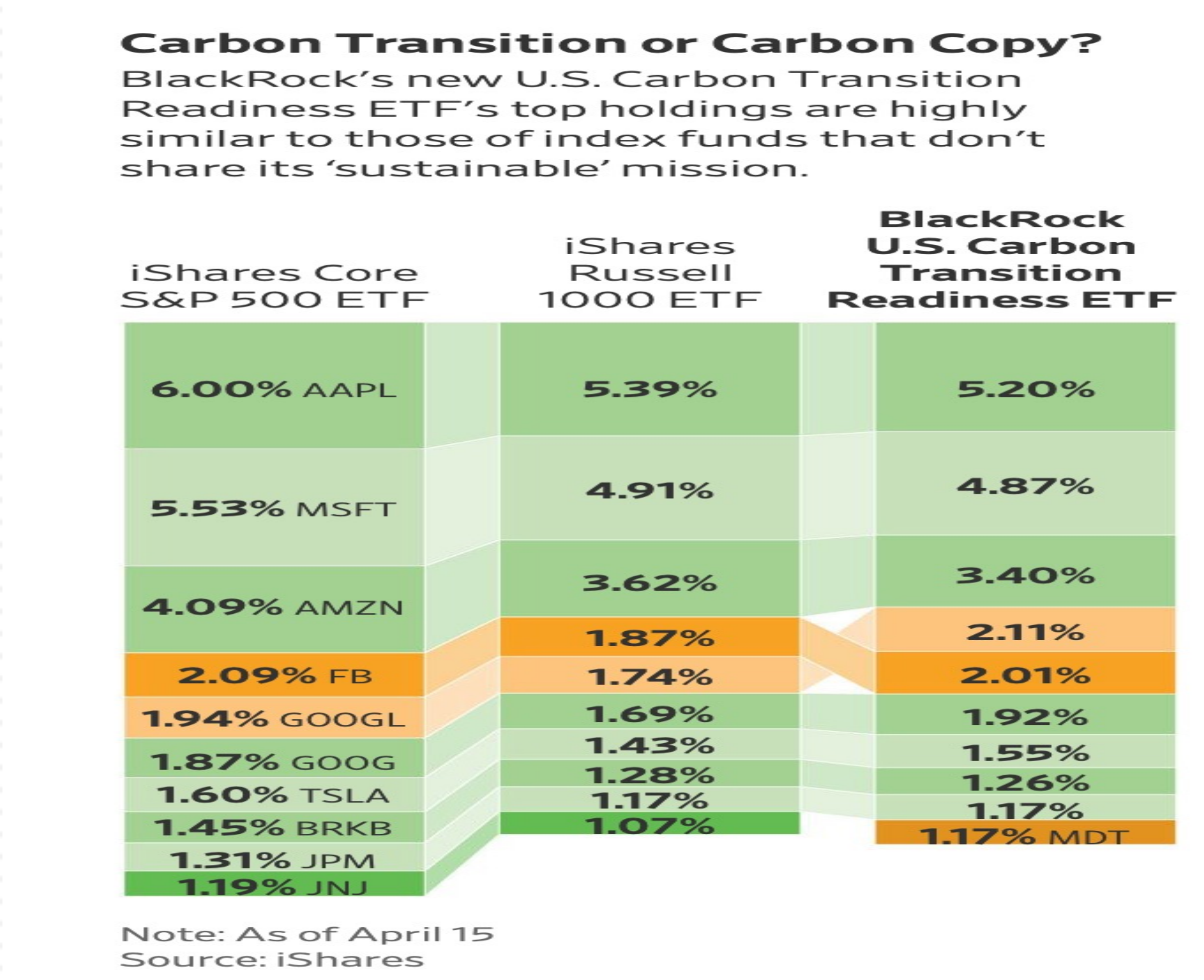
The Pricing Effect

- 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

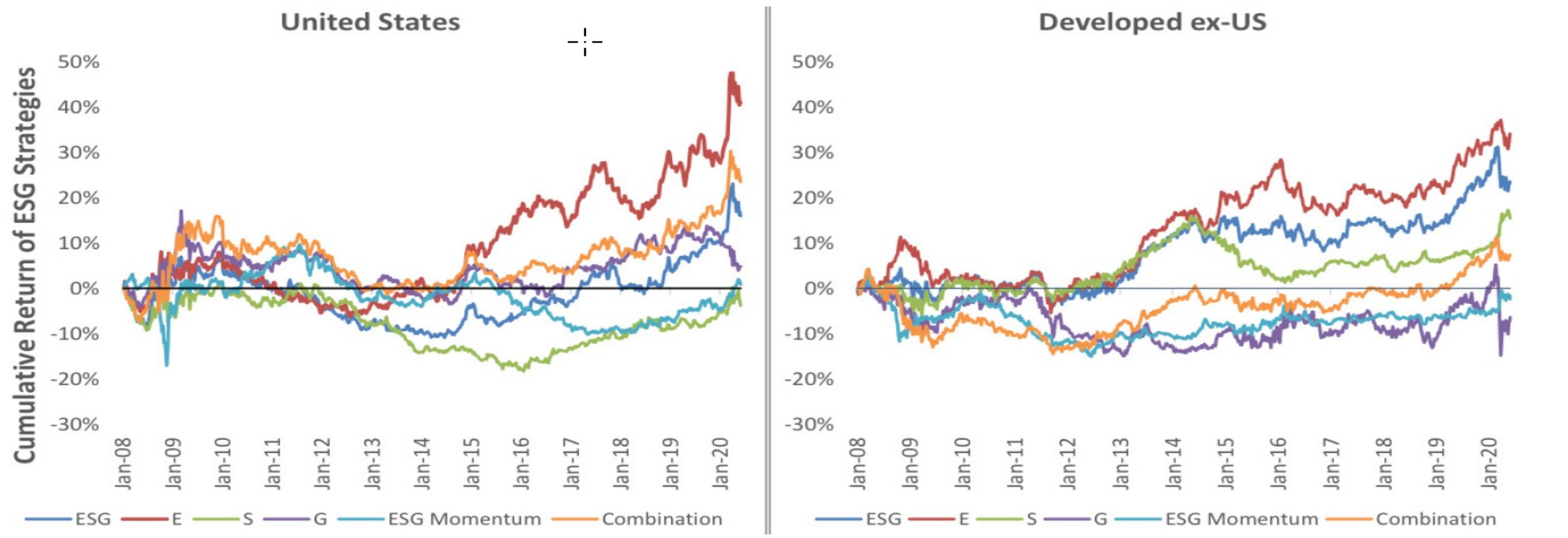


Expenses: 0.03%

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

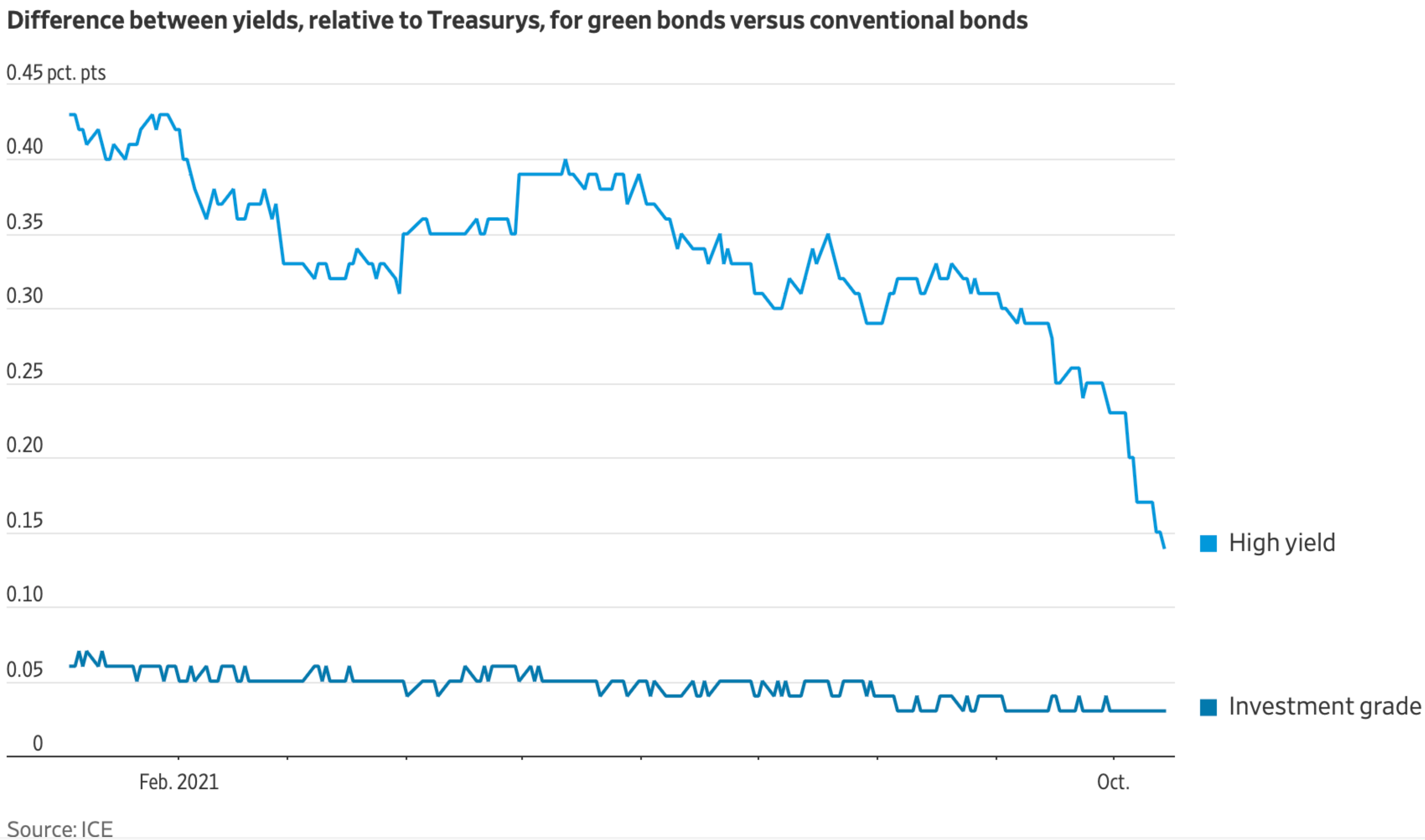
Source: Honey, I shrunk the ESG alpha

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



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. 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.
- 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

\+

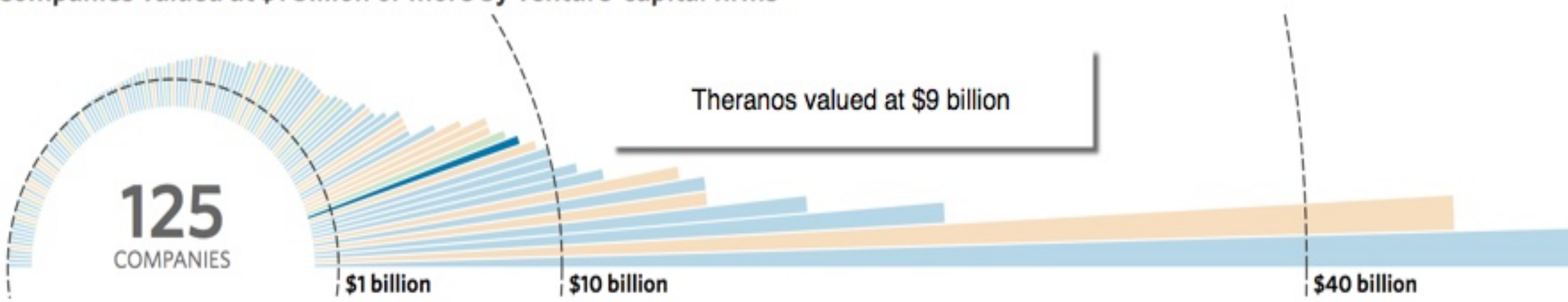
Money

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

\+

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



Valuations as of **October 2015**

Select companies from the chart or table for more detail.

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.

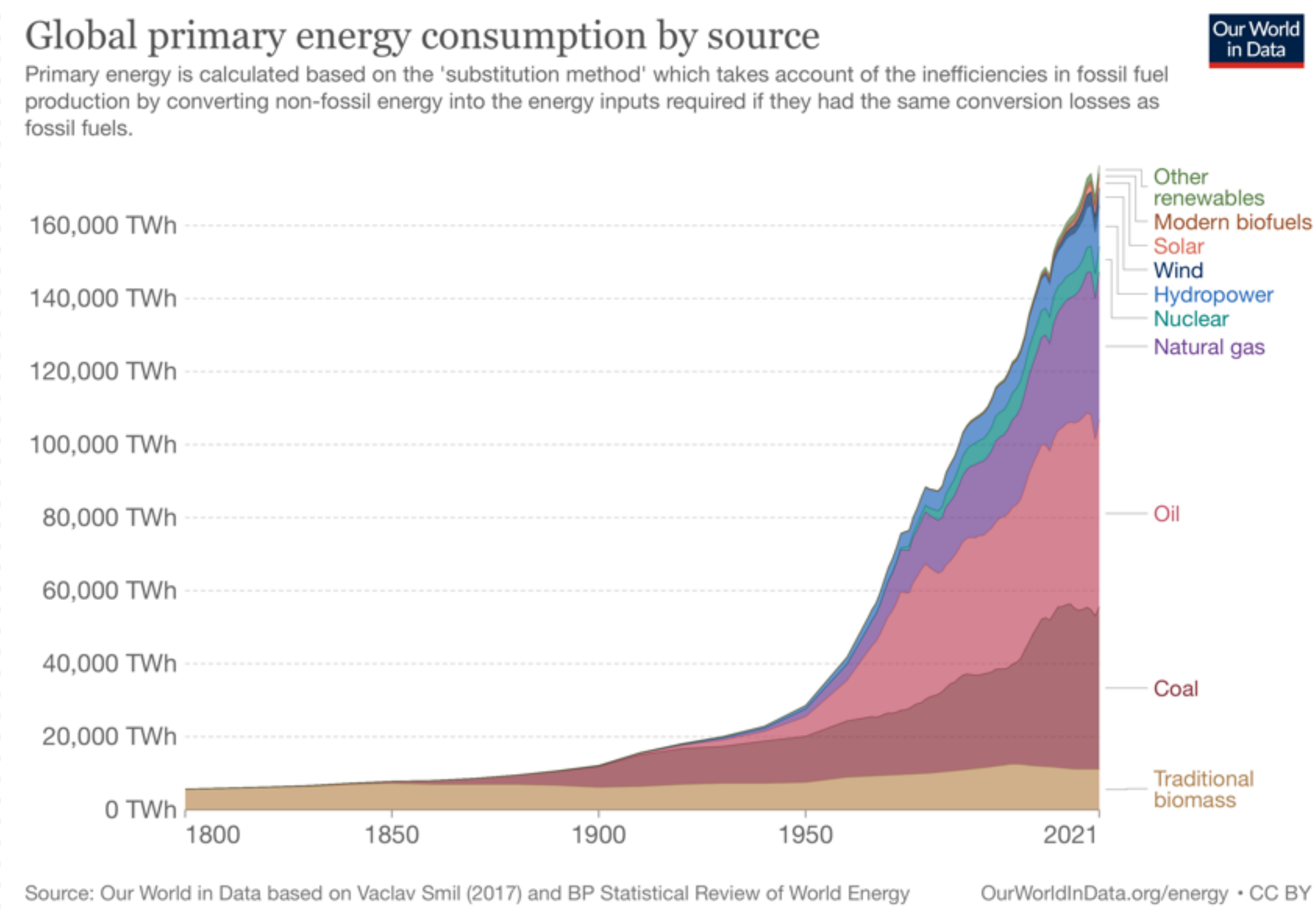
Private Equity in Fossil Fuels

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…

Behind the curtain…

And not surprisingly.. Barely a dent in dependence on fossil fuels



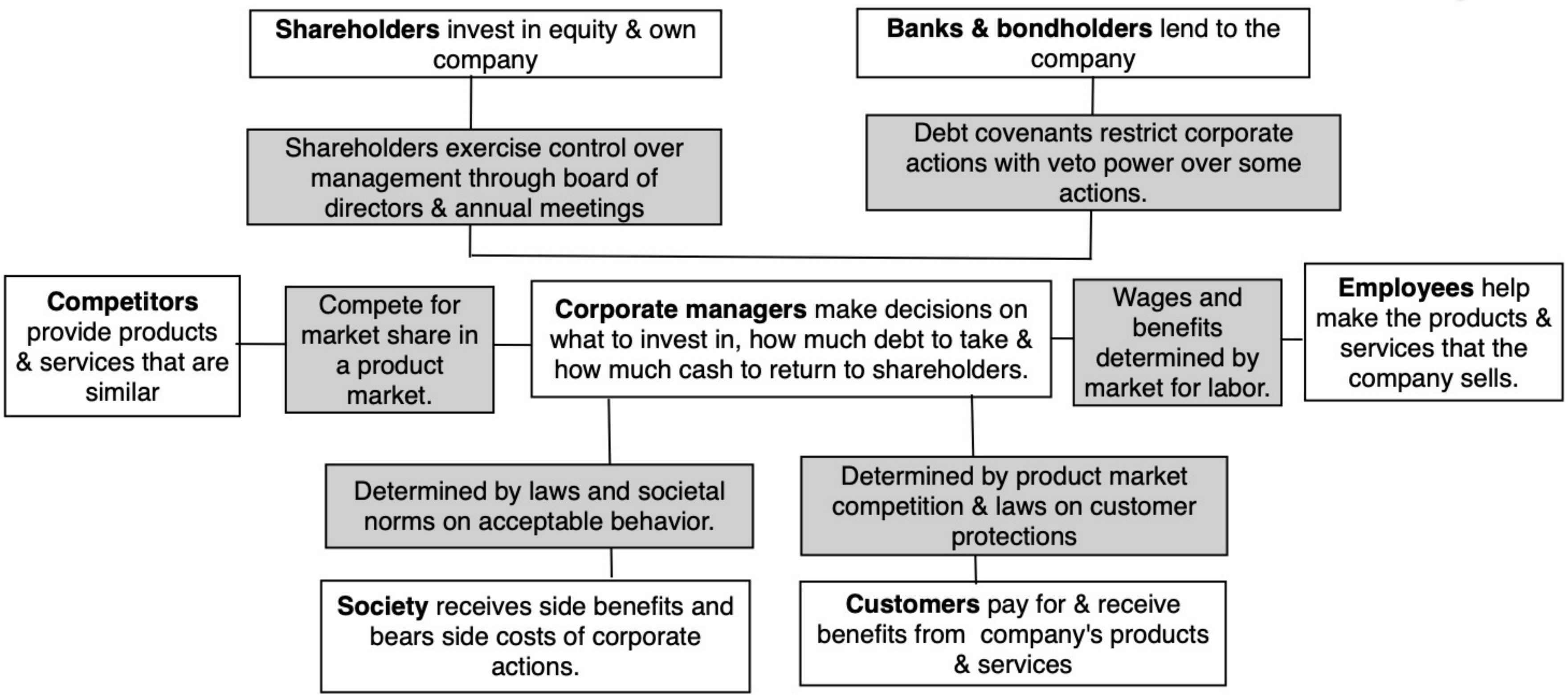
While increasing its costs…

- 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).

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 (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.

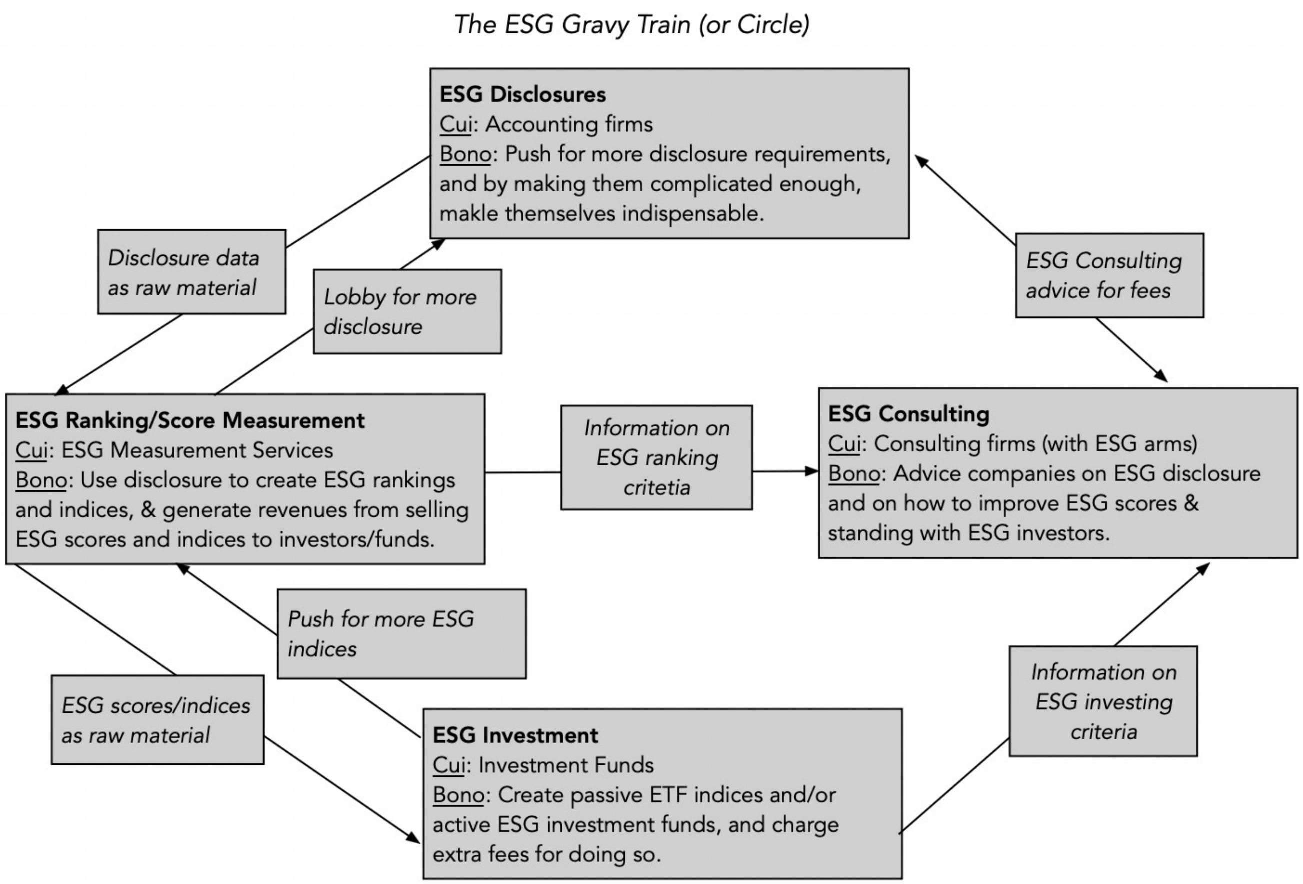
An inside perspective…

- 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?

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. 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.