KENAN INSTITUTE of Private Enterprise
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KENAN INSIGHTS

ESG Investing: Cure-all or Placebo?

New Series to Explore Stakeholder Capitalism

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The conversation surrounding stakeholder capitalism, a system in which business decisions serve the interests of a broader set of stakeholders, was significantly elevated in 2019 by a major Business Roundtable proclamation. Departing from the model of shareholder primacy long promoted by Milton Friedman, 181 CEOs committed to "lead [their] companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders." Rather than to single-mindedly maximize profits to enhance long-term shareholder value, possibly at the cost of other stakeholder groups, a company's purpose under such a system is to create long-term societal value.

Shareholder capitalism envisions value maximization as residing within the confines of legal and regulatory traditions and constraints; Friedman says the pursuit of profit requires "conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom." This means that shareholder capitalism is not consistent with undue monopolistic power or actions that weaken the fabric of society. Nevertheless, given we are collectively facing rising income and wealth inequality, major climate risks, geopolitical tensions and systemic barriers to economic opportunity, there is a strong argument to be made for a more inclusive form of capitalism that balances the critical roles of private enterprise, globalization and free markets while also creating broader economic opportunities and attending to important externalities. However, the proper execution of such a balanced vision involves difficult business and policy choices.

While such an idea has been brewing for some time, the conversation about the role of business in society was propelled significantly forward in 2020 by both the COVID-19 pandemic and the murder of George Floyd as business leaders faced increasingly tough questions about their treatment of struggling workers and their organizational diversity, equity and inclusion efforts.

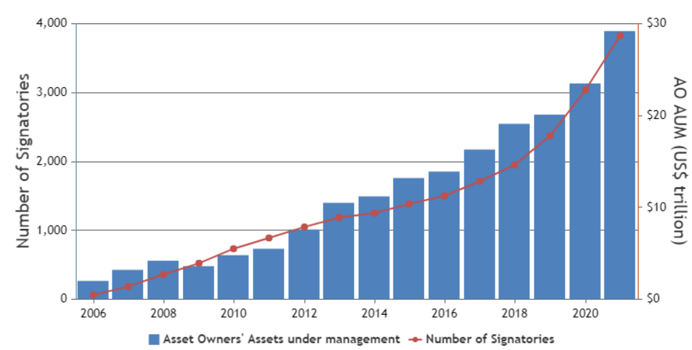
Despite these fast-moving developments, it is important to acknowledge that a move toward stakeholder capitalism does not come without controversy in academic, political and industry circles. While one can be whole-heartedly behind the spirit of a transformed (many would claim more inclusive) role for business in society, given the magnitude and complexity of these questions, there is a dire need for a careful reckoning particularly given that tradeoffs – such as whether to invest scarce resources in green research and development or worker training – are pervasive.

With a mission to leverage the private sector for the public good, the Kenan Institute is uniquely positioned to drive the conversation around stakeholder capitalism forward with a series of data-driven, objective analyses of these important but thorny topics.

The Rapid Growth of ESG Investing

To kick things off, we first seek to address one of the most rapidly evolving developments at the intersection of business and society: ESG investing. Broadly speaking, this represents an investment process that (in an ideal setting) integrates environmental, social, and governance objectives along with more traditional risk/return metrics. Interest in ESG investing has exploded; there are now more than 3,800 signatories to the United Nation's Principles for Responsible Investment, representing major asset owners, investment managers and service providers from around the world, with assets under management of almost $30 trillion USD (and continuing to grow).

PRI Growth, 2006-2021



The Untangling of E-S-G

While the ESG conversation has moved forward quickly, it is important to acknowledge that the E, S and G buckets are quite disparate and that they may themselves potentially engender challenging cross-bucket conflicts of interest. To better understand this, it is important to separate these out.

The environmental criteria that ESG investors may perceive as relevant range from energy use to pollution to natural resource conservation and more. Further, some investors may explicitly focus on downside environmental or climate risks, from the potential costs associated with negative climate shocks to perhaps more proximate adverse regulatory or policy changes. In contrast, social criteria can range from a company's working conditions with regard to the safety of its employees to progress on workforce diversity to the engagement of the firm in the challenges of the community within which it operates. Finally, governance criteria focus on the degree to which companies engage in transparent accounting, facilitate board representation and ensure minority shareholders are well represented in important business decisions.

Given the distinct nature of these buckets (and the significant challenges of measurement within each), fully integrating ESG principals creates a tension between how to weigh the relative importance of each of these buckets (and sub-buckets). Further, one can clearly envision important tradeoffs between buckets. For example, an investment in an operational process deemed more sustainable is necessarily costly (at least in the short run); how does that impact the ability of some firms to compensate their workers more generously?

What is ESG Investing, Really?

Before going too far into the challenges of defining objectives and acknowledging tradeoffs, it is important to point out that despite its rapid penetration throughout the financial landscape, ESG investing still means wildly different things to different people. To some, ESG investing may simply resemble an earlier iteration called "socially responsible investment" – which largely focuses on the avoidance of undesirable industries (e.g., coal and fossil fuels, tobacco products, or weapons manufacturers). Here, one is still trying to maximize standard risk/return metrics, but subject to some important investment exclusion restrictions. At the other extreme is true "impact investing," where a steward of capital is endeavoring to engender an explicit social or environmental outcome that is potentially quite divorced from any pecuniary return. And, of course, ESG can reflect everything in between. Taken together, this wide variation in intention, coupled with an imprecision with which ESG is defined in practice, begs the question – what really are the objectives of ESG integration? We provide a few thoughts:

(1) As mentioned above, some investors focus heavily on the potential for material risk mitigation. Specifically, they contend there are downside environmental, labor or customer risks that ESG considerations help to alleviate. This is certainly possible, but if there are material investment risks related to these issues, shouldn't a thorough traditional process already internalize them? Or, is it instead the case that recent years have unearthed important risks (or forced a better appreciation of those risks)? This is certainly plausible, but it should be acknowledged that it is not all that novel an idea that unexpected but consequential risk realizations require a more careful thinking about risk management going forward. If this is the case, then standard shareholder value maximization retains its primacy.

(2) Beyond risk, could elevated value creation associated with sustainable investments be achieved in a corporate setting? (Think capital expenditure, supply chain management, workforce diversity, etc.) Or, could asset managers who integrate ESG into their investment processes deliver superior risk-adjusted returns (what investors call α)? Of course, investments that generate (non-pecuniary) impact can create significant value for investors in a more holistic sense, but that impact is generally associated with financial tradeoffs through elevated costs elsewhere. However, some have argued that ESG integration represents an opportunity for financial value creation and elevated investment returns through, for example, customer acquisition (e.g., those who value sustainable products) or increased employee retention and productivity.[1,2]

Can ESG Investing Live Up to the Hype?

Despite the financial value creation potential, others have cautioned that there is an important confusion between recent realized investment returns and prospective, forward-looking expected returns.[3] If there is a rapidly growing demand for ESG or socially responsible

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[1] Edmans, A. (2011). Does the stock market fully value intangibles? Employee satisfaction and equity prices. *Journal of Financial Economics, 101*(3), 621 640. https://doi.org/10.1016/j.jfineco.2011.03.021

[2] Boustanifar, H. & Kang, Y.D. (2021, October 14). *Employee Satisfaction and Long-run Stock Returns, 1984-2020* (SSRN Working Paper). Social Science Research Network. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3933687

[3] Pastor, L., Stambaugh, R.F., & Taylor, L.A. (2020, August 12). *Sustainable Investing in Equilibrium* (Chicago Booth Research Paper No. 20-12). Social Science Research Network. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3498354

investments (as we have witnessed during the last decade), then the prices of those assets will increase, generating outsized, albeit temporary, returns. In the long run, assets that are demanded for their high ESG ratings will instead carry lower expected returns going forward perhaps because investors enjoy holding them for their non-pecuniary impact or because they may help to hedge important downside risks. Under this argument, the purported outperformance of ESG funds during the COVID pandemic is instead a manifestation of a sizable demand-driven repricing that will eventually yield lower returns in equilibrium.

Even if one holds the most optimistic view of ESG, there are several challenges in implementation. First, even in the best case scenario – in which ESG integration helps to mitigate risks and/or generate superior risk-adjusted investment returns – we remain very far away from any consensus on sustainability accounting. Specifically, there remains a tremendous degree of disagreement among ESG data providers. How can we credibly manage where we cannot agree upon what to measure? A critical next step for the evolution of ESG investing will be an evolving consensus on sustainability accounting.[4]

Second, there is also deep skepticism among some that ESG integration is anything but window dressing. For instance, Bebchuk-shows that the Business Roundtable firms mentioned above have done little to nothing in terms of fundamentally transforming their operations in any meaningful way as promised in their proclamation.[5] Further, Blackrock's former Global Chief Investment Officer for Sustainable Investing Tariq Fancy went so far as to call ESG a "dangerous placebo" through which we think we are making progress even though we are not. This illusion permits a kind of complacency, allowing us to avoid more consequential (but costlier) reforms. In addition, there are many high-cost investment products that look like little more than a repackaging of poor-performing funds under different names. This sort of greenwashing is an unfortunate and potentially costly distraction for both investors and policymakers as it may hinder an appropriate policy response.

Finally, for at least some of these considerations – and we contend some of the very important ones – there simply must be real economic tradeoffs. Climate risk, as a central example, is the result of an externality problem where the climate cost of production is not financially incurred by that actual producer and is instead borne by society. While there are clearly interesting growth opportunities in technological solutions that will help to address the climate crisis, we nevertheless need to collectively internalize costs. Forcing those who are imposing an externality on others, such as carbon emissions, to face the costs of their actions is the only viable mechanism to solve such a problem; and by doing so, such a solution would also support those technological growth opportunities. Accordingly, then, where are the policymakers? While ESG integration may help on the margin, nothing will replace a carbon tax (widely accepted by economists) to force change. While Fancy fears the placebo makes the symptoms worse, rather than serving as a mechanism to highlight important risks and then help steward capital toward potential solutions, he argues that ESG is instead a distraction from which policymakers can then abdicate their responsibilities. While this is a rather damning criticism, lest anyone think advocacy is ineffectual, there are important examples when consumer/corporate/investor behavior led to fundamental change in government policy (the South Africa divestment campaign is a prominent case in point).

The Undeniable Shift

Despite these concerns, and there are many, the conversation has undeniably shifted for the better. We are witnessing an energized discussion about the role of business in important societal issues that is heartening. From here, the relevant question is how best to direct this conversation toward business and policy solutions that are informed by rigorous, objective research. To that end, the Kenan Institute's forthcoming series will continue to explore and examine issues related to stakeholder capitalism, including:

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- The economics of shareholder primacy vs. stakeholder capitalism
- What impact can we really expect from ESG investing?
- Workforce diversity and inclusion
- The evolution in consumer behavior in the face of important economic trade-offs
- National and global policy – what must governments do, and can policymakers get there?

[4] For a recent illustration of the accounting challenges see https://www.wsj.com/articles/banks-promised-to-cut-funding-for-arctic-oil-drilling-money-flowed-anyway-11634468580

[5] Bebchuk, L.A. & Tallarita, R. (2021, August 31) *Will Corporations Deliver Value to all Stakeholders?* (SSRN Working Paper). Social Science Research Network. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3899421

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