ESG INVESTING: A SPECIAL (AND CRITICAL) REPORT

After my two reports on ESG funds' problem with humans and taxes generated strong media interest, I accepted an offer to teach a short module on ESG for McGill University in April. This report is a summary of my prepared remarks.

"Nothing is stronger than an idea whose time has come" observed Victor Hugo. As someone who ardently backed the absolute monarchy in his youth, became a lord under the Bourgeois regime of Louis-Philippe, and eventually embodied the ideals of the French Third Republic, Victor Hugo knew the power of big ideas – and the necessity to change them at the opportune moment.

Environmental, Social, and Governance (ESG) investing is one of these ideas whose time has come. The ESG movement, once a niche for hippies and tree huggers, has become the most powerful force in global capital markets: the 3,038 signatories of the U.N.' Principles for Responsible Investment manage more than $100 trillion, the European Commission passed the Non-Financial Reporting Directive, and ESG funds posted record inflows in 2020 thanks for their strong performance.

The second part will debunk **the myth that "investors should do well by doing good".** ESG funds' outperformance in 2020 was lucky: the sector is tilted towards tech and healthcare monopolies and avoids the employee-intensive firms which suffered the most from the pandemic. Second, **the notion of ESG alpha is an oxymoron**. ESG's *raison d'être* is to internalize the costs that a purely profit-driven capitalist system inflicts on other stakeholders. Internalizing costs is costly, by definition. Third, ESG ratings do not accurately measure and predict ESG risks: the definition of ESG risk is subjective, the correlation between the ratings of major ESG firms is low and recent high-profile catastrophes, such as the Deepwater Horizon oil spill, the diesel emission scandal, and the California wildfires were caused by firms with high ESG ratings.

The third part will discuss the dirty secret of the ESG movement: **ESG funds overweight large monopolies which employ relatively few workers and pay little taxes**. **<u>ESG ratings should also include jobs, taxes, and competition to address the issues of tax evasion, automation, and monopolistic concentration.</u>**

Last, the ESG movement must overcome three structural limitations to achieve its noble goals:

1 – **Public sector involvement**: only governments and regulations can ensure that public goods problems are solved, rather than "greenwashed".

2 – **ESG is inherently active**: relying on passive fund managers, index providers and proxy advisors to make capitalism moral again is like having an arsonist run the fire department.

3 – **The purpose of the corporation and corporate governance rules must be modernized** for ESG to live up to its promises.

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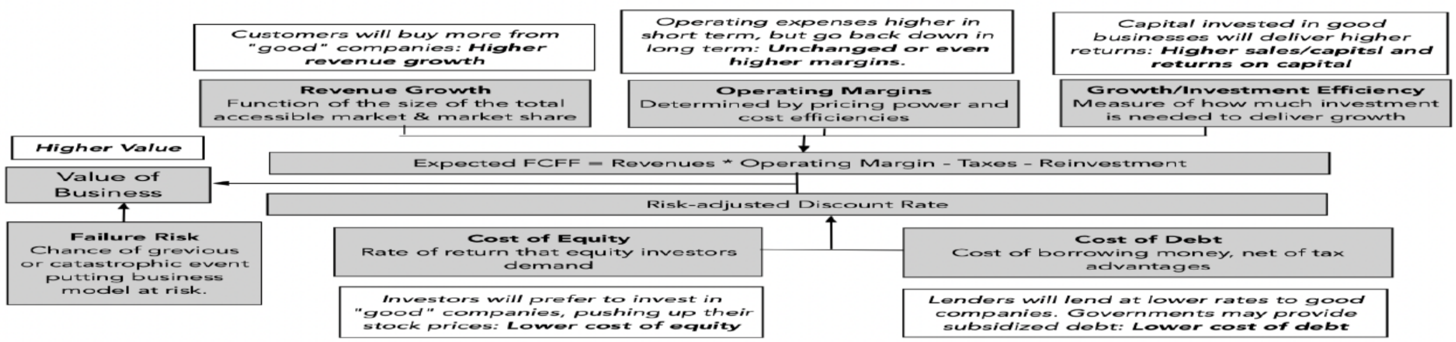
The ESG Fairy Tale

For many years, ESG consultants have repeated the mantra "of doing well by doing good". Environmentally-conscious, worker-friendly, and financially-successful Patagonia has been touted in Harvard Business School studies as a new way to align operations, values, and profits.

As B. Cornell and A. Damodoran explained in "*Valuing ESG: Doing Good or Sounding Good*" (2020), virtuous behavior could reward shareholders by acting on the four levers of value:

- Grow revenues faster by attracting values-driven consumers and selling premium goods and services
- Reduce long-term operating expenses thanks to low turnover and greater staff morale
- Deploy capital more efficiently by focusing on sustainable growth initiatives
- Reduce funding costs by accessing pools of ESG-conscious capital

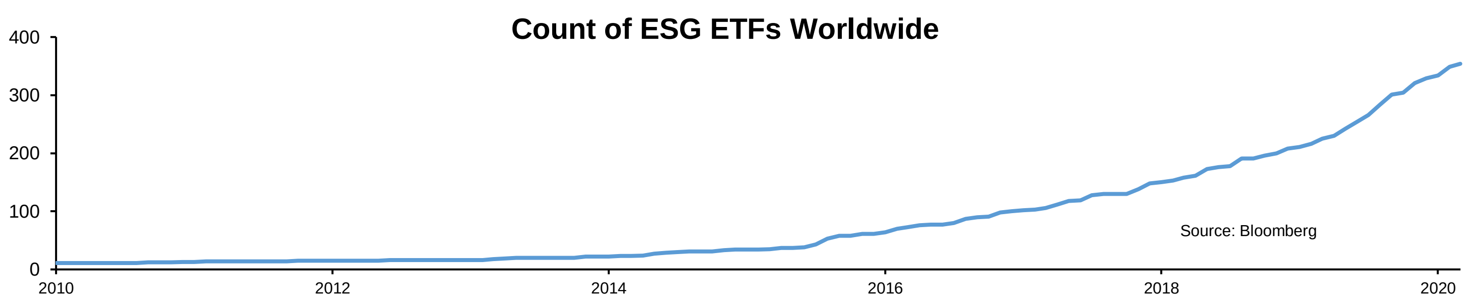
Figure 2: The Payoff to Being Good: The Virtuous Cycle



Source: A. Damodoran "*Valuing ESG: Doing Good or Sounding Good*" (2020)

Hundreds of papers have been written on the link (or lack thereof) between ESG ratings and stocks' returns. My impression is the same as with acupuncture: true believers validate their faith with a handful anecdotal successes, skeptics point to the lack of any discernible relation between inputs and outcomes, and reasonable people conclude that "at least it does not seem harmful so it may be worth trying".

Fund providers have certainly adopted the *ethos* of the time: **investors can choose from 354 ESG ETFs, ranging from U.S. sector funds to Chinese RMB bonds and Indonesian stocks**. Half of these funds were launched in the past two years.



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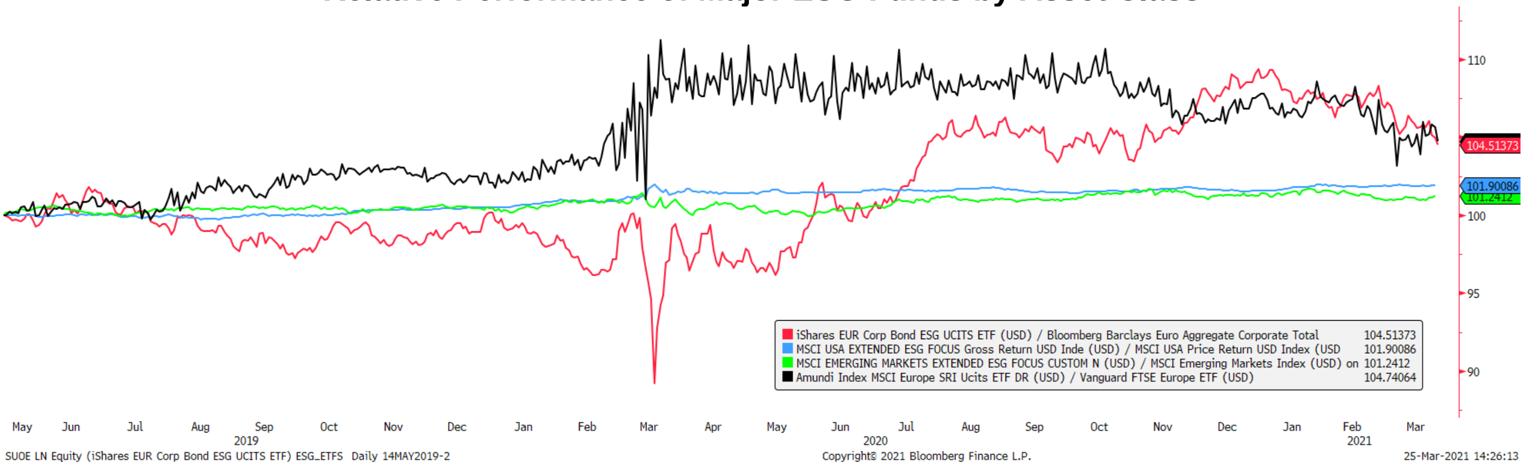
The past year seems to have validated this enthusiasm: the major ESG ETFs have outperformed market cap-weighted indices across asset classes. Blackrock's L. Fink summarized the industry's euphoric mood in his most recent letter to shareholders: "*Our investment conviction is that sustainability and climate-integrated portfolios can provide better risk-adjusted returns to investors.*"

Relative Performance of Major ESG Funds by Asset Class

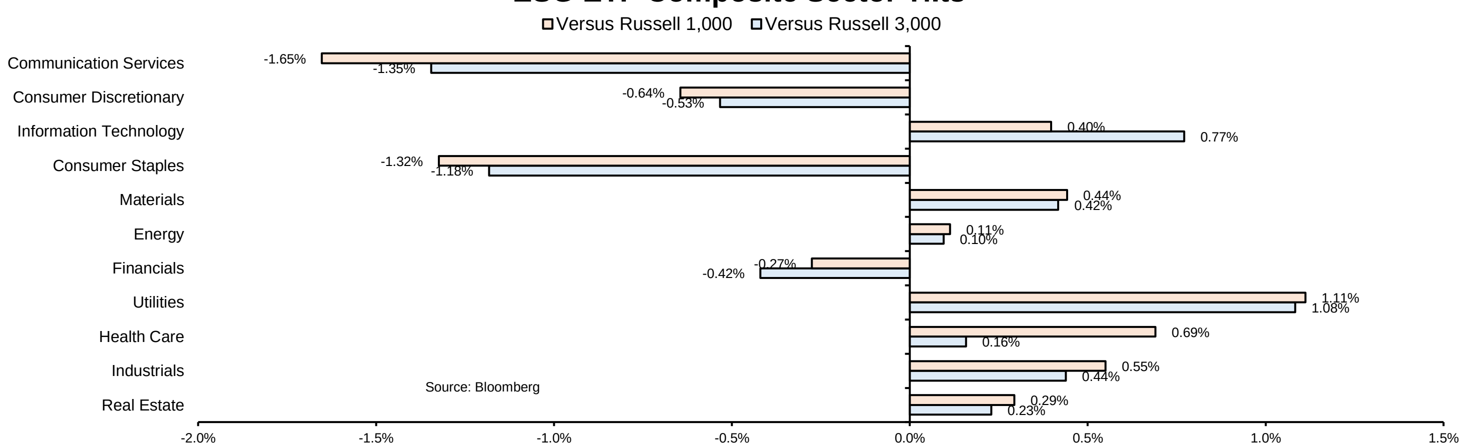


Flaws in the Narrative

Performance Claims

There are at least four major flaws in the ESG fairy tale. First, ESG's extraordinary year in 2020 owed more to "being at the right place at the right time" than to structural *alpha*. Aggregating the holdings of the largest US ESG ETFs into a generic "ESG ETF composite portfolio" reveals **a clear bias towards the technology and healthcare sectors, which benefitted from the global pandemic.**

ESG ETF Composite Sector Tilts



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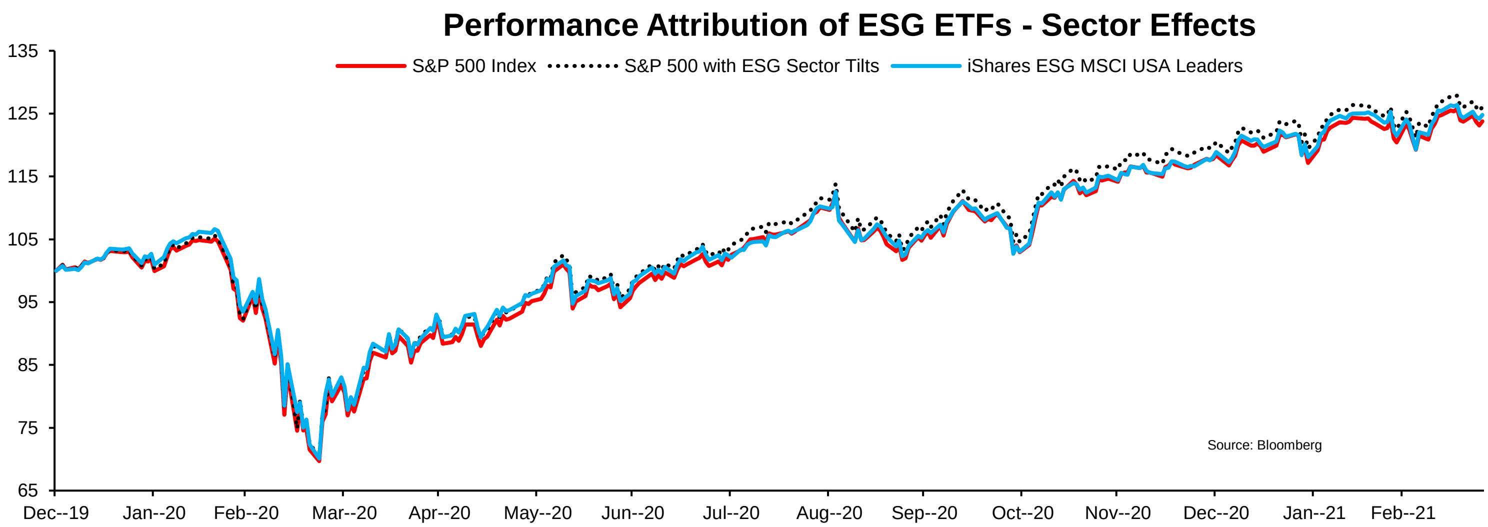
In fact, a non-ESG portfolio with the same sector tilts as the ESG composite ETF portfolio would have outperformed the S&P 500 index by 2% since the start of 2020, versus a relative gain of just 80 basis point for the largest U.S. equity ESG ETF.



Second, **ESG ETFs have benefitted from their unconscious bias against companies with a lot of employees**. As I explained in "ESG Investors Are Winning their Unintended War Against People", the average company in the ESG ETF composite portfolio has 20% fewer employees than the average Russell 3,000 company. Since algos and machines do not spread viruses, avoiding humans was a fortunate accident in 2020. As I argued in "the ESG Bubble: Saving the Planet, Destroying Societies", ESG ETFs also overweight tax-avoiding monopolies, which have accounted for a disproportionate share of the market's gains last year.

Third, the claim that companies which pay attention to ESG factors are generally well-run and focused on long-term goals may be correct, but it is insufficient to justify higher risk adjusted returns. The market would also need to be inefficient for this claim to be true, i.e., investors must systematically under-estimate the benefits of ESG ratings and they should continue to do so for the anomaly to persist. This seems hard to reconcile with the explosion of ESG funds and strategies in the past decade.

Fourth and most importantly, **the notion of ESG alpha is a contradiction in terms**. ESG's *raison d'être* is that the free market, when it is driven only by the profit motive, will create costs for other stakeholders – society, workers, and the environment. The ESG movement tries to internalize these external costs by rewarding virtuous companies with better access to capital and punishing sinful ones with a higher cost of capital. By definition, this means that virtuous companies will earn a lower return than sinful ones.

Tariq Fancy, Blackrock's former CIO of sustainable investing, pointed out that **the fairy tale that ESG should improve investors' return ultimately hurts the movement's goals by focusing on "greenwashing" initiatives, rather than facing the complex and costly problems of pollution, corporate governance, and inequalities**.

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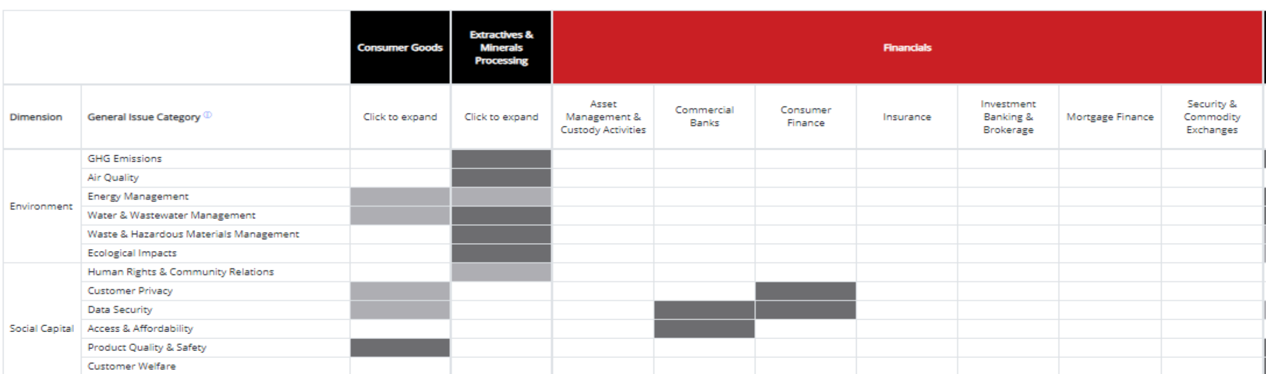
Can ESG Risk Be Measured?

Before making dubious claims about performance, ESG enthusiasts should ensure that their metrics are accurately measuring, and hopefully predicting, the nonfinancial risks which threaten stakeholders. Measuring ESG risk is an extraordinarily complex and burdensome task, partly due to the multiplicity of reporting standards and ratings. **Major reporting initiatives have been taken by at least seven institutions**: the UN Principles for Responsible Investing, the Global Reporting Initiative, the Sustainability Accounting Standards Board, the Carbon Disclosure Project, the SAM Corporate Sustainability Assessment, the Task Force on Climate-Related Financial Disclosure, and the Global Real Estate Sustainability Benchmark.

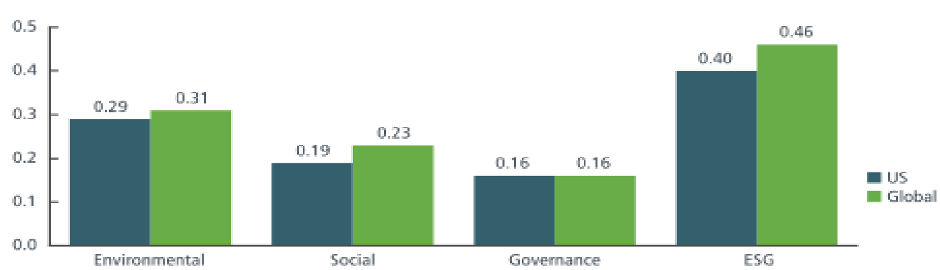
"To whom to report?" should be the easiest question. "What to report?" is the hard one. While GAAP accounting only attempts to provide a fair description of firms' operations in the past fiscal quarter, ESG investors are mostly concerned about future risks and "predictions are hazardous, especially about the future". SASB has developed a detailed industry-level [materiality map] and many of these discretionary choices can be debated. For example, the view that customer privacy and data security is not considered a material risk for asset managers and custodians was surprising to me, to say the least.



Source: [SASB]

Due to the proliferation of reporting standards and subjective differences in the assessment of what constitutes a material risk, ESG ratings are extremely dispersed. [Legg Mason] found that **the correlation between the four major ESG ratings was just 40% between 2012 and 2018.**

EXHIBIT 2: HISTORIC CORRELATION OF ESG RATINGS ACROSS UNIVERSE



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Second and most importantly, a high ESG rating does not always protect investors from catastrophic debacles, as illustrated by three recent high-profile scandals:

- BP changed its name to "Beyond Petroleum", invested heavily in renewable energy and was voted "the Most Accountable Company" by Accountability Rating in 2007. The 2010 Deepwater Horizon oil spill revealed disastrous flaws in BP's governance and risk management structure.

- In September 2015, Volkswagen was listed as "the most sustainable automaker in the world" by RobecoSAM. The emissions scandal showed otherwise two months later.

- PG&E had a better-than-average score for environmental factors and a better-than-average ESG rating from RobecoSAM and Sutainalytics just before the wildfires devastated entire Californian cities and the utilities' stock price.

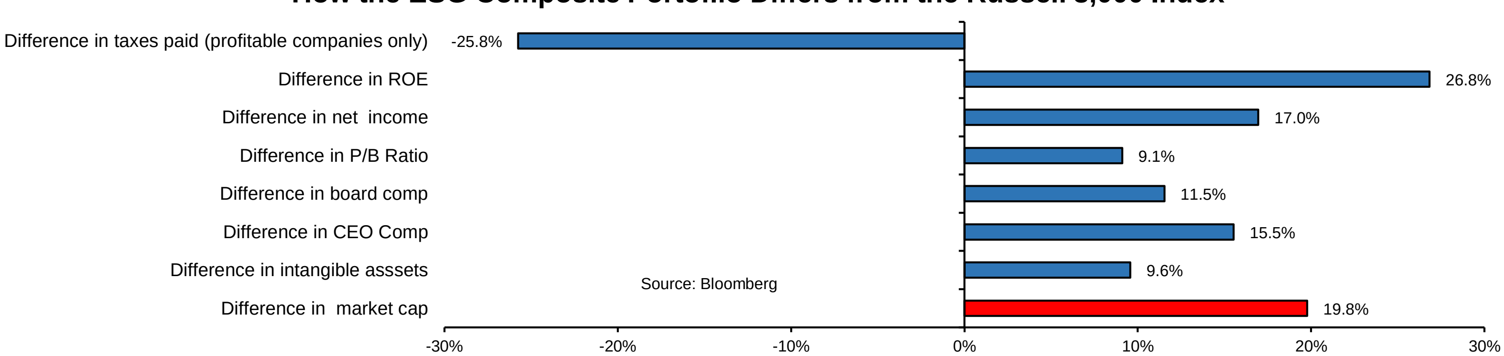
Each of these failures would deserve a much longer *post-mortem* analysis but a common element is **a bias towards "what is measurable" instead of "what is important"**. For example, environmental ratings reward somewhat insignificant initiatives such as recycling paper and strict travel policies for staff but fail to take into consideration the inadequate governance checks and perverse financial incentives which led to these three disasters.

Unintended Effects and Structural Flaws

ESG's Bias against Small Caps

Because ESG reporting is voluntary and fragmented, **ESG ratings tend to be biased in favor of large caps**. For example, the average capitalization in my ESG ETF composite portfolio is 20% larger than in the average Russell 3,000 company and 4% larger than in the S&P 500 index. Small companies, and especially private ones, do not have the time, capacity, or the incentives to disclose their ESG data. Since ESG scores generally reward data availability, ratings are mechanically skewed towards large caps. Furthermore, the practice of scaling emissions by market capitalization reinforces this bias: for example, Tesla benefits from its massive market capitalization and the fact that it sells relatively few cars.

How the ESG Composite Portoflio Differs from the Russell 3,000 Index



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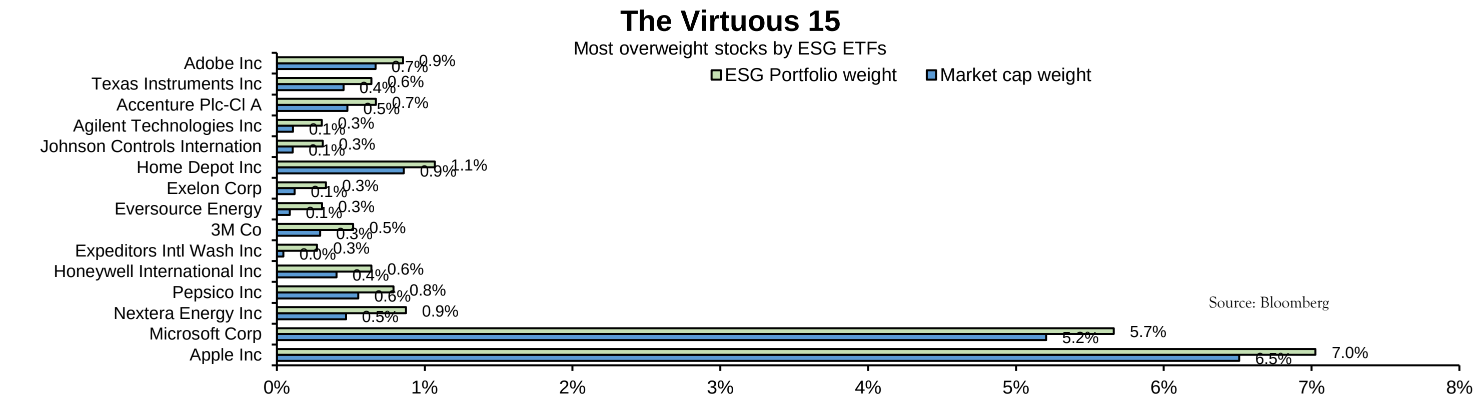
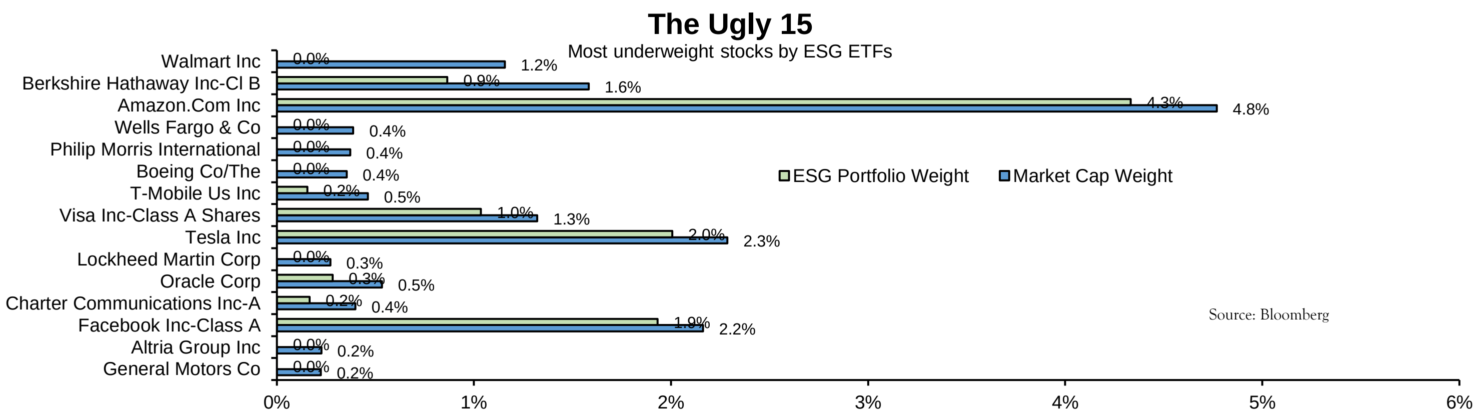
ESG's Bias Against Workers

The charts below shows the 15 most overweight and the 15 most underweight stocks in the ESG ETF composite portfolio, compared to these stocks' weights in the S&P 500 index. Unsurprisingly, Apple, Microsoft, and NextEra Energy dominate the list of virtuous stocks. On the other side of the virtue spectrum, stocks in problematic industries, such as Philip Morris, Altria, and Lockheed Martin are shunned entirely by ESG ETFs. So are "old economy" giants such as GM, Wells Fargo, and Walmart.

ESG funds' bias against worker intensive companies, which I described in "[ESG Investors Are Winning their Unintended War Against People]()" is also obvious: **the 15 virtuous companies employ just 1.9 million workers, against 5.1 million for the ugly 15.**





ESG's bias against workers is certainly unintentional, but it is a feature rather than a bug. **The more humans a firm employs, the more reprehensible behaviors will be committed**: robots and algos do not engage in sexual harassment, do not get injured on the workplace, and cannot be discriminated against. Second, many of the policies which are rewarded, such as community spending, covering gender re-assignment services and having a supplier diversity program are so costly than they can only be implemented by high-margin monopolies. As a result, **megacaps in the technology and healthcare sectors tend to have higher ESG ratings**. Job satisfaction will be a lot higher among small teams of highly-paid engineers and data scientists than among cashiers at Walmart and elderly care workers.

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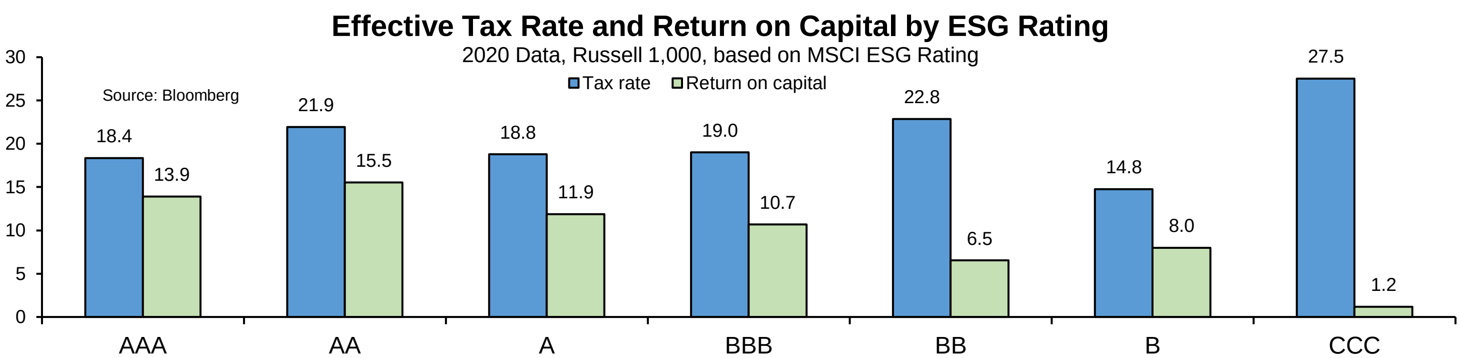
ESG's Problem with Taxes

The chart below, featured in "[the ESG Bubble: Saving the Planet, Destroying Societies]", shows firms' characteristics based on MSCI ESG ratings, which I used because of their transparency and wide coverage. (606 of the Russell 1,000 companies). Return on capital tends to be positively related to ESG ratings, which is consistent with the claim that **companies with a high ESG rating are generally better stewards of capital.**

More surprisingly, **there is an almost perfect inverse relation between companies ESG ratings and their effective tax rate**. CCC-rated companies pay an average of 27% in taxes, almost twice the rate paid by the virtuous AAA-rated group.



MSCI's ESG score is the result of 1,945 ESG metrics and I could only find five which were related to taxes. This seems consistent with my brief survey of the academic literature on the topic. The only paper[1] I found on the topic of ESG and tax avoidance acknowledged that paying taxes should be an important part of corporate social responsibility but did not explain how taxes are incorporated in ESG ratings – if at all.

Source: Bloomberg

Again, this bias is probably unintended but it is logical: the companies which rank highly in ESG metrics tend to be **globalized tech and healthcare monopolies with a small physical footprint, few employees, and a lot of intangible assets**. They can easily arbitrage differences in tax regimes between the many countries they operate in and reduce their tax liability via transfer pricing and by locating their intangible assets in the most favorable tax jurisdiction. Last but not least, shareholders started the ESG movement and SASB is funded solely by private donations (mostly Bloomberg and the big auditing firms). **Investors have a fiduciary duty to minimize their tax expense** so the problem can only be tackled by governments and regulators.

[1] J. Fonseca, *ESG Investing: How Corporate Tax Avoidance Affects Corporate Governance & ESG Analysis*, Illinois Business Law Journal, 2020

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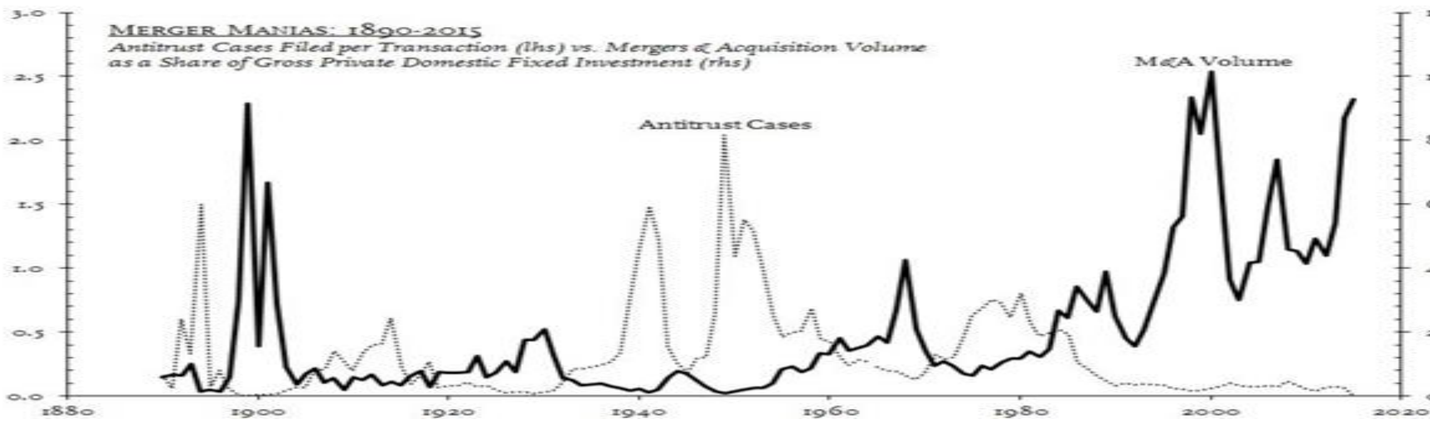
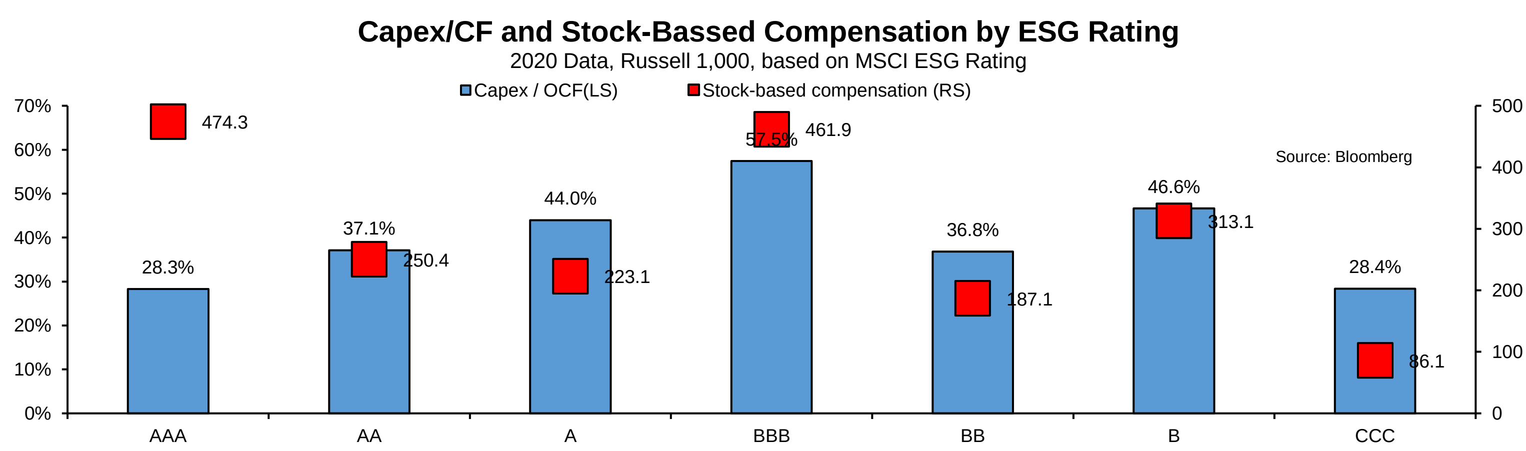
ESG and the Cartelization of the U.S. Economy

The two most eye-opening books I have read about the U.S. economy in the past decade were T. Philippon's ***The Great Reversal: How America Gave Up on Free Markets*** and D. Hearn & J. Tepper's ***The Myth of Capitalism: Monopolies and the Death of Competition***. These two books powerfully document **how every sector of U.S. economic life, from airlines to telecoms, healthcare to banking, and big tech to political lobbying, has become increasingly concentrated in the past 30 years.**



Source: *The Myth of Capitalism: Monopolies and the Death of Competition*

While I do not have access to the authors' data on industry concentration, the companies with high ESG scores (Microsoft, Apple, Visa, Mastercard, Intel, Morgan Stanley, Blackrock) usually have **high and resilient margins, well-compensated employees, and relatively low capital investments, which are signs of economic rents**. Big tech's preponderance in ESG funds can be seen as the highest stage of monopolistic capitalism. Big tech avoided antitrust enforcement as their "free" products enhanced consumer welfare (the litmus test for the FTC and the DOJ since the 80s), levered network effects to build unsurmountable moats, and abused NDAs and non-compete agreements to lock in employees and suppliers (see Apple vs Qualcomm): **the ESG movement gives these monopolies even more power by supplying them with cheap capital and restricting their competitors' investments**.



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Making ESG More Effective

ESG + Taxes + People + Competition?

ESG funds' bias in favor of tax-avoiding monopolies with relatively few workers could be easily fixed by minor tweaks in ESG ratings. Ratings could reward companies with a lot of workers, thus acknowledging that providing jobs is a public good in itself. I could not find anything on layoffs among MSCI's 458 social metrics, but it would be fairly easy to reduce the social score of profitable companies which engage in mass layoffs.

Similarly, **tax data is already reported in public filings so it could be incorporated as a separate category** (ESG+T?), acknowledging the basic reality that paying a fair share of taxes is the first step towards being a good corporate citizen and caring for the community.

Monopolistic behavior is a bit harder to measure but **ESG rating firms could use antitrust investigations and settlements for anti-competitive actions**. A high ratio of buybacks to capital expenditure could be treated as a sign of economic rent. I would also personally also favor **a negative score for political contributions and lobbying expenses** as a way to reduce rent-seeking activities by large monopolies.

The Necessary Role of the Government

The ESG movement should be lauded for starting the conversation and achieving significant results despite its limited means when most governments ignored these issues. But the problems which the ESG movement tries to tackle are ultimately about externalities and public goods and should be addressed by democratically-elected governments. In the words of A. Damodoran (2020):

"*For those whose primary concern is reducing the use of fossil fuels to combat climate change, the focus should be on electing officials who will enact laws consistent with those objectives. With the proper rules in place, companies can then go about the task of value maximization with worrying about social policy.*

Asking companies to bear the burden of being society's conscience is not only unfair, but it tilts the playing field in favor of the least socially conscious investors and companies. Put simply, if a subset of investors and companies play by ESG rules, investors in bad companies will earn higher returns than investors in good companies and bad companies will gain market share at the expense of good companies."

Managers and investors cannot really be blamed for doing their jobs of maximizing shareholder value. The ousting of Danone CEO E. Faber shows the difficulty of upholding noble commitments to "stakeholder capitalism" when the purpose of the corporation remains to maximize profits. Noteworthily, the shareholders who led the charge against E. Faber were all signatories of the UN's Principle for Responsible Investing, suggesting that money talks and generous proclamations of intent walk.

Similarly, it is delusory to expect shareholders to demand more taxation: the fight against tax evasion has to be led by governments, preferably in a globally-coordinated way.

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Last, the ESG movement could benefit from the help of courts in common law countries. There is enough evidence to suggest that ESG risk is indeed material and should be disclosed in a clear and transparent way to shareholders. At some point, the proliferation of sustainability reports and ESG promises will make it impossible for managers to maintain that these documents have no legal value. Ultimately, it is not FASB's opinions and recommendations but managers' fear of the SEC and the realization of their legal liabilities which led them to adopt and respect GAAP standards.

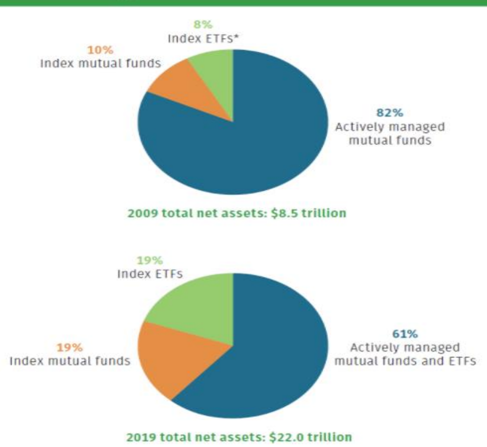
ESG Investing Is Inherently Active

While I believe that the big 3 index fund families' (Vanguard, Blackrock, and State Street) commitment to ESG is genuine, their business models are based on blindly following indices and minimizing costs. Asking passive investors to make capitalism moral again is like having an arsonist run the fire department. **Blackrock, which owns about 10% of every U.S. stock, has only 45 professionals in its investment stewardship team**.

These firms would respond that it is more efficient to hire proxy advisors such as Institutional Shareholder Service or Glass Lewis, but these two relatively small firms cannot complete such an immense task alone: for example, as of June 2017, the ISS Global Research team covered 40,000 shareholder meetings (about 250,000 votes) with 270 research analysts[2].

Proxy advisors and by extension the investors who rely on them focus on "low-cost / low value voting", which does not require much research: they typically vote for independent directors, splitting the roles of CEO and board chairman and against poison pills and multiple-class share structure. This check-list approach may reduce governance risk but it is unlikely to move the needle on the complex issues that the ESG movement aims to solve.

FIGURE 2.8
Index Funds Have Grown as a Share of the Fund Market
Percentage of total net assets, year-end



Source: Bloomberg

*This category includes a small number of actively managed ETFs.
Note: Data for ETFs exclude non–1940 Act ETFs. Data for mutual funds exclude money market funds.

Last but not least, **proxy advisors, index providers, and ETF issuers are also profit-maximizing entities with a fiduciary duty to their shareholders**. For example, S&P Global and MSCI are paid a percentage of the assets which track their indices and thus have a financial incentive to make sure that big popular stocks such as Apple and Microsoft are included in their ESG indices. When Blackrock "takes a tough line with HSBC over climate change", how does it balance the interests of HSBC's shareholders with demands of activist funds which may be its clients, and the desire to appeal to a new generation of values-driven investors?

Just as war is too important to be left to the generals, **the future of the planet is too crucial to be left to a small oligopoly of index funds, rating agencies, and proxy advisors.**

[2] B. Sharfman, *The Risks and Rewards of Shareholder Voting*, SMU Law Review, Vol 73, Issue 4, 2020

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Redefining the Corporation and Modernizing Corporate Governance

Most ESG issues ultimately lead to philosophical questions on the purpose of the corporation and the role of shareholders. The results of the private sector-driven ESG movement will be limited as long as corporations' "one and only one social responsibility of business is to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[3]

Either the heavy hand of government must change the rules of the game so that external costs are internalized via regulation and taxation, or the definition of the firm must evolve. **Changing legislation so that firms also have a general responsibility towards their employees, communities, and the environment would then allow courts to start treating sustainability reports and ESG commitments as legally-binding documents, rather than empty promises**.

Second, the general principles of corporate governance have not fundamentally changed since the birth of the modern corporation in the late 18th century. The current model is closer to (hopefully) "enlightened autocracy" than true shareholder democracy but shareholders are demanding a greater role. For example, institutional investors' revolt against excessive compensation packages for executives has led many governments to pass "Say on Pay" legislation. London Business School's Edmans and Gosling have suggested introducing a "**Say on Purpose" which would allow investors to ratify management's statements on purpose and monitor their implementation**.

The rise of a new generation of values-driven tech-savvy retail investors should be an opportunity to revise these standards: shareholders want to be consulted on more than dividend policy, mergers, and board composition.

How could we reconcile the structural (and generally positive) rise of index funds with the ambition of enlarged, direct, and proactive shareholder democracy? Maybe index fund providers should allow their investors to vote on ESG-related issues, or forfeit their votes? Maybe voting rights could be weighed by tenure to reward long-term shareholders? Maybe the next RobinHood will succeed not by offering "commission-free gambling" but by giving responsible investors a say in the governance of the companies they own?

[3] Milton Friedman, "*The Social Responsibility of Business is to Increase Its Profits*." Ethical Theory and Business 8th Edition, ed. by Tom L. Beauchamp, Norman E. Bowie, and Denis G. Arnold (New Jersey: Pearson, 2009.).

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