SOUNDING GOOD OR DOING GOOD: A SKEPTICAL LOOK AT ESG

Morality plays in markets!
Buzz Words and Magic Bullets!

- In my four decades in corporate finance and valuation, I have seen many "new and revolutionary" ideas emerge, marketed as the solution to all of the problems in business decision making.
- Most of the time, these ideas represent either a repackaging of existing concepts, with a healthy dose of marketing and selling, usually by consultants and bankers, and their magic fades quickly once their limitations come to the surface, as they inevitably do.
- The latest entrant in this game is ESG (Environmental, Social and Governance), and the sales pitch is wider and deeper. Companies that improve their social goodness standing will not only become more profitable and valuable over time, we are told, but they will also advance society's best interests, thus resolving one of the fundamental conflicts of private enterprise, while also enriching investors.
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.
ESG Services disagree...

Average, minimum, and maximum correlations across providers
Even on high profile companies...
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.

How does the market price the consequences of ESG?
- Price overadjusts to value change.
- Price correctly reflects value change.
- Price underadjusts to value change.

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

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

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

The "It Proposition": For "it" to affect value, "it" has to affect either the cash flows or the risk in those cashflows.
The Good shall be rewarded

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

- **Customers will buy more from "good" companies: Higher revenue growth**
- **Operating expenses higher in short term, but go back down in long term: Unchanged or even higher margins.**
- **Capital invested in good businesses will deliver higher returns: Higher sales/capital and returns on capital**

**Revenue Growth**
Function of the size of the total accessible market & market share

**Operating Margins**
Determined by pricing power and cost efficiencies

**Growth/Investment Efficiency**
Measure of how much investment is needed to deliver growth

**Higher Value**

**Value of Business**

**Risk-adjusted Discount Rate**

**Expected FCFF = Revenues * Operating Margin - Taxes - Reinvestment**

**Cost of Equity**
Rate of return that equity investors demand

*Investors will prefer to invest in "good" companies, pushing up their stock prices: Lower cost of equity*

**Cost of Debt**
Cost of borrowing money, net of tax advantages

*Lenders will lend at lower rates to good companies. Governments may provide subsidized debt: Lower cost of debt*
The Bad shall be punished

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

- Customers will buy less from bad companies: **Lower or negative revenue growth**
- Revenue Growth: Function of the size of the total accessible market & market share
- Operating expenses lower in short term, but higher in long term: **Unchanged initially, but lower margins in long term.**
- Operating Margins: Determined by pricing power and cost efficiencies
- Capital invested in good businesses will deliver lower returns: **Lower sales/capital and returns on capital**
- Growth/Investment Efficiency: Measure of how much investment is needed to deliver growth

**Lower Value**

- **Expected FCFF = Revenues * Operating Margin - Taxes - Reinvestment**
- **Risk-adjusted Discount Rate**

**Value of Business**

- **Failure Risk**: Chance of grievous or catastrophic event putting business model at risk.
- Bad companies are more exposed to big, negative event (crisis): **Higher failure risk**

**Cost of Equity**
- Rate of return that equity investors demand
- Investors will pull money out of “bad” companies, pushing down their stock prices: **Higher cost of equity**

**Cost of Debt**
- Cost of borrowing money, net of tax advantages
- Lenders will balk at lending to bad companies, demanding higher interest rates: **Higher cost of debt**
The Bad Guys win: Hell on Earth?

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

- **Bad companies outperform good companies.**
- **Revenue Growth**
  Function of the size of the total accessible market & market share

- **Operating Margins**
  Determined by pricing power and cost efficiencies

- **Bad companies, with fewer constraints, invest more efficiently:** Bad companies reinvest more efficiently

- **Expected FCFF = Revenues * Operating Margin - Taxes - Reinvestment**

- **Value of Business**

- **Risk-adjusted Discount Rate**

- **Cost of Equity**
  Rate of return that equity investors demand
  Bad companies report higher earnings & have higher stock prices: Bad companies have lower costs of equity

- **Cost of Debt**
  Cost of borrowing money, net of tax advantages
  Lenders lend based upon earnings/cashflow & bad companies look safer: Bad companies have lower costs of borrowing.
Value and ESG: The Evidence

- **A Weak Link to Profitability:** There are meta studies (summaries of all other studies) that shine summarize hundreds of ESG research papers, and find a small positive link between ESG and profitability, but one that is very sensitive to how profits are measured and over what period. 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.

- **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.

- **And 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, either in human or 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.
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.
Why returns to ESG are tough to read...

<table>
<thead>
<tr>
<th>Value Effect</th>
<th>Market Pricing</th>
<th>Investor Returns to ESG</th>
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<tbody>
<tr>
<td>ESG increases value</td>
<td>Markets overreact, pushing up prices too much</td>
<td>Negative excess returns for investors in good ESG firms.</td>
</tr>
<tr>
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<td>Positive excess returns for investors in good ESG firms.</td>
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<td>Markets react correctly, with prices increasing to reflect value.</td>
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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.
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), but have to adopt a more dynamic strategy built around either aspects of corporate social responsibility that are not easily measured and captured in scores, 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 COVID effect: ESG Fund Flows

Sustainable Funds Estimated Annual Flows

The COVID effect: ESG Returns

Sustainable Equity Funds: YTD Return Rank By Morningstar Category Quartile

<table>
<thead>
<tr>
<th>Quartile</th>
<th>1/1/20-6/30/20 Return Rank Category</th>
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With some pushback

- 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, provided no added payoff during the down period of the crisis (February and March 2020) and pushed returns down during the recovery phase.

- If success in active investing is defined as attracting investor money, ESG has had a successful run during COVID, but if it is defined as delivering returns, it is far too early to be doing victory dances in the end zone.
To conclude..

- In many circles, ESG is being marketed as not only good for society, but good for companies and for investors. In my view, the hype regarding ESG has vastly outrun the reality of both what it is and what it can deliver, and the buzzwords (sustainability, resilience) are not helpful.

- Much of the ESG literature starts with an almost perfunctory dismissal of Milton Friedman’s thesis that companies should focus on delivering profits and value to their shareholders, rather than play the role of social policy makers. The more that I examine the arguments that advocates for ESG make for why companies should expand mission statements, and the evidence that they offer for the proposition, the more I am inclined to side with Friedman.

- The ESG bandwagon may be gathering speed and getting companies and investors on board, but when all is said and done, a lot of money will have been spent, a few people (consultants, ESG experts, ESG measurers) will have benefitted, but companies will not be any more socially responsible than they were before ESG entered the business lexicon.