ESG: The good, the bad and the ugly, or just the bad and the ugly?

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According to PwC, it is estimated that globally about US$18-trillion is invested in firms that follow ESG principles. In the United States, in particular, 2021 was a very good year for ESG funds as their assets under management increased by 35 per cent over the previous year. ETFs following these environmental, social, and governance principles have been the fastest growing segment in the ETF space in the past few years.

But is the trend toward ESG-type investing a fad that will go away or a Trojan horse undermining the capitalist system and hurting investors, companies, and the economy? For example, the ESG craze and fear of regulations in recent years, and ensuing underinvestment in the oil and gas industry, have shifted not only the oil price dynamics, but also that for all commodities. Mining companies are returning capital to investors rather than investing to increase production out of fear of ESG regulations. This implies major shortages in metals down the road at a time when demand will be increasing due to renewable energy and electric vehicle production.

It makes sense to ask at this point, what is a CEO's primary role: is it to prioritize financial factors or prioritize social or environmental concerns? Corporate directors owe their duty to the corporation, and that is to maximize corporate profits, and not any other stakeholder, says the Supreme Court of Canada.

Pushing corporations and fund managers toward ESG, ESG ratings and other criteria may destroy shareholder value in light of the upfront costs of many ESG strategies, such as reporting, legal, staff training and compliance costs, as well as the new

regulatory requirements that introduce additional costs to the ESG fund management process.

It is true that the *raison d'être* of ESG ratings is that investors are not able to assess the ESG risk of a company by themselves and so we need ESG rating agencies. But does anyone really know what an ESG score is or means? There are a lot of raters using different inputs and methodologies in computing ratings, as well as a lack of common ESG standards and definitions around the globe. And so, how reliable are the ESG scores and do they correspond to actual compliance with ESG principles? A study at Columbia University and London School of Economics found that the compliance of firms with higher ESG scores was no better than that of firms with low ESG scores.

The key questions though remain: Do ESG based investments make money? And how do ESG factors affect the investment process? Answering these questions is not easy as the measurement of ESG ratings is very complex, and there is a lot of disagreement among ESG rating agencies about the proper way (if any) to measure ESG performance, as well as differences in ESG ratings provided by different ESG rating agencies. Methodologies differ because there are different ways that ESG rating agencies choose and aggregate ESG attributes, and in measuring these attributes. As a result, there is a lot of noise in the relationship between ESG scores and stock returns.

Many academic studies have investigated the relationship between ESG ratings and stock returns. They offer no conclusive evidence that investments that are based on ESG criteria outperform those that are not. Some studies find that good ESG performers earn higher stock returns while other studies report the opposite. Even those academics who find support for high ESG performance leading to higher returns report that the economic magnitude of a higher ESG rating is quite small and may not justify relocation of an existing portfolio and the incurrence of transaction costs. And yet other studies stress that it is important not to confuse expected and realized stock returns and argue that the expected stock returns of high ESG performers are low.

While research shows that ESG performance does not affect cash flows, ESG ratings do improve the quality and quantity of information available about the company. This reduces the risk that is associated with investing in the specific company. But if this is the case, this risk is diversifiable. Namely, it will not make a difference in a well-diversified portfolio and hence will have no impact on valuation. Indeed, there is only weak evidence that markets incorporate ESG into pricing.

At the end of the day, it seems to me, given the lack of hard evidence in favour of ESG investing, what drives ESG growth is simply the potential for consultants, bankers and investment managers to make money, as well as the fact that ESG funds normally carry higher margins. And as a 2020 study by Damodaran (NYU) and Cornell (UCLA) concludes "a lot of money will have been spent, a lot of people (consultants, ESG experts and ESG measurers) will have benefited, but companies will not be any more socially responsible than they were before ESG was invented."

This realization may have started to gain some ground, leading to some backlash: In 2022, for example, there has been a sharp decline in inflows in ESG funds, which fell by 70 per cent over the previous year. There was also a 60-per-cent decline in the number of new funds, according to Morningstar.

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