Socially responsible investing can be like searching for fool's gold

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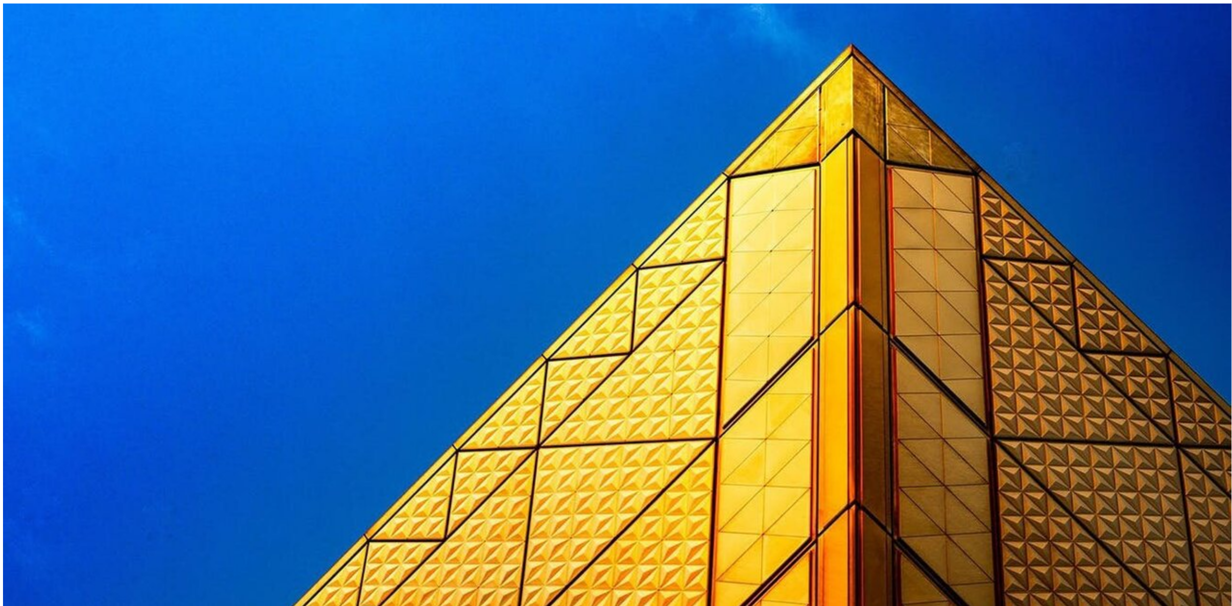

Many companies claim they're socially and environmentally responsible and attract investors who value strong corporate environmental, social and governance policies. But is it true? Credit: Takaharu Sawa/Unsplash

Investors are pushing companies to develop environmental plans, consider the social impacts of their operations and improve the integrity of how they are governed to ensure that women, workers and all stakeholders are fairly represented.

In other words, environmental, social and governance policies —ESG

for short —are now important business considerations.

ESG proponents argue that when companies place importance on reducing their carbon footprint, emphasizing workplace management or improving board diversity, they are doing good business that will generate greater long-term financial returns for their investors.

ESG investors base their objectives on achieving competitive financial returns along with one or more of the following:

- The belief that ESG principles can help companies contribute to investment returns through long-term value creation.
- Their values are consistent with the investments they hold. For example, those with strong views against nuclear energy will not invest in any mining or utility company involved in nuclear power.
- Investments should make a positive impact on the world. Extending the previous example, an ESG investor would buy shares in green energy companies, ultimately wishing to see those companies replace carbon-based energy sources.

How successful are ESG investors?

If ESG projects impact business performance, then it stands to reason that they should help drive financial returns. Many academic and industry studies have looked into this, however, and there is no conclusive evidence that ESG investing leads to superior returns for investors.

There is, however, evidence that ESG stock portfolios using negative screens (for example, by eliminating questionable companies such as tobacco producers or gun manufacturers) produce lower returns.

Finance theory shows that a well-diversified portfolio reduces risk without affecting returns. Eliminating stocks, especially entire industries, from a portfolio leads to a less diversified portfolio and therefore higher risks with the same return, or lower returns with the same risk. There is also evidence that morally questionable companies, divested by ESG investors, see their stock prices initially fall, but earn higher returns for their non-ESG investors going forward.

Studies also suggest that stock prices do not fully reflect the value of intangible assets, which include sustainability initiatives. In this case, ESG investors that identify such intangible assets and buy those undervalued stocks should logically earn superior returns once the market recognizes the stock's true worth and efficiently values those assets into the company's stock price. Research indicates this occurs to some degree.

How to determine ESG measures

There is concern within the investment community that there is no standard definition of what comprises ESG measures. Take the case below. There are two lists, with data from Capital IQ. One is the 10 largest investments in a large, established American ESG mutual fund, while the other is the largest 10 companies in the S&P 500 index. Which list, A or B, represents the ESG fund?

List A	List B
Microsoft	Apple
Apple	Microsoft
Amazon.com	Amazon.com
Visa	Alphabet
Danaher Corp.	Facebook
Adobe	Berkshire Hathaway
BlackRock	Visa
Thermo Fisher Scientific	Johnson & Johnson
Fidelity National Info Services	Walmart
Bank of America	JPMorgan Chase

List AList BMicrosoftAppleAppleMicrosoftAmazon.comAmazon.comVisaAlphabetDanaher Corp.FacebookAdobeBerkshire HathawayBlackRockVisaThermo Fisher ScientificJohnson & JohnsonFidelity National Info ServicesWalmartBank of AmericaJPMorgan Chase

You can forgive yourself if you had difficulty choosing the correct list. It's list A.

Four of the ESG mutual fund's top 10 holdings are the same as the S&P 500 index's top 10 holdings. In another example, a well-established Canadian ESG fund includes Suncor Energy, the largest oilsands

producer, as one of its top investments.

Well-known financial services firms such as MSCI, S&P Global and FTSE Russell rate companies for their handling of ESG issues. It is big business. Portfolio managers then use those ratings to identify which firms should be considered for their ESG portfolios.

In 2018, MSCI ranked electric car-maker Tesla No. 1 in ESG for auto manufacturers, while FTSE Russell ranked Tesla last on its ESG auto ratings. This is an example of how subjective these ratings are. The obvious problem is that it leaves investors in the dark about whether Tesla is in fact an ESG-positive company.

Recently, the U.S. Securities Exchange Commission announced it has launched an investigation and "… wants to know whether money managers are engaging in false advertising by saying funds are devoted to doing good when the reality is much murkier," according to Bloomberg.

Unintended consequences

To the extent that companies successfully carry out their ESG plans, positive environmental or social outcomes can occur. There may, however, be unintended consequences.

Vincent Deluard, a director at INTL FCStone Inc., a financial advisory firm, found that companies that are likely to do well on ESG scores typically produce more revenue and higher profit margins with few employees, are often found in higher human capital sectors such as health care or information technology.

Shareholders may get rich with these companies, but they do little to improve the lot of the average hourly wage earner. He writes: "ESG

investing was originally designed as a response to the flaws of capitalism, as a way to turn the profit motive in a force for good. However, ESG filters (unintentionally) reward the greatest illnesses of post-industrial societies: winner-take-all capitalism, monopolistic concentration, and the disappearance of jobs for normal people."

The average market capitalization per employee of the 10 ESG stocks (in List A above) is US$6.4 million per employee, while the S&P 500 company average is US$3.6 million. While this is simply anecdotal evidence, it is consistent with Deluard's findings.

Is investing for competitive financial returns based on ESG principles like searching for fool's gold? We can say the intent is noble, and the actions are sincere, but the execution is simply not developed enough to deliver the types of benefits socially responsible investments claim to deliver.

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