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The ESG performance paradox

ESG is such a broad concept that it risks becoming an excuse for fund managers to underperform their benchmarks while also charging higher fees

By Jordan N. Boslego

THE United States Department of Labor's (DOL) recent actions have cast a spotlight on the curious logic underpinning the case for environmental, social, and governance (ESG) investing.

More than 8,700 commenters wrote in July 2020 largely to condemn a new rule proposed by the DOL that would limit the ability of most employee retirement plans to select investments based on ESG factors. But the DOL's move is well-founded, and it's not surprising that many of the scathing critiques, accusing the DOL of everything from perpetuating racism to submitting to political interference, came from active fund managers.

The truth is, ESG is such a broad and haphazard concept that without strong fiduciary standards, it risks becoming a convenient excuse for those same fund managers to underperform their benchmarks while also charging higher fees.

ESG proponents often spin a win-win narrative, wherein corporate behaviour aligned with certain values and practices also leads to better financial outcomes and investment performance.

Yet like all complex issues, the reality is not so clear: Difficult decisions frequently arise when balancing the objectives of financial gain and social responsibility.

Psychologist Philip Tetlock terms uncomfortable situations like these as "taboo trade offs" – whether we admit it or not, socially responsible investment choices will sometimes come at the cost of financial returns. At the crux of the DOL's intervention is whether it is appropriate for plan sponsors to attempt to make those trade-offs on their beneficiaries' behalf.

The upshot: In the coming months, ESG integration practices could become the newest battleground in the growing tsunami of Employee Retirement Income Security Act (ERISA) breach lawsuits against fiduciaries.

The argument that ESG factors lead to better long-term performance outcomes is much harder to prove than we might imagine. Academics have found a surprisingly low correlation between ESG ratings across providers. In other words, experts can't even agree on which firms have solid ESG credentials in the first place.

Part of the problem is that the ESG umbrella encompasses so many different issues, whose salience is continually shifting.

So-called sin stocks such as tobacco and defence – which, incidentally, have beaten the broader market over the long term – were the original ESG castaways. Then for most of the last decade, ESG became nearly synonymous with combating climate change and measuring carbon footprints. Today, firms and investors are racing to compile metrics and scorecards on diversity and inclusion, which have rapidly moved to the top of the ESG agenda.

Let's assume for a moment that these measurement issues and taboo trade-offs didn't exist, that ESG exposures could be accurately identified and exerted a positive impact on corporate financial performance.

A second and even more difficult question then arises: To what extent is this information already incorporated into asset prices?

For most of the last decade, ESG became nearly synonymous with combating climate change and measuring carbon footprints. Today, firms and investors are racing to compile metrics and scorecards on diversity and inclusion, which have rapidly moved to the top of the ESG agenda. PHOTO: EPA-EFE

If ESG credentials are already priced into stocks, then the best investment strategy may actually be to buy the worst performers on ESG measures. To see why, consider that private equity firms don't seek out the best-run companies to acquire. Rather, they often target firms with serious operational problems because those companies have the largest potential value uplift if improved.

Likewise, today's ESG "laggards" are likely to face increasing pressure to reorient and improve themselves over time. If improving ESG credentials indeed augur better financial results, then these laggards could prove the best investments at today's prices.

This is another reason that structuring investments around strong ESG performance could have adverse financial consequences.

Fast forward to the long run – which economists are quick to point out never arrives – and assume that there's no more adaptation, and firms have all reached their steady-state ESG statuses. Even then, we would still expect firms with poor ESG credentials to outperform on average. Financial theory states that in order to bear the financial risks (and social stigmas) of holding these firms, investors would require higher returns.

That's the flipside of the argument that embracing ESG can lower a firm's discount rate: The lower the capital costs to the firm, the lower the rewards to its capital providers.

In sum, the DOL should not bow to criticism from vested interests for simply doing its job and attempting to ensure that workers attain the financial security they need to retire comfortably.

If ESG proponents are so confident in the win-win impact of ESG on performance, they should have no qualms with a regulatory requirement that this relationship actually be true.

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