



# CAPITAL IDEAS

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## Environmental, Social and Governance (ESG) Undermines the Social Responsibility of Businesses and Investment Managers

BY WAYNE WINEGARDEN

The concepts behind Environmental, Social, and Governance (ESG) investing and management are the latest theory trying to address a long-standing question: What is the appropriate social function of a business? This question predates Milton Friedman’s 1970 *New York Times* piece “The Social Responsibility of Business Is to Increase Its Profits,” but this article provides a useful benchmark for examining whether ESG adds value. According to Friedman,

*there is one and only one social responsibility of business—to use its 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.<sup>1</sup>*

A great deal of confusion surrounds this so-called Friedman Doctrine. It is not a paean to corporate greed, nor does it claim that “greed is good” – that framing is an inaccurate Hollywood caricature. Instead, the position recognizes that businesses fulfill an essential social role in society by ensuring that individuals and families have access to the goods and services they need or desire in the manner they want it produced. Performing this social function well is the key to prosperity, and profits are essential for performing this function efficiently.

For instance, the McKinsey Global Institute conducted a study of thirteen nations that documented the importance of consumer-oriented businesses in practice.<sup>2</sup> The study found that prosperous nations were more productive than poorer nations, which is a well-documented phenomenon. Interestingly, the nations with the most undistorted competition in product markets, such as the United States, were the ones with the highest levels of productivity.

Put differently, businesses operating in competitive markets and adhering to the Friedman doctrine will consistently strive to improve their products, streamline their production processes, and find better ways to serve their customers. The historical record demonstrates that this profit maximizing competitive process is the most efficient way to provide the social good of widely shared prosperity.

If generating prosperity is the core social role of businesses, then ESG adds value – either as an investment strategy or a management philosophy – depending on whether it enhances or detracts from businesses’ ability to fulfill this primary social function. The evidence clearly demonstrates that ESG detracts from businesses ability to serve this primary social function.

## **ESG INVESTING CREATES ADDITIONAL RISKS AND UNDERPERFORMS COMPARABLE NON-ESG ALTERNATIVES**

Many studies examining ESG’s impact on investment corporate profitability document that ESG investments underperform, and ESG-related proxy measures often harm financial returns.

- A 2002 study by Tracie Woidtke in the *Journal of Financial Economics* examined the impact from activist public pension funds on the market values of a sample of Fortune 500 companies.<sup>3</sup> Her results illustrate that increased shareholder activism by public pension funds is negatively correlated with stock returns. Particularly noteworthy, the firms receiving proposals from activist public pension funds promoting social agendas were valued 14 percent lower than similar companies without such agendas.
- Global index provider Scientific Beta “analyzed the performance data of all US equity ETFs classed as ESG or ‘socially responsible.’ These ETFs are domiciled in North America or Europe, and the analysis covered the period from 2012 to the end of 2022. Scientific Beta found that the average annual return for ESG ETFs was 0.2 percentage points lower than for comparable non-ESG ETFs. Although ESG ETFs outperformed by a margin of 4.2 percentage points in 2020, this was an anomaly, and such outperformance was not consistently delivered over the long term.”<sup>4</sup>
- A forthcoming paper in the *Review of Accounting Studies* found that “ESG funds appear to underperform financially relative to other funds within the same asset manager and year.”<sup>5</sup> The study also found that ESG funds charge higher fees, which are a major obstacle harming returns for average investors.
- A study in the *Journal of Portfolio Management* found that “the cost of socially responsible investing is substantial.”<sup>6</sup>
- A study by the Center for Retirement Research at Boston College found that socially responsible funds significantly under-performed their benchmarks and concluded that public pension funds are not suited for social investing.<sup>7</sup>
- A study by The Journal of Finance, which examined 20,000 mutual funds with a collective \$8 trillion in assets, funds rated highly for ESG factors did not outperform those rated poorly.<sup>8</sup>

ESG investing raises other concerns as well. As documented by Winegarden (2019), in addition to underperforming investment benchmarks, ESG funds tend to have levy higher management fees and bear larger risks.<sup>9</sup> These funds are riskier because they allocate a larger share of their portfolios toward their top holdings than broad-based investment funds. Less investment diversity inflates performance if these stocks are rising but is devastating when their performance lags.

Despite its frequent use, ESG is also a vague and broad concept that limits the applicability of many ESG strategies. For instance, due to ESG’s vagaries, there is a wide divergence in ESG investment strategies. Some funds simply refuse to invest in certain industries. Others will only invest in companies that meet specified

ESG criteria. Often, investment strategies that only invest in companies that meet a pre-specified ESG criteria are inappropriately justified based on the results of ESG funds that simply refuse to invest in select industries (e.g., firearm manufacturers). Such inapplicable justifications create unknown risks for investors in ESG funds or the beneficiaries of pension funds investing in ESG strategies.

The problems created by ESG's opacity are even greater. Due to the broad number of topics covered by ESG, one organization's ESG star is another's laggard. For example, raising the minimum wage paid to some arbitrary level (say \$15 an hour) is a typical goal of ESG proponents. But what if that same company does not minimize its impact on greenhouse gas emissions? An ESG fund that emphasizes governance could rate this company highly whereas an ESG fund that emphasizes a company's environmental impact could rate it poorly. Under these conditions, it is unclear how an investment manager should determine whether the company is ESG compliant or not.

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Also concerning, many ESG funds do not actually execute on their stated strategy. For instance, a 2019 *Wall Street Journal* article found that, compared to non-ESG funds, the portfolios of several ESG funds held a larger share of bonds issued by Saudi Arabia – a country with large oil interests and a terrible human rights track record.<sup>10</sup>

## **ESG CREATES UNKNOWN AND POTENTIALLY HIDDEN RISKS**

Another oft-ignored concern is that many of the risks associated with ESG funds are typically hidden from fund investors and beneficiaries. Take investments into alternative energy technologies – an industry that is often an ESG investment priority. These funds are assuming investment risks that the current alternative technologies will flourish, and that fossil fuel consumption will decline.

This assumption is feasible. The International Energy Agency's (IEA) Sustainable Development Scenario, for instance, foresees a large drop in the demand for fossil fuels and provides a sense of the potential economic outcome should demand fall as activists expect.<sup>11</sup>

However, declining future demand for oil is far from certain and there are sound arguments supporting a forecast of growth in fossil fuel demand for the foreseeable future. Oil currently fuels around one-third of the world's energy needs and is an irreplaceable component in thousands of consumer products.<sup>12</sup> While it is possible that viable alternatives will pan out, it is also possible that none of them will. Even if the technologies pan out, these new innovations must experience dramatic growth to meaningfully impact the demand for fossil fuels, which is far from certain.

The viability of future electric vehicle (EV) sales is also uncertain. EVs are supposed to be a major displacer of oil demand, yet, as Goldman Sachs has noted, sales are flagging and “the team's bear case for EV sales is becoming more likely.”<sup>13</sup> There are also other barriers standing in the way of an EV revolution that include insufficient supplies of the necessary rare earth elements.<sup>14</sup> Without these materials, it is technologically impossible to physically build the necessary number of EVs. The shortage of EVs will mean that sales of traditional internal combustion engine automobiles will remain robust, as will oil demand.

There are also unknowns regarding whether consumers will accept EVs. According to the head of Ford UK, most people are “still concerned about a number of things - range, the charging infrastructure, the lack of

information available to customers and obviously the price as well.”<sup>15</sup> Unless consumers embrace EVs more wholeheartedly, the IEA’s declining oil demand scenario is unlikely to come to pass.

Obstacles to the development of alternative energy are not just applicable to EVs either. Similar market obstacles exist for the alternative electricity generation technologies, the replacement for fossil fuel-based plastics, and the thousands of other products that use or are derived from fossil fuels.

Then there is the problem of how future emissions targets will be achieved. The typical assumption is that countries will meet lower emissions goals by transitioning away from fossil fuels. But this is also an assumption. Another way that global emission goals can be met is through carbon capture and sequestration, or other technologies that reduce emissions from fossil fuels. Meeting the targets through these technologies could mean that global emissions will be declining, but fossil fuel use may not be – it could even be increasing.

All these unknowns create risks for ESG investors; however, these risks are rarely expressed by ESG advocates. Importantly, investment managers assuming these risks in pursuit of non-financial goals are violating their fiduciary responsibility – private pension fund managers are not acting “solely in the interest” of the plan beneficiaries as the Employee Retirement Income Security Act of 1974 (ERISA) requires.

## **ESG RAISES ADDITIONAL CONCERNS FOR PRIVATE AND PUBLIC PENSION FUNDS**

Providing a secure retirement is not just the primary social responsibility of pension funds. As Supreme Court Justice Benjamin Cardozo noted, it is also their legal responsibility under ERISA. In recognition of the ERISA concerns ESG raises, the Department of Labor, which oversees private pension funds, issued a Field Assistance Bulletin in December of 2020.<sup>16</sup> This Bulletin reiterated the department’s policy that “a fiduciary may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals.”<sup>17</sup> It is also noteworthy that the DOL’s concerns are long-standing. As cited in Munnell and Chen (2016), “in 1980, a key DOL official published an influential article warning that the exclusion of investment options would be very hard to defend under ERISA’s prudence and loyalty tests.”<sup>18</sup>

As this opinion correctly notes, options have value. Limiting the investment opportunities based on ESG criteria eliminates options and, therefore, imposes costs on pension funds. Munnell and Chen (2016) raises similar concerns with respect to public pension funds stating, “that although social investing may be worthwhile for private investors, lower returns and fiduciary concerns make public pension funds unsuited for advancing ESG goals.”<sup>19</sup> SEC Commissioner Hester Peirce echoed these concerns in remarks at the 2018 Annual SEC conference,

*It may be useful to pause here and clarify an important point. If an individual wants to invest in companies that align with her moral beliefs, that is fine. An individual investor is certainly free to make trade-offs to risk lower returns for whatever other interest she may have. Nor is there a problem with certain funds pursuing stated social interest goals. Many such funds exist. Assuming they have disclosed their objectives as a part of their investment strategies they not only may, but must pursue the ESG guidelines they have set for themselves. Such funds have proliferated in recent years, and investors seeking to apply ESG standards to financial interests will find many options available to them. I am not taking issue with these arrangements as long as ESG investors do not force the companies in which they invest to take steps that harm the company’s long-term value.*

*The problems arise when those making the investment decisions are doing so on behalf of others who do not share their ESG objectives. This problem is most acute when the individual cannot easily exit the relationship. For example, pension beneficiaries often must remain invested with the pension to receive their benefits. When a pension fund manager is making the decision to pursue her moral goals at the risk of financial return, the manager is putting other people's retirements at risk.<sup>20</sup>*

Unlike individual investors, pension funds represent thousands of individual investors who cannot choose the pension fund that is investing on their behalf. If you work for a specific employer, then your retirement savings will be invested on your behalf by the investment managers chosen by your employer. You have no choice.

Some workers will agree with specific ESG policies that a pension fund is supporting, while others will not. But the beneficiaries who do not agree with the ESG policies cannot self-select themselves out of the investment fund. As a result, pension funds that support ESG programs are supporting political policies that violate the principles of some of its members, while possibly hurting returns for beneficiaries. These concerns raise serious doubts regarding the appropriateness of ESG investing for public and many private pension funds.

## **IF IT IMPROVES PROFITS, THEN ESG IS UNNECESSARY**

ESG claims that the responsibility of businesses goes beyond maximizing companies' profits and includes managing companies for the benefit of all stakeholders" because business' operations also impact employees, suppliers, and the broader community where they operate. ESG advocates will argue that investors and customers—particularly Millennials—expect companies to operate in a manner that complies with a stakeholder perspective. Therefore, pursuing ESG initiatives will enhance companies' profits. As a result, fund managers can promote better financial returns and improve social outcomes by prioritizing ESG considerations – the quintessential win-win.

There are examples of such opportunities. For instance, as many people grow wealthier, they demand that their products are produced using ESG-compliant methods. Take the environment. Once people's incomes have surpassed a certain threshold, there is a strong empirical relationship between rising incomes and the demand for improved environmental stewardship.<sup>21</sup>

Companies that are attempting to maximize their profits (the Friedman doctrine) will be better environmental stewards under these circumstances. Therefore, if an ESG program is profit-enhancing, then firms adhering to the Friedman doctrine will pursue these activities. Since profit maximization is consistent with the social responsibility demands of ESG advocates, the addition of a new stakeholder capitalism is superfluous. From an investment perspective, investment managers that simply focus on maximizing returns will invest in companies with superior fundamentals, regardless of the reason. They do not need any new investment mantras to invest in companies that are meeting consumers' demand for ESG compliant attributes.

Not all ESG programs are profit enhancing, however. There are many examples of ESG programs reducing corporate profitability because consumers are simply unwilling to cover the additional costs of the programs. Take corporate commitments to a net-zero emissions operation as an example. Such commitments require large capital outlays and changes in production processes that will increase costs. These higher costs pose risks if consumers are unwilling to cover these additional costs. Under these circumstances, the company will lose

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sales and revenue. In response, either costs will have to be cut elsewhere (e.g., employee costs will need to be reduced) or profits will be reduced. Either way, the ESG program has introduced additional performance risks.

While companies implementing ESG would still invest in these profit detracting ESG programs, companies adhering to the Friedman doctrine will not. Similarly, investors focusing on maximizing returns will not allocate resources to the companies implementing profit-detracting ESG programs.

The same cannot be said for companies adhering to the ESG doctrine. These firms will implement unprofitable ESG programs because they are demanded by stakeholders. Since the programs detract from profits, the additional cost of these programs forces these businesses to either reduce returns to investors, reduce compensation to employees, or provide either higher cost or lower quality goods that their customers judge to be inferior. Simply put, these businesses are fulfilling their primary social role of serving the needs of consumers less efficiently. Regardless of the tradeoff incurred, businesses providing ESG programs that consumers do not demand are diminishing overall national prosperity.

## PLAYING POLITICS IN THE BOARDROOM

While stakeholder capitalism would cause a decline in prosperity under these conditions, what about the social goals desired by ESG advocates or other stakeholders? Does achieving the social goals of ESG advocates create a net benefit for society when they are achieved at the expense of widespread prosperity?

It is difficult to weigh these alternative costs and benefits within a corporate boardroom setting, which is why the “within the rules of the game” caveat of the Friedman doctrine is so important. If there is a social good that needs to be achieved that is not demanded by consumers, then it is the social responsibility of the public sector to set the appropriate laws and regulations. Perhaps these “rules of the game” will favor the ESG advocates, perhaps they will favor the consumers. Regardless of the decision, the issue should be resolved in the political arena.

Take global climate change as an example. ESG advocates would claim that, regardless of what consumers are willing to pay, a company should use low (or lower) emission energy sources even if the sources are less reliable and more expensive based on the current technological constraints. In the instances where consumers are unwilling to fund these higher costs, then the demands of the ESG advocates will impose costs on consumers, investors, and/or employees. ESG advocates will claim that the public good created when greenhouse gas emissions are reduced outweighs the burden imposed on the consumers who must now purchase more expensive products. Those who are harmed will likely disagree.

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It is the government's social responsibility to mediate between these competing interests and decide which public goods should be provided, and at what cost. It is inappropriate for private organizations to usurp this government authority and set social policy for the country. The same logic holds for all other goals that ESG advocates desire, but customers of businesses are unwilling to fund. Therefore, in cases where customers do not demand ESG attributes, companies should still adhere to the Friedman doctrine and the contentious policy issues that create the “rules of the game” should be established through the political process.

## CONCLUSION

There are signs that ESG's deficiencies may be dampening the interest in ESG compliant investments. As Morningstar reported,

*U.S. sustainable funds suffered their first calendar year of outflows since Morningstar began keeping track more than 10 years ago, making 2023 their worst calendar year on record. Investors pulled \$5 billion from U.S. sustainable funds in the fourth quarter for a total of \$13 billion last year amid lagging performance, continued political scrutiny in the United States, and a bad year for an iShares fund.<sup>22</sup>*

Given ESG's higher costs and underperformance, such outflows make sense. Ideally, the outflows represent a broader rethinking of ESG. Organizations, whether public or private, lose effectiveness when they do not focus on their core competencies. Running social programs or making political decisions for the nation are not, and should not, be part of any businesses' core competency. ESG fails to make this crucial distinction. As a result, it diminishes businesses' ability to fulfill their primary social responsibility of generating broad-based economic growth.

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*Wayne H. Winegarden, Ph.D. is a Senior Fellow in Business and Economics at the Pacific Research Institute and director of PRI's Center for Medical Economics and Innovation. He is also the Principal of Capitol Economic Advisors.*

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