Senate Bill 7: Prohibiting ESG Investment - Article 1

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An Inconvenient Truth About ESG Investing

by Sanjai Bhagat | March 31, 2022

Summary. Investing in sustainable funds that prioritize ESG goals is supposed to help improve the environmental and social sustainability of business practices. Unfortunately, close analysis suggests that it's not only not making much difference to companies' actual ESG...more

As of December 2021, assets under management at global exchange-traded "sustainable" funds that publicy set environmental, social, and governance (ESG) investment objectives amounted to more than $2.7 trillion; 81% were in European based funds, and 13% in U.S. based funds. In the fourth quarter of 2021 alone, $143 billion in new capital flowed into these ESG funds.

How have investors fared? Not that well, it seems.

To begin with, ESG funds certainly perform poorly in financial terms. In a recent Journal of Finance paper, University of Chicago researchers analyzed the Morningstar sustainability ratings of more than 20,000 mutual funds representing over $8 trillion of investor savings. Although the highest rated funds in terms of sustainability certainly attracted more capital than the lowest rated funds, none of the high sustainability funds outperformed any of the lowest rated funds.

That result might be expected, and it is possible that investors would be happy to sacrifice financial returns in exchange for better ESG performance. Unfortunately, ESG funds don't seem to deliver better ESG performance either.

Researchers at Columbia University and London School of Economics compared the ESG record of U.S. companies in 147 ESG fund portfolios and that of U.S. companies in 2,428 non-ESG portfolios. They found that the companies in the ESG portfolios had worse compliance record for both labor and environmental rules. They also found that companies added to ESG portfolios did not subsequently improve compliance with labor or environmental regulations.

This is not an isolated finding. A recent European Corporate Governance Institute paper compared the ESG scores of companies invested in by 684 U.S. institutional investors that signed the United Nation's Principles of Responsible Investment (PRI) and 6,481 institutional investors that did not sign the PRI during 2013–2017. They did not detect any improvement in the ESG scores of companies held by PRI signatory funds subsequent to their signing . Furthermore, the financial returns were lower and the risk higher for the PRI signatories.

Why are ESG funds doing so badly? Part of the explanation may simply be that an express focus on ESG is redundant: in competitive labor markets and product markets, corporate managers trying to maximize long-term shareholder value should of their own accord pay attention to employee, customer, community, and environmental interests. On this basis, setting ESG targets may actually distort decision making.

There's also some evidence that companies publicly embrace ESG as a cover for poor business performance. A recent paper by Ryan Flugum of the University of Northern Iowa and Matthew Souther of the University of South Carolina reported that when managers underperformed the earnings expectations (set by analysts following their company), they often publicly talked about their focus on ESG. But when they exceeded earnings expectations, they made few, if any, public statements related to ESG. Hence, sustainable fund managers who direct their investments to companies publicly embracing ESG principles may be over-investing in financially underperforming companies.

The conclusion to be drawn from this evidence seems pretty clear: funds investing in companies that publicly embrace ESG sacrifice financial returns without gaining much, if anything, in terms of actually furthering ESG interests.