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# Valuing ESG: Doing Good or Sounding Good?


*BRADFORD CORNELL*

*ANDERSON GRADUATE SCHOOL OF MANAGEMENT*

*WESTWOOD, CA 90025*

bcornell@ad.ucla.edu

*ASWATH DAMODARAN*

*STERN SCHOOL OF BUSINESS*

NEW YORK UNIVERSITY

NEW YORK, NY 10012

adamodaran@stern.nyu.edu

*Abstract*

In the last decade, companies have come under pressure to be socially conscious and environmentally responsible, with the pressure coming sometimes from politicians, regulators and interest groups, and sometimes from investors. The argument that corporate managers should replace their singular focus on shareholders with a broader vision, where they also serve other stakeholders, including customers, employees and society, has found a receptive audience with corporate CEOs and institutional investors. The pitch that companies should focus on "doing good" is sweetened with the promise that it will also be good for their bottom line and for shareholders. In this paper, we build a framework for value that will allow us to examine how being socially responsible can manifest in the tangible ingredients of value and look at the evidence for whether being socially responsible is creating value for companies and for investors.

## Introduction

Using criteria based on environmental, social and governance (ESG) considerations has become an increasingly important aspect of investment decision making, particularly for high profile institutional investors. Bloomberg reported on February 8, 2019 that Europe alone has "some $12 trillion committed to sustainable investing." Fish, Kim and Venkatraman (2019) state that sustainable assets under management worldwide were approximately $30 trillion by 2019. On the corporate side, there has been a growing awareness of the need to be or at least appear to be socially responsible, either to fend off pressure from interest groups and media, or to market themselves to customers. A statement published by the Business Roundtable (2019), and signed by CEOs major companies, announced that "*While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholder*s." In a follow-up letter to CEOs, Lawrence Fink, the CEO of Blackrock, stressed that a company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders.

In this paper, we investigate the interaction between ESG related investment criteria and value, both from the perspective of investor wondering whether and how to incorporate social issues into investment choices as well as from the perspective of companies considering the value effects of being more socially responsible. We begin by looking at how corporate social standing is measured, and then develop a simple valuation framework to examine how and where ESG choices made by firms play out in value. Specifically, we look at how being a "good" company can make it more valuable, and the drivers of that higher value, and also how being a good company can make it less valuable, casting doubt on the sales pitch of ESG's most ardent promoters, which is that good corporate behavior will always be rewarded with higher value.

We examine the evidence with the intent of trying to evaluate the link between corporate social responsibility and value. We begin by looking at how "good" companies perform, on growth and profitability measures, relative to "bad" companies, and find that the research here is thinner and the overall evidence remains mixed. We then look at the extant research on how corporate social responsibility and investment returns are related and find the results to be inconclusive on the central question of whether higher ESG ratings are associated with greater risk-adjusted returns. While there are some studies that find that companies that score high on the corporate responsibility scale reward investors with greater risk-adjusted returns, there is little evidence that socially responsible funds that invest in these companies deliver excess returns. In this regard, we note that much of the ESG literature conflates value changes and investor returns and we argue that positive returns to investors in companies that score highly on ESG are murky indicators of whether ESG is value-creating. Finally, we address the question as to what decisions regarding ESG considerations should be made by corporate executives and what decisions should be province of public policy determined through the political process.

## Social Responsibility & Environmental Awareness

Much of the debate around ESG and corporate social responsibility starts with the premise that we can differentiate clearly between "good" and "bad" companies, but that is clearly not the case. Unlike profitability and returns, where there are accepted measures of both, and numbers to back them up, social responsibility is often in the eyes of the beholder. It should come as no surprise that a ranking of companies from good to bad by Greenpeace bears little resemblance to a listing of good and bad companies by a group focused on labor rights.

There are numerous reasons to interpret results regarding the impact of ESG ratings screens on portfolio performance, ambiguous as they are, with particular care. The first problem that arises when attempting to assess the impact of ESG information on investment performance is defining what is meant by "ESG information." It turns out there are a large number of organizations attempting to answer that question. Li and Polychronopoulos (2020) report that as of year-end 2019 they had identified 70 different firms that provide some sort of ESG rating. Furthermore, they note that this does not include the multitude of investment banks, government organizations and research organizations that conduct ESG-related research that can be used to create customized ratings. Fish, Kim and Venkatraman (2019) document that more than 600 ESG ratings were produced in 2018.

This problem would not be so bad if all the ratings were effectively similar, but this is not the case. There is a substantial literature documenting the divergence of ESG ratings for the same firms which includes Berg, Koelbel, and Rigobon (2019) Chatterji, Durand, Levine, and Touboul (2016), Dortfleitner, Halbritter, and Nguyen (2015), Semenova and Hassel, (2015) and Li and Polychronopoulos (2020). The rating organizations differ not only in how to measure the various ESG criteria, but also with respect to what criteria are deemed worthy of measurement. In some cases, the criteria are so numerous that it is difficult to separate those that are germane from those that are not. For instance, Bloomberg's ESG data covers 120 environmental, social, and governance indicators. Nonetheless, virtually all the raters include the most highly publicized indicators in their ratings. These include carbon emissions, climate change effect, pollution, waste disposal, renewable energy, discrimination, diversity, community relations, human rights, and independent directors. But they still fail to agree on how these indicators are to be measured.

Finally, we question why governance, a measure that has historically been defined in research in terms of responsiveness of managers at publicly traded companies to their shareholders, is bundled with environmental responsiveness and social consciousness, two concepts that often require managers to put the interests of other stakeholder groups ahead of shareholders. It may be that the governance that is incorporated in the ESG concept is different from the conventional governance measures, but if it is, any references to the payoff to good corporate governance should be not be part of the ESG sales pitch, because it represents a mindset diametrically opposed to the stakeholder value mindset that underlies ESG. The stakeholder wealth maximization objective, floated as an alternative to stockholder centrality, is a concept that has acquired followers, many of whom are also in the ESG camp, but Bebchuk and Tallarita (2020) discuss its limits.

## Value and Social Responsibility

Before looking at the existing research on the relationship between social responsibility and value, we need a value framework. That framework will allow us to identify key value drivers, and then assess how these drivers are affected, in positive or negative ways, by attempts by companies to be more socially responsible and environmentally conscious. In this section, we first develop that framework and then apply it to assess the valuation implications of ESG related actions.

***The Drivers of Value***

There is no mystery as to what determines the value of a business. In its simplest form, the value of a business comes from the expected cash flows it can generate over time, discounted back at a "risk adjusted" discount rate.

Expected Cashflows in time period

$$Value = \frac{E(CF_1)}{(1+r)^1} + \frac{E(CF_2)}{(1+r)^2} + \cdots + \frac{E(CF_n)}{(1+r)^n}$$

Risk-adjusted Discount Rate

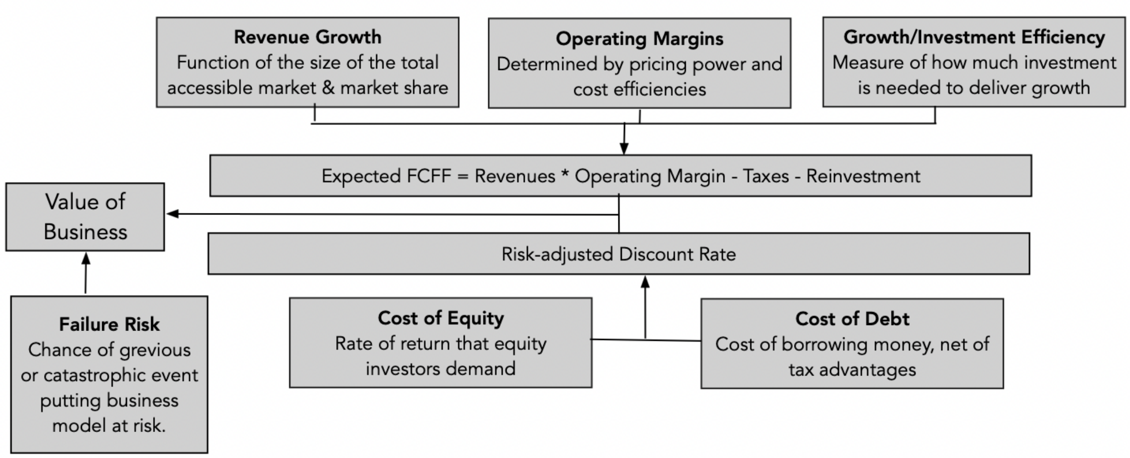
Note that there is nothing in this structure that a company towards short term profitability, since it allows that company to trade off lower profits (and cash flows) in the near term for higher profits and cash flows in the future. Taking a deeper dive into the value equation (see Damodaran (2013) or McKinsey on Valuation (2018)) highlights four drivers:

1. <u>The Growth Lever</u>: Most companies and investors view growth favorably, since it allows companies to scale up, and in the process, make small operating numbers into bigger ones. We will focus on *growth in revenues*, rather than growth in operating or net income, as the cleanest measure of this scaling up, since it requires that companies sell more of their products and services. (In contrast, earnings can grow because of margin improvements, arising out of economies of scale and cost cutting). The revenue growth can come from a market that is growing or from increased market share.
2. <u>The Profitability Lever</u>: Ultimately, there is no benefit to scaling up for a business, if it never makes money. We measure the profitability of a business by its *operating profit margin*, calculated as operating income after taxes divided by revenues. We focus on operating rather than net profit margin, since the latter is not only affected by business profitability but also by financial leverage.

3. The Investment Efficiency Lever: Growth in revenues requires investment in the resources needed to produce these goods and services. Rather than relying on the narrow accounting definitions of capital expenditures, we define reinvestment broadly to include not only investments in plant and equipment or working capital but also in expenditures on research and development and on acquisitions. Investment efficiency is measured by how much reinvestment is needed to deliver the forecasted increase in revenues (from the growth lever), with more efficient companies delivering greater added *revenue for every dollar of capital invested*.
4. The Risk Lever: Rather than get mired in endless debates about risk and return models in finance and the difficulties of measuring risk, we argue that risk in a valuation shows up in two places. The operating risk of a business as a going concern, measuring uncertainty about revenues and operating income in the future, is captured in a *cost of capital*; higher costs of capital, for any given set of expected cash flows, will lead to lower value. There is also the risk that the company will not survive as a going concern, and this risk is highest early in the corporate life cycle (since two thirds of start-ups fail) and late in the corporate life cycle (as aging companies, find themselves caught between declining operations and large debt loads). We capture this risk as a *risk of failure*, with a higher risk of failure leading to lower value.

The role of the four value drivers is illustrated in Figure 1:

*Figure 1: The Drivers of Value*

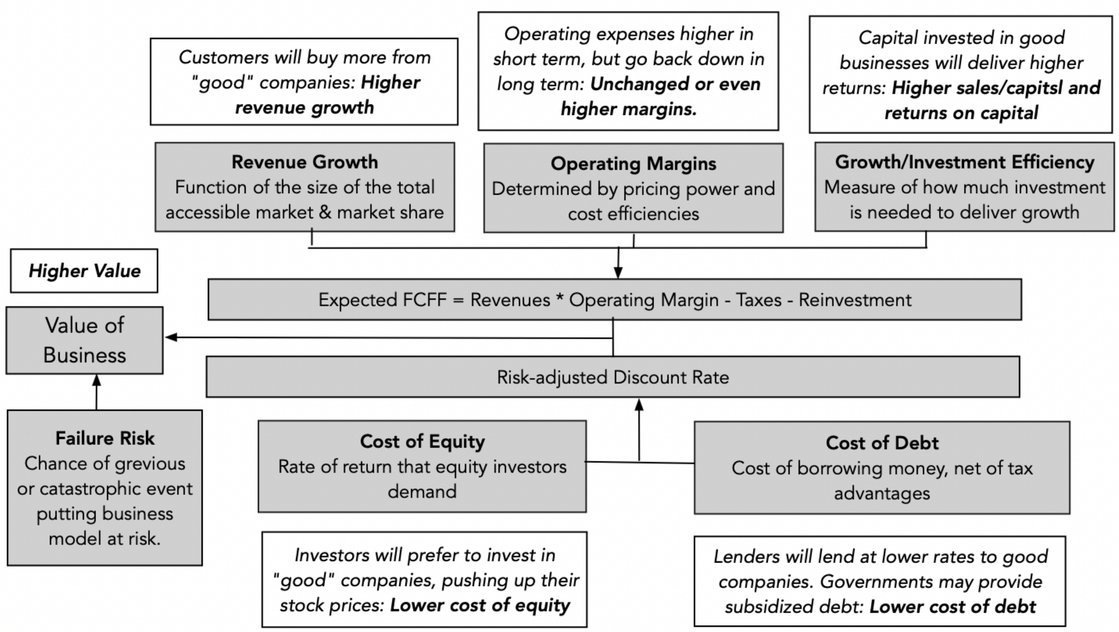


If being a "good company" increases value it will have to show up in these inputs. It is this framework that we use to analyze what we call the virtuous cycle, where doing good and doing well go hand in hand, followed by the punitive scenario where being bad causes backlash and failure and finally a dystopian world, where bad companies end up being rewarded at the expense of good companies.

### *The Virtuous Cycle*

The most direct way to induce companies to behave in a socially responsible manner is to make in their financial best interests to do so. There is a plausible scenario, where being good creates a cycle of positive outcomes, which makes the company more valuable. Figure 2 describes this virtuous cycle:

Figure 2: The Payoff to Being Good: The Virtuous Cycle




In terms of Figure 2, being good benefits the company on every dimension. Customers, attracted by its social mission, favor its products over its competitors, allowing it to gain market share and to grow revenues. Although being "good" creates more operating expenses in the short term, the company's cost structure adjusts quickly to new norms allowing for unchanged or even higher margins in the long term. This allows good companies to invest more efficiently than bad companies. That may seem like a stretch but consider a few of the most positive scenarios. A firm that spends more on employee wages and welfare might bear higher costs, at least initially, but this firm may not only have less employee turnover, but those employees may be motivated to work more efficiently to deliver better results. Similarly, seeking out suppliers who meet a social code may lead to higher input costs, in the near term, but these suppliers may also provide higher quality inputs and be less likely to switch to competitors. With regard to the discount rate, equity investors, attuned to social responsibility, direct their money towards good companies, potentially driving down the cost of equity, and lenders are willing to provide more attractive terms, and governments may offer subsidized loans to a company because of its social or environmental missions.[1] Finally, by operating as a good corporate citizen, the company minimizes the chance of a scandal or a catastrophic event that could put its business model at risk. In the language of ESG, it makes them a more "sustainable business".

For proponents of corporate social responsibility, this is the best-case setting for their cause, because being good and doing well converge. This scenario holds, though, only because customers, employees, investors and lenders all put their money where their convictions lie and are willing to make sacrifices along the way. For this scenario to unfold at a company, it must meet specific criteria:

1. <u>Smaller, rather than larger</u>: While it is not impossible for a large company to hit all the high notes in the virtuous cycle, it is far easier for a small company than a large one, because even a small subset of all investors can provide the capital at the favorable terms needed for this scenario to unfold.
2. <u>Niche business, with a more socially conscious customer base</u>: Adding to the smallness theme, it is easier for a company that serves a small customer base to attract customers with its 'good company' mantle than a company that seeks to reach a mass market. A company like Patagonia, with revenues of $750 million, can more easily make the compromises to stay socially responsible than a company like Nike, with revenues of $34.35 billion, is forced to make compromises that will undercut its goodness.

[1] See, for example, Goldman Sachs (2019).

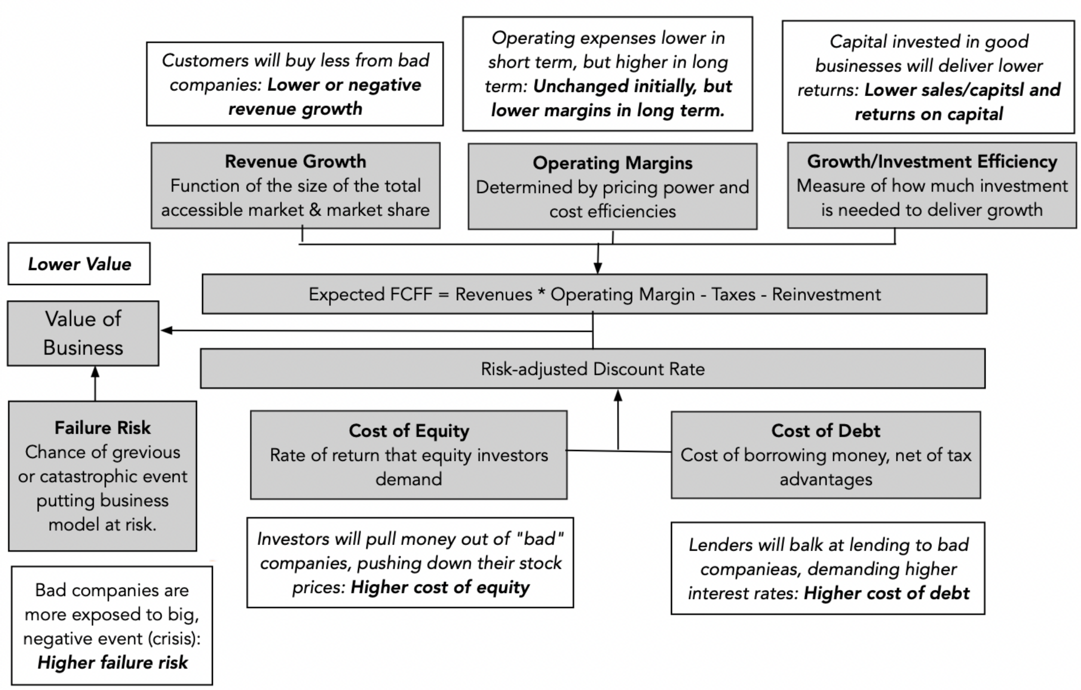
3. A privately held company or a public company with an investor base that values corporate goodness and prices it in: Being a private company can help, especially if the payoff to corporate goodness is long term, another point working in Patagonia's favor. A public company that is closely held or controlled by its founders can also make choices that may not be feasible for a widely held company with a vocal stockholder base.

It is worth noting that the companies that tend to be most vociferous about their social conscience tend to meet these criteria, at least early in their corporate lives. However, they will face a challenge, if they are successful and want to grow, because growth will bring in customers and investors not so committed to ESG. The acid test of social consciousness occurs when a company scales up and must decide whether to continue to grow or accept a lower scaling (and perhaps) lower value in order to preserve it good company status.

***The Punitive Scenario***

Even if good companies are not rewarded by customers and investors, the case for ESG can still be made, if bad companies get punished by the same groups. This less upbeat scenario is captured in Figure 3:

Figure 3: The Punishment for Being Bad: The Punitive Vision



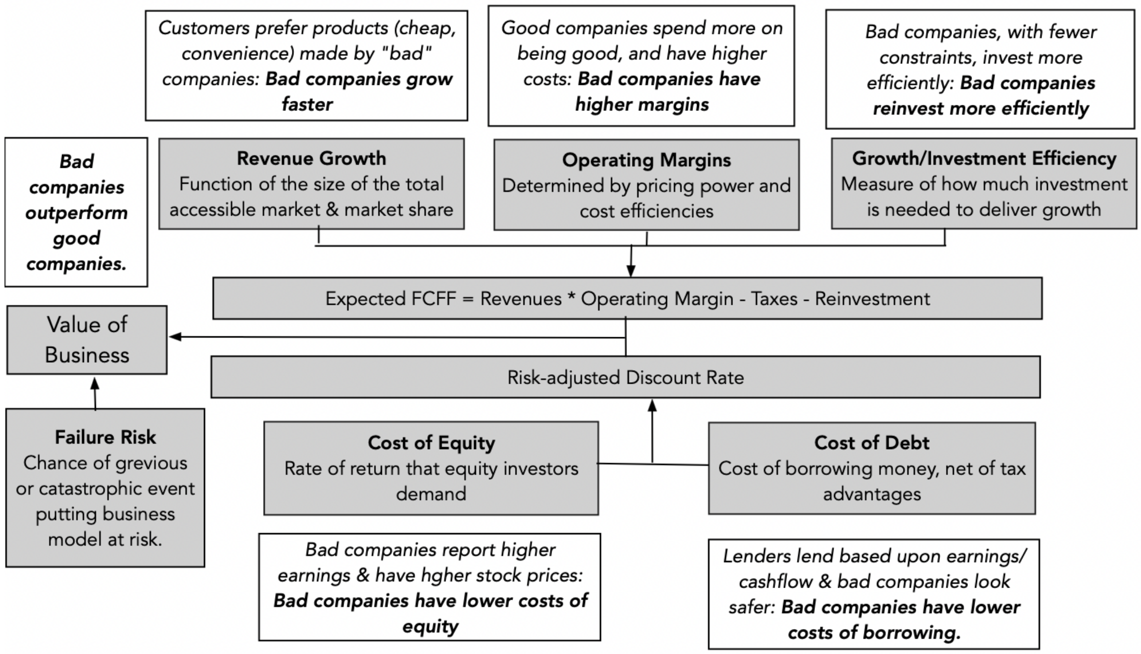
Here, the punishment for bad companies is meted out from every direction, with customers refusing to buy their products, even if they are lower priced and higher operating expenses (and lower margins) in the long term, as the company has trouble holding on to employees and finding suppliers. As investors are less willing to buy their shares, the cost of equity goes up, and lenders are leery about lending money to the company, leading to higher costs of debt. Finally, these companies risk exposure to grievous, or even catastrophic events, arising from operating with too little consideration of societal costs. It is often these events, such as the Union Carbide gas leak in Bhopal, Vale's dam bursting in Bhopal and BP's oil spill in the Gulf of Mexico, that highlight shortcomings and create long term problems for the company.

With regard to promoting social responsibility, this scenario is not as good as the virtuous cycle, because it will tend to scare companies away from being "bad" rather than induce them to be "good." That said, this is a more realistic pathway to corporate social responsibility, because there are examples of "bad" companies that one can point to as cautionary tales. Consider the rise and fall of Valeant, a Canadian pharmaceutical company that rose from a small market capitalization to being one of the largest companies in the sector, in terms of market cap. Along the way, its business model was to acquire drugs still under patent protection that were being "underpriced", and to reprice them to generate substantial profits. While the model was legal, it pushed ethical and moral bounds, and when a series of missteps led to a backlash, the market capitalization not only melted down quickly, but the company's bad reputation became an almost insurmountable obstacle to its rehabilitation. Regulators cracked down on the company, scientists refused to work in its research department, and politicians used it as a punching bag. Eventually, the company had to replace its top management, abandon its business model and change its corporate name, and even with all that it is still struggling.

***Dystopian World***

There is a final and darker scenario that is also plausible, where being good does not yield an upside and bad companies are not punished but are rewarded, creating a perverse outcome where bad companies outperform good ones, not only on operating metrics, but also with respect to stock returns. Figure 3 portrays this scenario:

Figure 4: The "Bad" Companies win: The Dystopian Vision




In this scenario, bad companies mouth platitudes about social responsibility and environmental consciousness without taking any real action, but customers buy their products and services, either because they are cheaper or because it is convenient, employees continue to work for them because they can earn more, and investors buy their shares because the expected returns are higher for reasons discussed later. As a result, bad companies may score low on corporate responsibility scales, but they will score high on profitability and stock price performance.

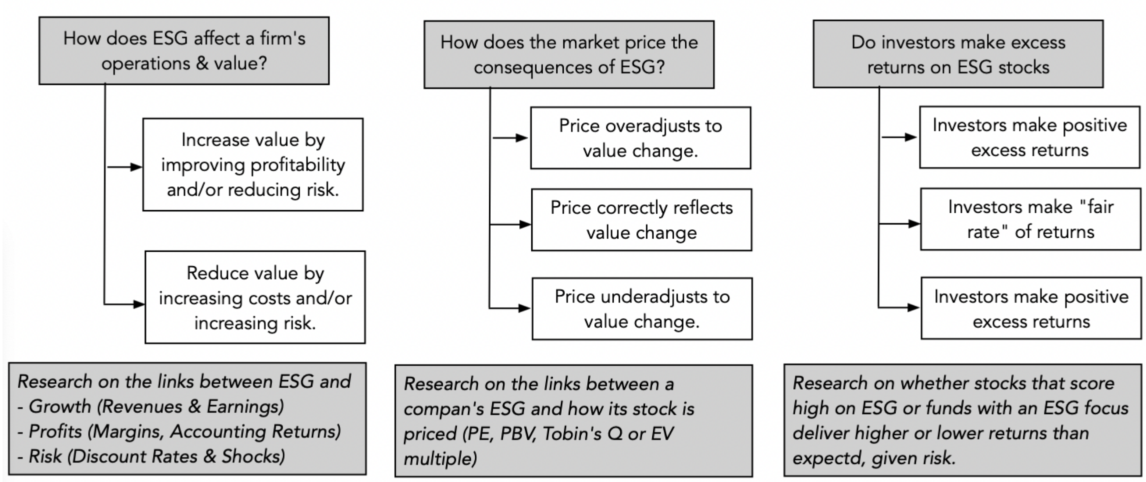
## The Evidence on ESG and CSR

Testing whether social responsibility pays off is difficult for two reasons. One is that, as we noted earlier, there is no consensus on what comprises a good company, with different raters using different metrics and measures. The second is that even within the research, there is be confusion regarding what is being tested, and what the findings say about the payoff to being socially responsible. As we see it, there are three fundamental questions:

- *Do “good” companies create more value than “bad” companies?* If good companies grow faster and are more profitable than bad companies, it would clearly supportive of the virtuous cycle, and lead to good companies being more valuable than bad ones. An alternative possibility is that if bad companies are viewed as riskier than good companies, that would lead them to have higher costs of equity and capital, and lower values, also supportive of the thesis that it is better to strive for corporate responsibility.
- *Do markets price good companies higher than bad companies?* If good companies are priced higher by markets, either because they are perceived to be better performers or because investors prefer to hold them as investments, it too would be a powerful incentive for companies to be socially responsible.
- *Does investing in good companies earn higher average returns than investing in bad companies?* If investments in good companies offer higher expected returns, it would make the push towards socially responsible investing much easier.

Figure 5 considers the possible answers to each of the three questions, and how they their interactions make testing the effects of ESG difficult:

*Figure 5: The Big Questions on ESG*




The bulk of research to date has focused on answering the last question. As our review below documents, the answers are highly ambiguous. A major reason for the ambiguity is the failure to consider sufficiently the impact of market pricing on the observed returns. To illustrate the problems, we begin by assuming that investors are rational, and markets are efficient, but investors prefer good ESG companies. We then go on to consider the added impact of possible mispricing.

Fama and French (2007) develop a simple framework that can be applied to show how investors preferences for good companies affect expected returns. They show that when utility functions for at least some investors include variables other than future consumption, prices deviate from the standard predictions of conventional risk and return models. In particular, if investors prefer to invest in good companies, the expected return on companies that are socially responsible will be lower, with the magnitude of the effect depending on how much money they have to invest. With upwards of $30 trillion of investment being affected by ESG considerations, the price impact is likely to be material. As an illustration of this effect, Hong and Kacperczyk (2009) study what they call "sin" stocks, i.e., companies involved in businesses such as producing alcohol, tobacco and gaming. They hypothesize that these are stocks for which investors have negative tastes. Consistent with Fama and French's theory, Hong and Kacperczyk find that sin stocks are less commonly held by institutions and that they have higher average returns than otherwise comparable stocks. They conclude that investors must be compensated in terms of greater expected return for the reputational cost associated with holding sin stocks. In the ESG space, Goss and Roberts (2011) report that companies facing concerns regarding social responsibility pay higher interest rates on their loans, relative to companies without those concerns, leading to a higher discount rate for firms.

In recent years, there have been attempts to explicitly build ESG into an asset pricing/return framework, with the intent of explicitly adjusting discount rates for differences in ESG. Zerbib (2019) develops an asset pricing model that incorporate investor tastes for socially responsible companies (Sustainable-CAPM) and applies the model to US stocks from 2000-2018 to find that investor taste for sustainability creates an average exclusion effect of 3% for sin stocks. Pedersen, Fitzgibbons and Pomorski (2020) incorporate the information in ESG score about fundamentals and investor preferences into deriving an ESG-efficient frontier and use it to conclude that the sin stock premium is smaller than estimated by Hong and Kacperczyk for sin stocks, but that there remains a premium.

The theoretical results in the spirit of Fama and French are based on the assumption that the market is in equilibrium. But concern over ESG is a relatively new phenomenon coming to the fore during the past 10 years or so, it is possible that market prices have been adjusting to a new equilibrium that reflects ESG considerations. As the market adjusts to incorporate ESG information, and assuming that the information is material to investors, the discount rate for highly rated ESG companies will fall and the discount rate for low rated ESG companies will rise. Due to the changes in the discount rates, the relative prices of highly rated ESG stocks will increase and the relative prices of low ESG stocks will fall. Consequently, during the adjustment period the highly rated ESG stocks will outperform the low ESG stocks, but that is a one-time adjustment effect. Once prices reach equilibrium, the value of high ESG stocks will be greater and the expected returns they offer will be less. In equilibrium, highly rated ESG stocks will have greater values, but investors will have to be satisfied with lower expected returns. As one example of this adjustment process, Bebchuk, Cohen and Wang (2013) document the disappearance of a return premium associated with highly rated corporate governance during an earlier period. This adjustment process means that the measured performance of stocks as a function of their ESG rating will depend on the sample period. If the sample is drawn from a time period during which the adjustment is underway, highly rated ESG stocks will be found to outperform and the reverse for low ESG stocks. On the other hand, if the sample is drawn from a period after which the adjustment is complete, highly rated ESG stocks should be observed to have lower average returns.

The situation is further complicated, if market prices are not always rational and can overreact or underreact to ESG information. In this context, Table 1 considers six possible combinations of answers to the first two questions, on operating value and market pricing, and how they relate to excess expected returns for investors:

*Table 1: Value Effects, Market Pricing and Excess Returns*

| *Value Effect* | *Market Pricing* | *Investor Returns to ESG* |
|---|---|---|
| ESG increases value | Markets overreact, pushing up prices too much | Negative excess returns for investors in good ESG firms. |

| | | |
|---|---|---|
| ESG decreases value | Markets overreact, pushing down prices too much | Positive excess returns for investors in good ESG firms. |
| ESG increases value | Markets underreact, with prices going up too little. | Positive excess returns for investors in good ESG firms. |
| ESG decreases value | Markets underreact, with prices going down too little. | Negative excess returns for investors in good ESG firms. |
| ESG increases value | Markets react correctly, with prices increasing to reflect value. | Zero excess returns for investors in good ESG firms. |
| ESG decreases value | Markets underreact, with prices going down too little. | Zero excess returns for investors in good ESG firms. |

Given the plethora of possibilities, a finding that investments in highly rated ESG stocks provide positive excess returns provides little about the payoff to companies of being socially responsible, because it is entirely driven by what markets incorporate into stock prices. Adding to the empirical messiness is the difficulty of measuring ESG that we noted at the start of this paper, with different interest groups prioritizing different elements of social goodness in coming up with their scores. Despite such potential short-run complexity, in the long run we would expect rational pricing to obtain. Based on the Fama and French analysis this implies that if investors have a preference for highly rated ESG stocks then those stocks will offer lower average excess returns. Note that this conclusion is contrary to the views of many ESG advocates in the investment profession. For instance, Blackrock CEO Larry Fink (2020) states that, "*Our investment conviction is that sustainability and climate integrated portfolios can provide better risk-adjusted returns to investors*." We find little support for this conviction in either the theory or empirical evidence. On the other hand, there is some good news for high ESG companies in that those lower expected returns mean lower discount rates and lower discount rate produce greater valuations.

***ESG and Value***

To summarize, being socially responsible (or improving your ESG standing) can make a firm more valuable, either by increasing profitability and cash flows or by reducing the discount rate. In this section, we summarize the research findings are on both fronts.

*Operating Profitability and Cash Flows*

The argument that socially responsible companies should generate higher profits, either because they have greater revenues, or face lower regulatory and legal costs, and that these lead to more sustainable healthy performance seems to rest largely on faith. As an example, Larry Fink's (2020) assertion in his letter on social responsibility that "*a company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders*" comes with little or no supporting evidence. Even when the linkage is tested and a positive relationship is found between ESG scores and profitability, a question regarding causality remains. Causality can run the from performance to a higher ESG rating because companies that are doing well are in a better position to spend money being socially responsible. In this context, ESG spending can be thought of as a luxury good that successful companies buy to embellish the reputation of management.

If there is a consensus views that emerges from the research evidence, it is that the relationship is positive, but the findings are fragile and sensitive to both how ESG and profitability are measured. An early study by Waddock and Graves (1997) found that companies that ranked high on social performance (what they termed CSP, a precursor to ESG) also ranked high on financial performance. However, Zhao and Murrell (2016) extend the Waddock-Graves study over a longer time period (1991-2013) using a larger sample and conclude that the original findings do not hold up. In a review of the literature, Margolis, Elfenbein and Walsh (2009) examined 251 studies of the linkage between ESG and operating profitability in 214 papers and found only a small positive link between the two, leading them to concluded that "citizens looking for solutions from any quarter to cure society's pressing ills ought not appeal to financial returns alone to mobilize corporate involvement". Pedersen, Fitzgibbons and Pomorski (2019) also find that firms with good governance realize higher accounting rates of return, but this result is not robust to different measures of ESG or to different profitability metrics. Nolet, Filis and Mitrokostas (2015) use Bloomberg's ESG scores for S&P 500 firms find a negative relationship between ESG and return on capital, though they find that imposing a non-linear relationship creates a U-shaped relationship, which they construe, rather hopefully, as evidence that the long-term effects are positive. Schreck (2011) tries to control for the endogeneity problem, i.e., whether good performing companies are socially responsible or socially responsible companies are good performers and concludes that there is no link between profitability and social responsibility.

*Risk and Social Responsibility*

If the link between profitability and ESG is weak, there is still the possibility that value is higher for companies that are socially responsible, if they are less risky, with two variants on the risk story. In the first, companies that are socially responsible are rewarded with lower discount rates, which leads to higher value, because investors prefer to hold good companies and build these preferences into expected returns. In the second, bad companies or companies that score low on ESG expose themselves to reputational and disaster risks that are infrequent but can have a large impact when they occur.

### *Disaster and Reputational Risk*

An alternate reason why companies would want to be "good" is that "bad" companies are exposed to disaster risks, where a combination of missteps by the company, luck, and a failure to build in enough protective controls (because they cost too much) can cause a disaster, either in human or financial terms. That disaster can not only cause substantial losses for the company, but the collateral reputational damage created can have long term consequences. Gloffner (2018) created a value-weighted portfolio of controversial firms that had a history of violating ESG rules and reported negative excess returns of 3.5% on this portfolio, even after controlling for risk, industry and company characteristics. He argues that these lower excess returns are evidence that being socially irresponsible is costly for firms, that markets don't fully incorporate the consequences of bad corporate behavior. It is important to stress that results such as these require that markets fail to incorporate the impact of bad behavior. Once the market has incorporated the bad behavior, the return discount should disappear or even become a premium. Karpoff, Lott and Wehrly (2005) examine fines, damage awards and market capitalization losses at firms that violate environmental standards. They find that these firms suffer significant market value losses but that these losses are roughly equivalent to the legal penalties imposed. They find no evidence of additional losses from reputational damage.

It is worth noting that this argument for ESG is less an argument for companies to be "good", because they will be rewarded, than for companies not to be "bad", because they will be punished. It is in keeping with the punitive vision that we outlined earlier, but as we noted there, it is a much less ambitious argument, with less in terms of social payoff from corporate actions, than the utopian vision, where being good will deliver higher growth, more sustainable profit margins, and higher returns on capital.

***ESG and Pricing***

If being socially good creates a payoff for firms either as higher cash flows or a lower discount rate, their values should increase. But will markets have the foresight to look past what may be near-term lower earnings and reward them with higher pricing? That question is important not only from the lofty perspectives of efficient markets, but it can also have more immediate consequences. To the extent that markets are myopic and ignore the value effects of being good, the managers of these firms, whose compensation and tenure are tied to stock price performance and/or current financial performance, may be loath to follow the path of social responsibility.

The research on this question is sparse, due to two challenges. The first is that it requires a measure of ESG that can be correlated with current pricing, with that pricing measured using multiples such as PE, price to book, or EV to EBITDA. The second is that even if a correlation exists, it is difficult to establish causation. In other words, do companies with high ESG scores get rewarded with higher market pricing or are companies with higher market pricing just more favorably viewed by society? One simple proxy that can be used to address the question of the link between ESG and pricing is to look at the pricing multiples of stocks held by ESG funds versus the rest of the market. A snapshot from early 2020, for instance, yields the following:

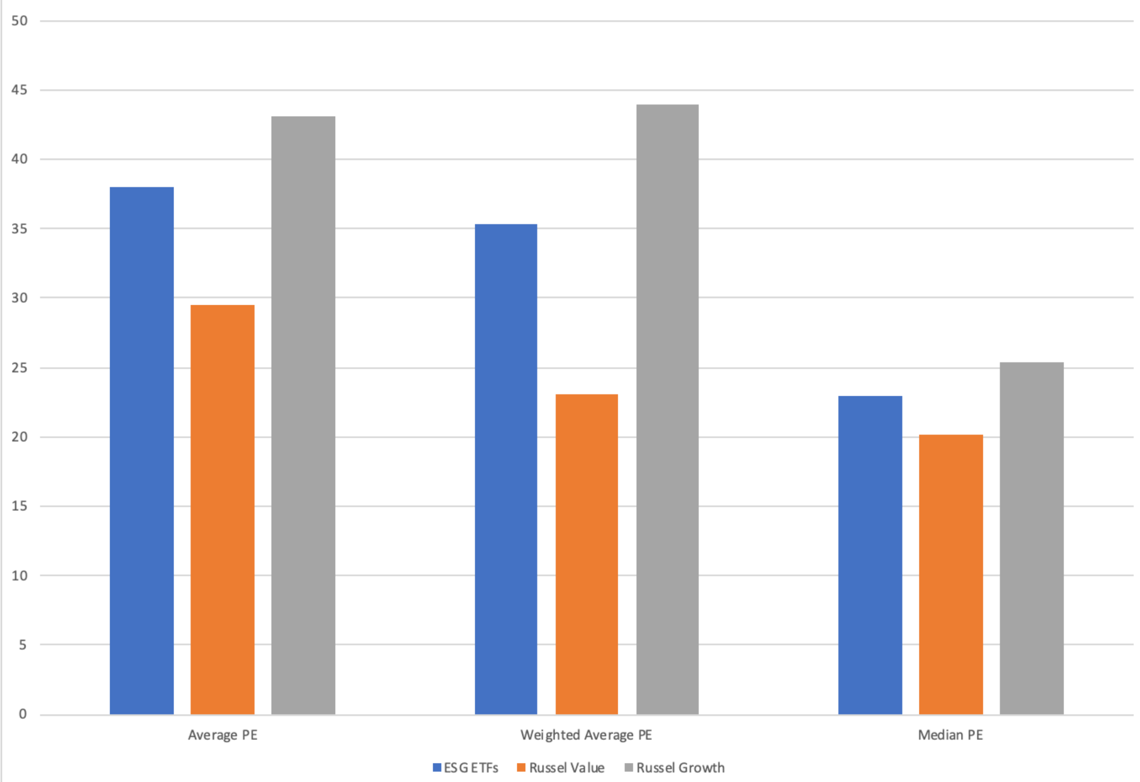



*Figure 6: ESG and PE ratios*

Source: FactorResearch

The chart suggests ESG stocks are priced closer to growth than value stocks, but without controlling for the differences in growth, it is difficult to draw a strong conclusion about whether this is indicative of a forward-looking market incorporating ESG considerations.

One way to avoid the interlinkages that make it difficult to isolate the effects of ESG on pricing is to focus on ESG events, i.e., events that would lead to market to reassess a firm's ESG standing. Capelle-Blanchard and Petit (2017) look at 33,000 ESG news stories on one hundred listed companies between 2002 and 2010 and conclude that negative events cause a market drop of 0.1% but that firms gain nothing from positive events. This finding is echoed by Mitsuyama and Shimuzutani (2015), who study the market reaction to announcements of the ESG Branding of Japanese firms, where firms are recognized for their "goodness." The authors find little evidence of a positive market reaction to the announcements.

In summary, the evidence that markets reward companies for being "good" is weak to non-existent, which can either be taken to mean that markets are rationally assessing ESG actions and finding that they have little effect on value or that markets are short sighted and are not incorporating the long-term value increases associated with being more socially conscious. Either conclusion is not promising for ESG advocates; the first undercuts their central thesis that being good translates into doing well, and the second makes it less likely that managers will invest more in ESG, because they will realize few tangible benefits in the market today.

***Investor Returns and Social Responsibility***

As we noted earlier in the section, the weakest test of the payoff to positive ESG behavior is looking at returns earned by investors on stocks that score well on the ESG scale, because it can be compatible with a wide range of possibilities, some of which are not favorable to the ESG case. That said, the bulk of the research on ESG has been done in this area and the findings have been read broadly, and in our view, often casually as evidence that being socially good delivers positive results.

To begin with, the notion that adding an ESG constraint to investing increases expected returns is counter intuitive. After all, a constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost. To illustrate, the TIAA-CREF Social Choice Equity Fund explicitly acknowledges this cost and uses it to explain its underperformance, stating that "The CREF Social Choice Account returned 13.88 percent for the year [2017] compared with the 14.34 percent return of its composite benchmark … Because of its ESG criteria, the Account did not invest in a number of stocks and bonds ... the net effect was that the Account underperformed its benchmark."[2]

The research in this area, though, is directed at answering the question of whether you can have your cake (be socially conscious as an investor) and eat it too (by earning higher returns).[3] Based on theoretical work such as Fama and French, this combination is

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[2] TIAA-CREG Annual Report, 2017, Page 34.

[3] Some of the research, especially the portions that are sponsored either by ESG funds or institutes that are promoters of social responsibility, has to be discounted because of the bias that they have towards finding that investing in ESG stocks generates positive excess returns.

unlikely and requires market mispricing. At a practical level, the empirical findings are mixed. Di Bartolomeo and Kurtz (1999) showed that stocks in the Anno Domini Index outperformed the market, but that the outperformance was more due to factor and industry tilts than to social responsiveness. Derwall, Guenster, Bauer and Koedijk (2005) look at the payoff to socially responsible investing by comparing the returns on two portfolios, created based upon eco-efficiency scores, and conclude that companies that are more eco-efficient generate higher returns, which cannot be explained by investment style or industry factors. Note that some of the strongest links between returns and ESG come from the governance portion, which, as we noted earlier, is ironic, because the essence of governance, at least as measured in most of these studies, is fealty to shareholder rights, which is at odds with the current ESG framework that pushes for a stakeholder perspective.

## The Politics of ESG

Milton Friedman's thesis that companies should focus on delivering profits and value to their shareholders, rather than playing the role of social problem solvers, is now largely treated as passé. To review, what Friedman (1962) said was *"There is one and only one social responsibility of business–to use it 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*." In comparison, the Business Roundtable (2019) statement signed by numerous leading CEOs recently stated, in a document that repeatedly stressed the importance of all stakeholders, "*Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.*" At the risk of sounding like Neanderthals, we think Friedman's viewpoint has much to recommend in the ESG space. Just because the cause is a good one does not mean decisions related to public policy should be turned over to corporate managers. In fact, if ESG advocates are right and being good is value increasing, they would find Friedman in agreement with them, and it is only if they are wrong, and being good comes at the expense of value, that they would find themselves in disagreement with Friedman.

To illustrate, consider the example of a company that is in the business of producing fossil fuels. The current consensus seems to be that these companies are bad companies and that investors should avoid investing in these companies. That said, a substantial part of the global economy, not to mention our consumption needs, as individuals, for transportation and heat, are dependent on a continued production of fossil fuels. If the counterpoint is that public policies provide tax incentives and benefits that fail to adequately discourage the production and consumption of fossil fuels, that points to a problem with government policy, and not with the fossil fuel companies that operate in the space. Clearly within a diverse society like the United States there will be large groups of people who think that current policies are too lax, too stringent, or just about right, when it comes to fossil fuel production and usage. In short, for those whose primary concern is reducing the use of fossil fuels to combat climate change, the focus should be on electing officials who will enact laws consistent with those objectives. With the proper rules in place, companies can then go about the task of value maximization with worrying about social policy. Asking companies to bear the burden of being society's conscience is not only unfair, but it tilts the playing field in favor of the least socially conscious investors and companies. Put simply, if a subset of investors and companies play by ESG rules, investors in bad companies will earn higher returns than investors in good companies and bad companies will gain market share at the expense of good companies.

The reality is that there is no public consensus on many social and environmental issues, and because there is such disagreement regarding what public policy should be, this issue is not likely to be resolved any time soon. In the meantime, is it appropriate for company executives, who have been neither elected nor empowered to make social decisions, to decide that the prices set in the economy are not appropriate indicators for making corporate decisions because the government has failed to enact the proper policies to accountant for externalities? Climate and energy issues are not unique in this regard. Many of the other ESG criteria suffer from the same problem. Are corporate executives qualified to evaluate these social policies? More importantly, what gives them the right to evaluate such policies on behalf of their shareholders and other stakeholders such as employees?

The same issues arise regarding investment firms. Should institutional investors be using ESG related information in making investment decisions? The answer is a simple yes, if it assumed that they have reason to believe they can increase risk adjusted expected returns by so doing. But the issue becomes much more controversial if the investors are willing to forego return in order to affect social policy. As was the case with corporate executives, on what basis should financial professionals who have not stood for election be making decisions about social policy? The point is that despite some of the grumbling about their behavior, public policy, in most cases, should be left to elected officials. It is there job to enact appropriate regulations. With proper policies in place, there is no reason for companies not to follow Milton Friedman's dictum.

## Conclusion

In many circles ESG is being marketed as not only good for society, but good for companies and for investors. In our view, however, the hype regarding ESG has vastly outrun the reality of both what it is and what it can deliver. The potential to make money on ESG for consultants, bankers and investment managers has made them cheerleaders for the concept, with claims of the payoffs based on research that is ambiguous and inconclusive, if not outright inconsistent with some of the claims. The evidence as we see it is nuanced, and can be summarized as follows:

- The evidence that socially responsible firms have lower discount rates, and thereby investors have lower expected returns, is stronger than the evidence that socially responsible firms deliver higher profits or growth. There are clearly firms that benefit from being socially responsible, but there are just as clearly firms where being socially responsible creates costs with no offsetting benefits. Telling firms that being socially responsible will deliver higher growth, profits and value is false advertising. In addition, many of the firms that promote ESG are successful for other reasons.
- The evidence is stronger that bad firms get punished, either with higher discount rates or with a greater incidence of disasters and shocks. ESG advocates are on much stronger ground telling companies not to be bad than when they tell companies to be good. In short, expensive gestures by publicly traded companies

to make themselves look "good" are futile, both in terms of improving performance and delivering returns.

- The evidence that markets incorporate social responsibility into pricing is weak, except for companies that are labeled as bad firms. Furthermore, there is a weak link between ESG and operating performance. In addition, the fact that markets do not reflect that link should serve as a note of caution when marketing ESG to corporate managers.
- The evidence that investors can generate positive excess returns with ESG-focused investing is weak, and there is no evidence that active ESG investing does any better than passive ESG investing, echoing a finding in much of active investing literature. Even the most favorable evidence on ESG investing fails to solve the causation problem. It appears just as likely that successful firms adopt the ESG mantle as adopting the ESG mantle makes firms successful.

Much of the ESG literature starts with an almost perfunctory dismissal of Milton Friedman's thesis that companies should focus on delivering profits and value to their shareholders, rather than play the role of social policy makers. The more that we have examined the arguments that advocates for ESG make for why companies should expand mission statements, and the evidence that they offer for the proposition, the more we are inclined to side with Friedman. The ESG bandwagon may be gathering speed and getting companies and investors on board, but in our view, when all is said and done, a lot of money will have been spent, a few people (consultants, ESG experts, ESG measurers) will have benefitted, but companies will not be any more socially responsible than they were before ESG was invented. In our view, what is needed is an open, frank, and detailed national dialogue concerning ESG related public polices, particularly those related to climate change. Hopefully, that discussion will produce wise policies that will set the legal and regulatory framework in which corporations operate. With the proper framework in place, corporations can get back to focusing on maximizing shareholder wealth.

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