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Can Companies Be Virtuous and Still Turn a Profit?

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Progressives love it. Conservatives hate it. And the controversy surrounding it is ever-increasing. The issue? ESG--Environment, Social, Governance.

One of the hottest trends in the world of investing, ESG is an outgrowth and refinement of "corporate social responsibility (CSR)", a business concept that has gained greater traction over the last two decades. Both ESG and CSR are rooted in the question: What should be the role of the corporation in society? Should it focus solely on making and increasing a profit (serving shareholders) or increasing social and environmental concerns into business operations (serving stakeholders)?

Although the question is philosophical, the answer may be political. The ESG agenda will face scrutiny by the House of Representatives this term, with Andy Barr (R-KY), chair of the House Financial Services Subcommittee, leading the questioning of Wall Street banks and asset managers regarding their social and climate goals. He has gone on record asserting that banks should serve creditworthy borrowers and focus on earnings and profitability, while the Federal Reserve should refrain from the "greening" of the financial system, in general.

The backlash against ESG is not confined to Congress however. Last year, Florida banned state pension fund managers from incorporating ESG into investments while Texas barred BlackRock, BNP Paribas, and Credit Suisse from doing business there because of these companies' boycott of energy firms. West Virginia did the same.

Unquestionably, ESG is big business. More than $35 trillion of assets worldwide are monitored using a sustainability lens, and assets in sustainable funds equal over $330 billion. Deloitte estimates ESG-dominated assets could represent half of all professionally managed assets by the end of the year. Additionally, companies have raised about $320 billion in green bonds last year, and clean energy tax credits are part of the Inflation Reduction Act, adding further incentives for investors.

One of the biggest problems with ESG is measurement. While there are sustainability indexes galore, such as the Dow Jones Sustainability Index (DJSI) and MSCI, the design and methodologies vary widely. Scoring methodologies focus on how well companies manage their

internal processes, rather than the real-world impacts of their products. For example, British American Tobacco has been recognized as a leader on the DJSI, despite selling over 600 billion cigarettes a year. NYU business professor Hans Taparia points out that last year McDonald's received an uptick in their ESG rating due to changes in packaging material and waste disposal; yet, its greenhouse gas emissions from its operations and supply chain grew by 16% from 2015 to 2020.grew by 16% from 2015 to 2020.

One may ask: Is it fair to select the same factors and weights for both mining companies and IT firms? Commercial banks and packaged goods firm? Yet, investors are paying nearly a record premium for shares of companies with the best ESG scores over the ones with the worst ratings, according to Bank of America, although ESG investors do not have access to comparable, accurate measures, making it nearly impossible to attribute results or make impact claims. At the end of the day, ESG rankings (like college rankings) are "beauty contests".

Measurement is irrelevant unless it links to performance. So, how do ESG funds actually perform? ESG advocates claim ESG investments produce higher profits, better stock returns, lower capital costs and increased investment flows. But statistically-oriented academic studies (over 1,100 peer-reviewed papers) along with numerous case studies failed to demonstrate that. More than two thirds of studies do not show a positive correlation between ESG and financial returns. One should note, too that ESG funds typically charge fees 40 percent higher than traditional funds.

According to George Serafeim of Harvard Business School, ESG measures such as reducing waste, strengthening relationships with external stakeholders and improving risk management and compliance are "good business hygiene". That being the case, then banks and corporations should incorporate ESG into their policies, plans and operations while ensuring that *the dominant, most important measure by far—financial performance—remains the priority #1*.

Unfortunately, in many respects ESG as conceived, promoted and implemented has become a sham---the mantra of crusaders of wokedom who seek to shame and shake down corporations in the name of societal virtue. These ESG zealots are either clueless as to the purpose of private enterprise or clearly understand it and oppose it vehemently on ideological grounds. Sadly, rather than challenging the ESG lobby, many big companies and the Wall Street community have decided to outwoke the wokesters and jumped on the ESG bandwagon bigtime, fueling a lucrative ESG industry. Witness Black Rock, a firm in the vanguard of ESG, that will spend $1 billion next year on data tracking of ESG factors.

Most companies do the right thing and adhere to the most important ESG principles on their own. The bottom line for these companies *is*—and must be--the bottom line. The fundamental challenge for them is to ensure that they achieve the prime goal of their fiduciary responsibility—to make a profit efficiently, effectively, honestly and sustainability to the benefit of their shareholders. In so doing, all stakeholders in society will be rewarded, as well.

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