THE PERILS OF ESG INVESTING

By Michael Faulkender

"ESG is a scam. It has been weaponized by phony social justice warriors."
-Elon Musk, May 18, 2022 on Twitter

Over the last decade, a growing craze in investing has been the ESG movement—investing in companies based on their Environmental, Social, and Governance practices. Such practices differ depending on whose definition one is using, which is part of the problem, but this generally involves a firm's activities to reduce its carbon footprint (E), its attention to diversity and inclusion (wokeism) among its stakeholders, particularly its employees (S), and the practices of its leadership and Board of Directors (G). While individual investors are free to invest in whatever they want and free to vote on shareholder proposals however they like, in today's investing environment, most investing and voting is delegated to portfolio managers. Pension plans and mutual funds allocate a significant portion of the capital in our financial markets, which firms rely on to fund their investments. Thus, portfolio managers have a great influence on which endeavors are funded, and they are often the pivotal voters on shareholder proposals. Progressive fund managers are using other people's money to drain capital from key American industries and undermine the direction of our economy. As we discuss below, the intended result is the underfunding of energy and national security companies that provide the fuel and protection American families need to live, stay safe, and realize their potential. Recognizing this potential threat, the Department of Labor under the Trump Administration implemented a rule to limit the nefarious activities of ESG fund managers. The Biden Administration quickly reversed those policies and is now targeting American industry with legislative goals such as the Green New Deal and SEC rules that would embolden the ESG titans. In short, the liberal elite has now taken the reins in many corporate boardrooms, and average American investors have lost control over their retirement finances. Countering ESG efforts is one of the key consumer protection issues of our time.

BACKGROUND

At the core of corporate governance is the concept that economists call a principal/agent problem. Whenever there is a delegation of decision-making, will the person making the decision (the agent) act in his own interest or in the interest of the ultimate beneficiary (the principal)? Ultimately, companies are owned by individuals (principals) and should be operated with their interests in mind. However, a modern corporation is incredibly complex and has potentially millions of shareholders. It is neither possible nor practical to inform them about and have them vote on every decision the company makes. Therefore, the governance structure is one in which the shareholders elect a Board of Directors and the Board hires, incentivizes, monitors, and potentially terminates senior management (agents). Day-to-day operating decisions are made by those senior managers. An extensive academic literature exists that examines how to ensure that companies are managed for the benefit of their owners, because the objectives of a manager may not perfectly overlap with the desires of the owners. (Shleifer and Vishny, 1997)

For decades, the premise of corporate governance is that the objective for management should be shareholder value maximization. As articulated by Milton Friedman, "in a freeenterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society." (Friedman, 1970) The shareholders are the owners and residual claimants to the operations of the firm. After selling its products or services, paying its employees, taxes, suppliers, and creditors, whatever is left over belongs to the owners. If the product or service is highly successful and costs are contained, the shareholders can realize very large profits. However, if the revenues are low but the costs are high, it is the shareholders who are the first to take losses. Employees are still paid for the hours they worked, suppliers for the goods they provided, and creditors for the debts they are owed. These payments are made unless the company goes bankrupt, in which case the shareholders are wiped out, but the other claimants are still partially or fully paid out of any remaining assets of the firm. The argument in favor of maximizing shareholder value is that a company only creates value in the long run for its shareholders if it keeps its customers happy, its employees willing to continue working for the company, its suppliers voluntarily selling inputs to the company, its creditors compensated, and its regulators satisfied. Employees can always leave and work elsewhere, consumers can always purchase from competitors, and suppliers can always sell to others. It is the shareholders who have long-term capital at stake; an individual shareholder can only exit if he finds another investor to voluntarily purchase his ownership stake.

Over time, investors have moved away from direct ownership of individual stocks and instead now primarily purchase mutual funds or exchange traded funds (ETFs). The academic literature largely argues that this is driven by a desire for diversification; small exposures to many activities will be less risky than concentrating wealth in just a few enterprises. Because transaction costs are generally charged per trade (irrespective of quantity), realizing diversification for an individual shareholder is extremely expensive. Imagine for a moment that an investor wanted to purchase all 500 stocks in the S&P 500 and paid a transaction fee of $5 per stock purchased. Realizing that diversification would cost $2,500. Now imagine that 10,000 people wanted to do that. Total transaction costs would be $25 million. Consider instead the creation of a mutual fund that pooled all the money and then purchased each of the 500 stocks on behalf of the investors. Each of the 10,000 investors pay $5 to buy the mutual fund ($50,000 in total) and then the fund buys the 500 stocks ($2.500). The total cost is $52,500 instead of $25 million. The investors are just as diversified, but the total costs are reduced by 99.8%.

However, this adds a new dimension to the agency problem. We do not just have potential conflicts between the ultimate owners and the managers of the companies; now we have mutual fund managers acting as middlemen between the shareholders and corporate managers. Instead of each individual owner deciding what to own (asset allocation) and how to vote on elections for directors and shareholder proposals (corporate governance), it is the mutual fund managers who choose what stocks to hold and how to vote on behalf of the mutual fund's investors. Note that this assumes that the buyers of the mutual fund are the ones directly investing in it. The largest pools of money are retirement funds and pension plans, which hire money managers to act as the trustee of the retirement funds, thereby adding yet another layer of agency. In either case, do mutual fund managers know the desires of investors? Or do the mutual fund managers just buy what they want and vote their personal preferences, irrespective of the desires of the ultimate owners?

PROXY ADVISORS

One approach to determine how money managers should vote on director nominations and shareholder proposals has been to hire proxy advisors to justify their voting decisions. Companies such as Institutional Shareholder Services research the nominees for directorships and the governance votes investors will cast at the annual shareholder meeting. From that research, they then make recommendations to the mutual fund companies regarding how to vote. Does such an approach make sense? On the one hand, there is a similar transactions cost logic to this approach. Researching information takes time and effort, largely irrespective of whether one is voting one share or voting 10,000 shares. If mutual fund companies can hire an advisor who is doing that research for hundreds of funds, they can spread that information acquisition cost over larger numbers of shares, bringing down costs. On the other hand, we have now created three levels of agency (corporate officers, mutual fund managers, proxy advisors). If this is pension or 401(k) money, the retirement plan trustee is a fourth level of agency.

How do the proxy advisors know what to recommend? Some mutual funds and money managers have started stating their governance philosophy in their prospectus, and the advisors recommend votes they perceive to be consistent with those objectives. While money managers used to focus almost entirely on reducing transaction costs and optimizing the risk/return trade-off, many mutual fund managers today look to differentiate themselves on the "values" that guide their governance voting. For instance, BlackRock votes its shares based on an assessment of the Environmental, Social and Governance (ESG) activities of the company. If investors have access to complete markets and are able to invest through mutual funds that align with their own views, this approach is efficient. However, markets are incomplete; few competitors to ESG exist from an ideological perspective regarding the values investors would like to guide their portfolio's allocation and governance voting. Additionally, individual workers often do not have any choice of who manages their 401(k) plan or pension fund.

THE ESG PROBLEM

A significant problem with this approach is that given all the agency issues described above, one needs a clearly defined, measurable standard to evaluate the performance of both corporate management and portfolio managers. Under the law, that standard has been the fiduciary duty to optimize risk-adjusted shareholder returns. It has served as an agreed-upon standard that can be measured and therefore used in litigation to enforce contracts. When a standard is murky or in-the-eye-of-the-beholder, such as measures of ESG[1], it is impossible to enforce consistently. How do executives, investors, or courts trade off shareholder returns against the unmeasured environmental, societal, and governance impacts of firms? If corporate managers reduce shareholder returns because they claim to have enhanced employee diversity, have they fulfilled their fiduciary duty? As argued by Bebchuk and Tallarita, "the push for ESG metrics overlooks and exacerbates the agency problem of executive pay, [to] which both scholars and corporate governance rules have paid close attention. To ensure that they are designed to provide effective incentives rather than serve

[1] One reason this assessment is so difficult is that there is not agreement on what constitutes ESG. As Berg, Kolbel, and Rigobon document in their evaluation of six large ESG rating organizations, "ESG ratings from different providers disagree substantially… [I]n our data set, the correlations between ESG ratings range from 0.38 to 0.71." (Berg et al., 2019) The result is that what constitutes strong ESG performance from one perspective gets little attention from another. As the authors go on to state, this disagreement "makes it difficult to evaluate the ESG performance of companies, funds, and portfolios, which is the primary purpose of ESG ratings."

the interests of executives, pay arrangements need to be subject to effective scrutiny by outsiders. However, our empirical analysis shows that in almost all cases in which S&P 100 companies use ESG metrics, it is difficult if not impossible for outside observers to assess whether this use provides valuable incentives or rather merely lines CEO's pockets with performance-insensitive pay." (Bebchuk and Tallarita, 2022)

Even if we could measure ESG and contract on it, what is the impact on shareholders and real economic activity? If asset allocation is based on ESG criteria, what impact does that have on the returns realized by the investors? A recent article by Pastor, Stambaugh, and Taylor argues that "in equilibrium, green assets have low expected returns because investors enjoy holding them". The argument is straightforward: take two stocks that offer identical future cash flows, but one is labeled "green" while the other is not. If the preferences of some investors are to virtue signal through their asset holdings, there will be higher demand for the "green" stock, which will push up the current price of the stock. However, because future cash flows are identical, mechanically the realized rate of return on the "green" stock will be lower. Such investors are willing to accept lower rates of return because they derive utility from the virtue signaling and are therefore indifferent from a utility maximization perspective.[2] However, if other investors in the fund (such as co-workers who are in the same retirement plan) do not derive utility from holding green stocks and are only looking for the best risk/return tradeoff, they are made worse off. Consistent with this hypothesis, Harrison Hong and his co-authors Ing-Haw Cheng and Kelly Shue find "some ESG investments being value-reducing and motivated by agency problems." (Hong et al., 2019)

If shareholders earn lower returns, does that sacrifice ultimately alter the investments that are made by firms? Berk and van Binsbergen investigate whether the divestiture of certain companies from portfolios has the potential to alter corporate investment. They argue that "given current levels of divestiture in the market today, the levels are so small, the effect on the stock price is so small it can't possibly have any real effects on investment strategy, and that to give a large enough effect to really affect the investment strategy of companies, you would need 85 percent of investors to divest. And we are so far away from that high number that we don't think a divestiture strategy is at all effective in achieving social change." (Berk and van Binsbergen, 2022) In other words, these authors contend that absent an exceptionally large portion (85%) of investment dollars simultaneously divesting from particular companies, what investments are funded is unlikely to be changed. While it may seem that corporate investment has not been impacted, it is important to note that the authors do not consider the simultaneous impacts of ESG asset allocation, regulation, and litigation on corporate investment.

Buttressing the ESG movement, despite its flaws, the Securities and Exchange Commission (SEC) recently proposed a rule mandating new environmental disclosures. As it states in a press release, "The proposed rules also would require a registrant to disclose information about its direct greenhouse gas (GHG) emissions (Scope 1) and indirect emissions from purchased electricity or other forms of energy (Scope 2). In addition, a registrant would be required to disclose GHG emissions from upstream and downstream activities in its value chain (Scope 3)." (SEC, 2022) Arguably there are many pieces of information that investors might want as they value companies and determine which ones to include in their portfolios. However, the creation of that information is not free. If a sufficient number of investors demanded this information, they can call upon management to provide it under the firm's

[2] Note that this assumes that there are not an equivalently wealthy offsetting number of investors looking for the highest rate of return who therefore demand the non "green" stock who drive the prices into alignment with each other.

established shareholder governance system. Mandated disclosure forces firms to spend the money gathering and providing that information, even in cases where the shareholders of that particular firm are not requesting it. As the Wall Street Journal noted, the inevitable result of such a rule is to "saddle companies with new costs, discourage private firms from going public, and encourage some public firms to go private." (Wall Street Journal, 2022)

The disclosure rules also have the potential to alter corporate behavior and create new risks. For example, the proposed rule requires companies to disclose which Board committee is evaluating climate risks, or if no committee does so, explain why they do not evaluate climate risk. In practice, it is likely that Boards will form such a committee. Will that committee focus on climate to the exclusion of other productive issues that should occupy Board and management attention? The tendency to get what is measured and its negative consequences for corporate behavior is a significant risk arising from the SEC's proposed rules. It is also not clear that such disclosure requirements would be effective. As argued by Bettignies, Liu, and Robinson, regulatory oversight can generate negative impacts for corporate social responsibility (CSR). They "find that firms in the UK receive lower CSR ratings after increased regulatory oversight compared to firms from the other 15 European countries which did not experience mandatory disclosure requirements." (Bettignies et al., 2020)

A further concern is that altering asset allocation, using corporate governance tactics, and imposing greater regulation simultaneously to raise the cost of capital for certain industries has the potential to put energy security and national security at risk. (Goldstein et al., 2022) According to the U.S. Energy Information Administration, "in 2019, 80% of domestic energy production was from fossil fuels." (EIA, 2020) Advocates of green energy have yet to articulate how we are going to replace all that energy from fossil fuels at prices Americans can afford in the timeframe they seek. As a recent Brookings Institute report by Samantha Gross explains, "Those pushing to end fossil fuel production now are missing the point that fossil fuels will still be needed for some time in certain sectors…Renewable electricity generation alone won't get us there." (Gross, 2020) Despite this absence of a substitute, the Biden Administration welcomes higher energy prices and is more interested in having our foreign adversaries provide us with additional fossil fuels than expanding our own domestic production of them. (Sabes, 2022) Additionally, the very industries where investment and innovation may most reduce greenhouse gas emissions are the ones that ESG fund managers seek to deprive of the capital necessary to fund those investments. Lauren Cohen, Umit Gurun, and Quoc Nguyen find "that oil, gas, and energy producing firms—firms with lower Environmental, Social, and Governance (ESG) scores, and who are often explicitly excluded from ESG funds' investment universe—are key innovators in the United States' green patent landscape. These energy producers produce more, and significantly higher quality, green innovation." (Cohen et al., 2020) The results of the Biden Administration's policies are higher gas prices for Americans, less domestic investment, and the enrichment of our potential enemies who use proceeds from high oil prices to fund such activities as Iranian terrorism and Russia's invasion of Ukraine.

The out-of-favor industries are not limited to energy firms but also often include such important sectors as defense contractors. (Liu, 2021) The very companies that work closely with the Department of Defense to ensure that our Nation has the weapons necessary to protect us from foreign tyrants who seek to harm Americans both at home and abroad are shunned by many ESG fund managers. Considering Russia's invasion of Ukraine and the recognition that national defense is integral to the protection of democracy, that attitude may be changing. As Kurt Feuerman and Anthony Nappo recently wrote, "It's easy to understand why the defense industry was maligned in a world attuned to ESG issues.

Defense companies make products that kill people, which are often sold to bad actors. Now, as Ukrainian president Volodymyr Zelensky seeks weapons support from the West, defense contractors are playing a crucial role for defending democracy—a basic ESG human rights goal." (Feuerman and Nappo, 2022) Will the belligerent actions of an autocrat help ESG fund managers recognize the societal benefits of a strong defense sector and alter their views on capital provision to this sector?

FIGHTING BACK

Due to these investor protection concerns, the Department of Labor under the Trump Administration implemented a rule under ERISA, which covers private employer and union retirement plans, confirming that "ERISA fiduciaries must evaluate investments and investment courses of action based solely on pecuniary factors—financial considerations that have a material effect on the risk and/or return of an investment." In addition, it "bars them from sacrificing investment return or taking on additional investment risk to promote non-pecuniary goals." (Department of Labor, 2020) The objective of the rule is to ensure that retirement plan fiduciaries focus on the cash flows and rates of returns those investments are projected to generate. Plan managers may not incorporate their non-economic political or social goals into their portfolio decision-making. The enforcement difficulty is that portfolio managers may argue that ESG factors identify cash flow risks, meaning this rule may not be entirely effective in curbing these practices. Unfortunately, the Biden Administration quickly started the process to reverse this rule not long after coming into office. (Bernard, 2021)

Absent adequate federal protection, some states have started addressing the issue. For instance, Texas recently passed a law that requires any stocks owned by the state must not be issued by companies that boycott energy investments. The text reads that if a "financial company continues to boycott energy companies, the state governmental entity shall sell, redeem, divest, or withdraw all publicly traded securities of the financial company." (LegiScan, 2021) West Virginia's State Treasurer recently announced that the state will no longer do business with BlackRock. "The decision was based on recent reports that BlackRock has urged companies to embrace "net zero" investment strategies that would harm the coal, oil, and natural gas industries." (Barker, 2022) Florida (DeSantis, 2021), Oklahoma (Allen, 2021), and North Dakota (North Dakota Bill Actions, 2021) are among the states also looking to push back against the harms the ESG movement are causing.

CONCLUSION

ESG investing is another attempt by progressives to realize their socialist agenda. Instead of realizing financial strength for their investors, ESG fund managers' objective appears to be the creation of an alternative mechanism for progressive activists to realize desired political outcomes that they cannot achieve through the legislative process. Liberals know that they cannot convince majorities in the House of Representatives and the Senate to enact the environmental policies that they desire. Instead, they are now looking to hijack the corporate governance process in the private economy to impose that agenda. They have partnered with money managers such as BlackRock and Vanguard to impose their agenda on companies through the shareholder governance process. Partnering with large pension plans such as CalPERS (the California Public Employees' Retirement System), these liberal fund managers use the pools of capital they manage to try to force companies to change their environmental policies or realize particular social outcomes, even if they come at the expense of shareholder returns. They seek to starve American companies that improve the lives of their fellow citizens of the capital they need to operate their organizations. The investment funds belong to Americans, primarily to save for retirement, and without their consent, some of these fund managers appear to be voting their ideological preferences rather than the financial interests of those Americans.

The Biden Administration is a willing co-conspirator in damaging the financial, energy, and national security of our Nation in the name of its green agenda. Yet again, its quest for power shows no limits on the extra-constitutional steps it is taking to transform America into its perceived socialist utopia. The American people must put a stop to their reckless destruction of the greatest nation to have ever existed.

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