What Recent Anti-ESG Rhetoric Gets Wrong:

It's right to be critical, it's wrong to be cynical

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We are long-term, values-based, and socially responsible investors. We view consideration of environmental, social, and governance (ESG) factors as essential in forming portfolios of high-quality companies that are better positioned to reduce risk and identify opportunities. We believe that companies proactively managing business risks related to ESG issues make better contributions to the global economy and are more resilient.

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Recent critiques of environmental, social, and governance (ESG) investing tend to seek emotive rather than rational appeal, with critics using words like "delusional," "incoherent," "scam," "cabal," "idiots," or "knaves." Such rhetoric may be useful in grabbing attention and fueling clickbait, but it distracts from valuable and informed discussion. While critical assessments of what ESG investing does well and how it could be improved should be encouraged, hyperbolic claims undermine the goal of improving this evolving form of investment analysis.

In navigating anti-ESG media, it's valuable to separate those well-founded criticisms from misguided cynicisms.

Well-founded critiques:

Greenwashing is likely occurring in the ESG market.

Recent regulatory probes into some large asset managers have shown that concerns over greenwashing in ESG investing are merited. With money rushing into the space, it's unsurprising to find a few nefarious actors looking to make a quick buck. In this sense, recent ESG criticisms should propel the concept forward, calling for greater accountability rather than cancel it all together.

Firms that mislead investors will lose their trust and thus their assets to manage, while firms that are readily transparent about their ESG processes and performance should win investors' trust. This ability to rapidly assert preferences is foundational to financial markets and allows markets to be one of the most democratic mechanisms on the planet. To provide transparency, Saturna produces annual impact reports for its funds with ESG mandates (Amana Mutual Funds, Saturna Sustainable Funds). These reports not only provide historical and relative benchmark data on how those funds have performed; they also delve into case studies that explore how we analyze the trade-offs that occur in ESG investing. While greenwashing may be present, it's not inherent. Asset managers can do better to provide their investors with the same transparency sought in the companies they hold.

There is little agreement among data providers.

Many criticisms of ESG investing point to the lack of correlation across various ratings organizations and suggest this undermines ESG investing, writ large. Saturna has long recognized this issue, raising it through our own research in *The Case For Active Management in ESG*.[1] The weak correlation across ESG ratings doesn't mean the practice should be thrown out; rather, there's an important role for discerning human analysis.

The criticism is that credit rating agencies differ little in their ratings, and thus differentiation in ESG ratings is a fatal flaw. However, this claim is *non sequitur*. Credit rating agencies look for risk of default and expected recovery in default. ESG metrics, on the other hand, provide insight on both risks and opportunities. ESG ratings should be considered more akin to sell-side research than credit ratings. To be sure, ESG is a largely subjective space. Still, how one weighs decreasing emissions versus community impacts of decarbonization is not unlike weighing a company taking on more debt to expand its capacity. There are constant trade-offs that are weighed by the market every day; over time, preferences for the trade-offs will be sorted out. As Benjamin Graham said, "in the short run, the market is a voting machine but in the long run it is a weighing machine."

Misguided cynicisms:

ESG practitioners have overlooked how and whether ESG affects firm value. Even if ESG does end up adding value, it's a one-time payoff.

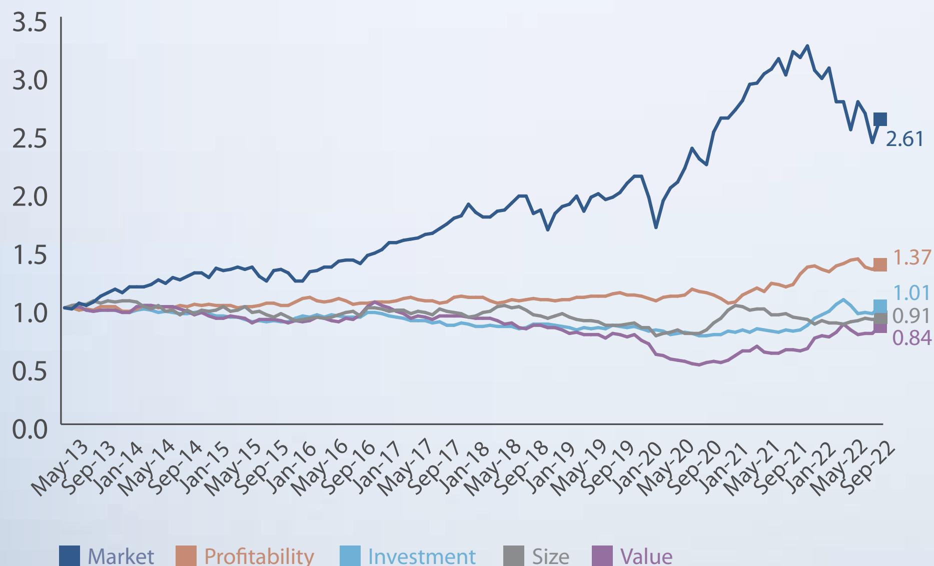
There are varying degrees of cynicism in response to how ESG analysis plays into investment decisions and investment performance. On the extreme end, there are claims that ESG investors don't care about returns and have failed to substantiate how ESG relates to a company's sales, margins, returns on capital, or risks. On the more moderate side, there is the efficient market claim that if ESG has any bearing on financial performance without adding risk, then it will be priced in and subsequently have lower returns than riskier factors.

The first claim seems to have ignored the preponderance of work done by non-governmental organizations (NGOs), academics, and practitioners, which link various ESG issues to the fundamental inputs (cash flows, growth, and discount rate) of a corporate valuation. Simply put, there's a reason why investors are focused on *material* ESG issues. The second claim is founded in the efficient market hypothesis and, to its credit, is elegant. If only markets were perfectly efficient.

Saturna is willing to accept that markets are decently efficient and would argue ESG data will help them become more efficient. In that spirit, it makes perfect sense that investor disdain for Energy stocks in recent years drove up the cost of capital and thus the expected returns for the sector. Where we want to push back is on the notion that strong performance can only be priced in once, and future excess returns stem only from higher risk.

In the 1960s, the Capital Asset Pricing Model (CAPM) put forth the idea that a stock's expected return depended on its risk compared to the market. Since then, the CAPM was found to be a mediocre tool for explaining stock performance, and has widely been supplanted. First there was the Fama-French three-factor model, which added size (small capitalization versus large) and value (value versus growth) as reasons for greater returns. Eventually, this was expanded to the Fama-French five-factor model, which added investment (conservative versus aggressive) and profitability (robust versus weak).

Since Fama and French initially published their findings that profitability helps explain stock outperformance (June 2013[2]), the profitability factor has been the best performer of all the additional explanatory factors (size, value, profitability, and investment) to market risk. Saying greater profitability is riskier and thus commands consistently higher returns is far-fetched, and nine years is certainly enough time for an efficient market to arbitrage away any non-risk-related excess returns. Yet profitability has continued to outperform.



Why does this matter to ESG performance? There are two reasons. First, it undermines the notion that persistent excess returns can only be found through excess risk. Second, a New York University (NYU) meta-analysis of 245 studies between 2016 and 2020 found that 58% of studies confirmed a positive relationship between ESG and financial performance, while only 8% confirmed a negative relationship.[3] In other words, there's likely a positive relationship between ESG and profitability.

A critic might follow up by noting that a correlation between ESG and financial performance does not substantiate a causation that ESG leads to strong financial performance. This criticism is distracting. Causation is not what matters; what matters is the correlation. Whether robust ESG performance caused the company to be well-run is not as important as whether the market values the relationship between ESG and financial performance. To this end, the same NYU meta-analysis found studies with a long-term focus were 76% more likely to establish a positive or neutral relationship between ESG and financial performance than studies with a short-term focus.[4] We can debate if the chicken or the egg came first, but the data shows ESG initiatives are associated with long-term performance.

ESG practitioners pretend trade-offs between E, S, and G don't exist.

ESG cynics have also recently claimed that practitioners ignore the trade-offs inherent in all decision-making processes. "Is it really possible to build vast numbers of wind farms quickly without damaging local ecology?" an article published in The Economist in summer 2022 asked. "By suggesting that these conflicts do not exist or can be easily resolved, ESG fosters delusion."[5] Nowhere have we seen it suggested that such trade-offs do not exist. At Saturna's investment committee meetings, we frequently discuss, for instance, the metal intensity of transitioning to a low-carbon economy and the ESG impacts associated with mining and refining those metals. To again use a financial analysis analogy, we don't only look at a company's profit margin to determine its attractiveness for investments — we look at myriad metrics, including how the company intends to balance maintaining margins while growing its business. ESG is no different. It's a piece of the mosaic that gives us a view of the whole company.

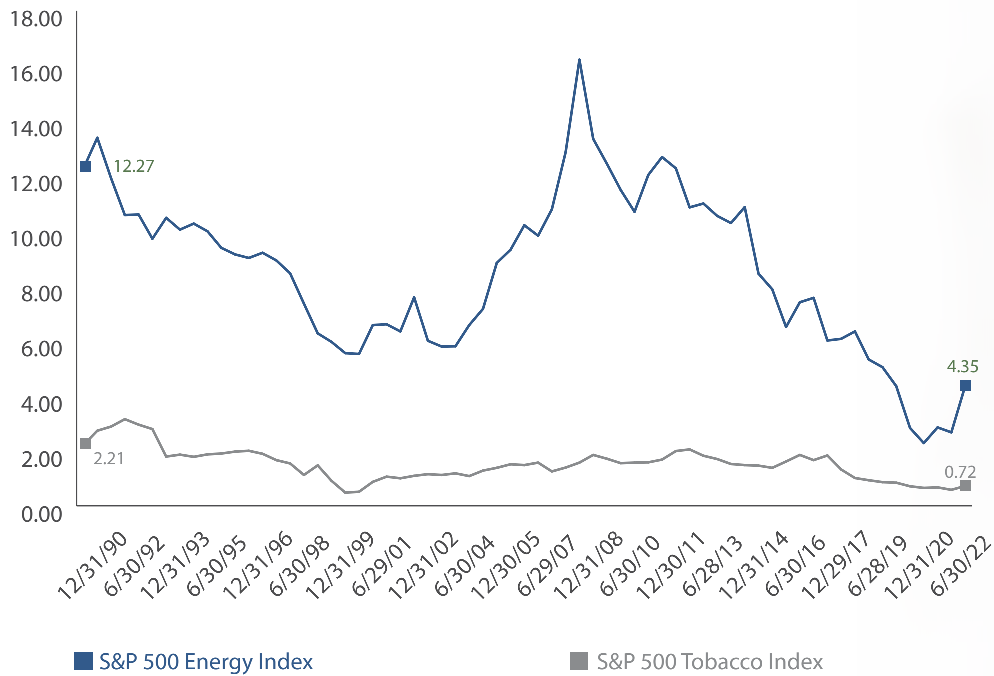
Being good for society can't be good for investors.

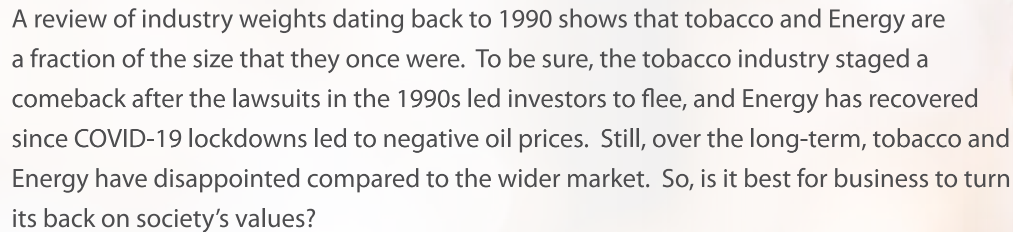
To push back against ESG claims of "doing well by doing good," some cynics might go so far as to say, "the truth is that, most of the time, being good will cost you and/or inconvenience you."[6] What a moral compass!

As Adam Smith wrote, "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest." Yet it is not out of spite by which we get our dinner. Instead, society asserts its values through the elaborate workings of the free market. The baker produces bread because people need food to survive and are willing to pay for that bread. If people prefer bread made from grains grown in ethical and environmentally sensitive means, and are willing to pay more for such bread, the baker will naturally be encouraged to meet this demand. In this same vein, a rude baker should expect to see their customers opt for the friendlier competitor up the street.

It is the same premise behind ESG investing; doing well by your employees, customers, and wider society may be rewarded with better productivity, sales growth, and/or a clean social license to operate. Thus, stakeholder primacy and shareholder primacy need not conflict! While many have countered the "doing well by doing good" claim with anecdotes of superior returns from the tobacco industry and the Energy sector, in many cases those returns were after both were already beaten up. Let's look at their relative sizes in the S&P 500.

Industries in Decline





A review of industry weights dating back to 1990 shows that tobacco and Energy are a fraction of the size that they once were. To be sure, the tobacco industry staged a comeback after the lawsuits in the 1990s led investors to flee, and Energy has recovered since COVID-19 lockdowns led to negative oil prices. Still, over the long-term, tobacco and Energy have disappointed compared to the wider market. So, is it best for business to turn its back on society's values?

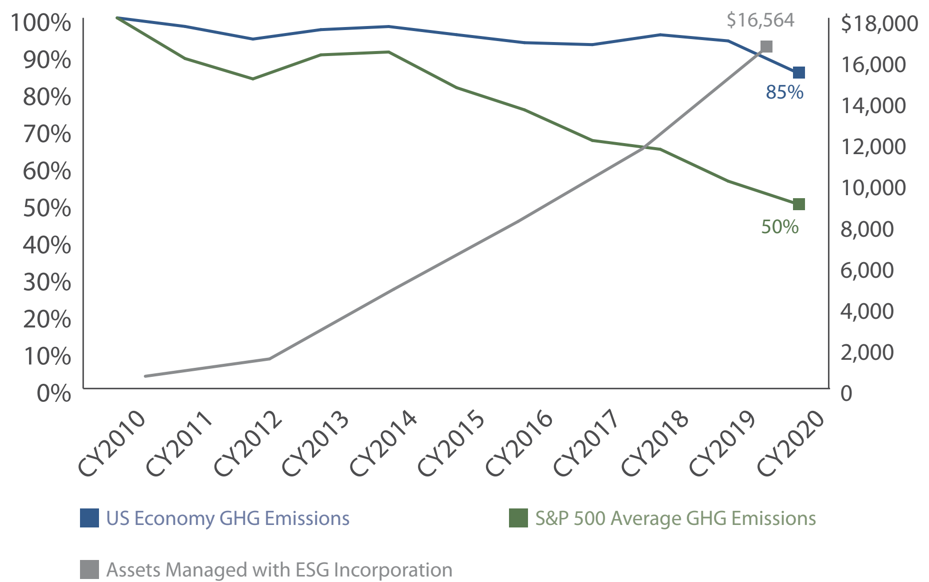
ESG either seeks or allows policymakers to ignore their ESG duties.

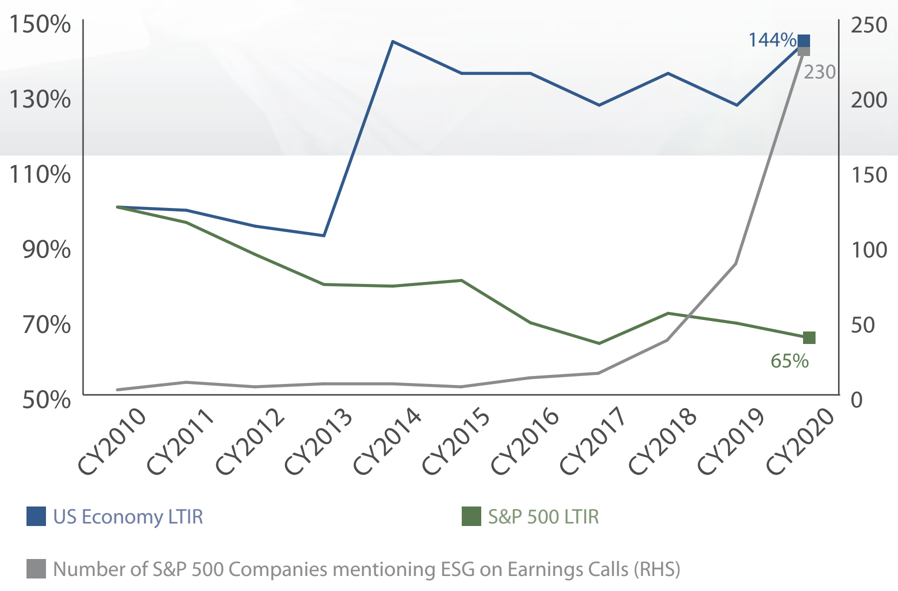
Another criticism that ignores both the hypothesis and objectives of ESG is the claim that ESG investors at best allow policymakers to ignore their ESG duties, and at worst seek to wrest control of these duties. ESG has arisen because of political inaction. It does not seek to subvert democracy. In fact, quite the opposite. It utilizes the most democratic system in the world: markets. Consumers vote with their purchases, investors vote with their dollars, and workers vote with their time and effort. What's more, a critical theory in many ESG investment theses is that greater government action (e.g., carbon taxes, stricter labor laws, stronger product oversight) is likely to happen but not yet fully priced by markets.

ESG has no positive ESG impact.

The final criticism that warrants addressing is the idea that ESG has not and will not lead to improvements in corporate ESG impacts. "Sustainable investing was like selling wheatgrass to a cancer patient," says Tariq Fancy in his article on Medium. "There's no evidence that wheatgrass will do anything to stop the spread of cancer, but it's tempting to believe it."[7] We give it to the critics — substantiating whether ESG investing is making positive impacts at a societal level is a tough task, made harder by incomplete current data and a dearth of historical data.

Through our annual impact reports for our ESG funds, Saturna seeks to highlight how these funds select stocks with better ESG impacts. While these reports show how Saturna selects ESG leaders for our portfolios, we need to take a broader view for ESG to have wider societal impacts. Over the past five years ESG has moved to the executive level, across the S&P 500, with mentions of the term "ESG" growing at an exponential rate. Not only is the C-Suite talking about ESG, it's walking that talk. Between 2010 and 2020, average greenhouse gas (GHG) emissions (Scope 1 & 2) for the current cohort of S&P 500 constituents have fallen by 50%, versus the wider US economy where emissions have only fallen by 15%.[8] Even more striking, lost-time incidence at these companies has been cut by 35%, while it has increased by 44% in the US wider economy.





We grant the critics this: the graph comparing GHG emissions to US assets uses average GHG emissions, as only 47% of the current S&P 500 constituents reported in 2010, but 75% reported in 2020. Saturna will also concede that the correlation between rising corporate discussions on ESG and the improved ESG performance does not substantiate correlation that ESG investing has led to the lower impacts. Still, to ignore this correlation while saying companies are unable to be a part of the solution without government intervention is to ignore the data.

Quite simply, markets can't be separated from society; they are a part of it. If society wants cleaner, more diverse, and more ethical companies and markets, then people are fully in their right to leverage their investments and assert their values. Failing to recognize this ignores the role of markets, through which society allocates its capital according to its wants and needs. At the same time, critiques of ESG are part of a functioning market; they will make the industry more reflective and force it to improve. Markets work through trial and error, and the evolution of ESG is no different.

Footnotes

[1] Klimo, Scott and Fegley, Bryce. "The Case For Active Management in ESG." Saturna Capital, From the Yardarm, August 09, 2018. https://www.saturna.com/insights/yardarm/case-active-management-esg

[2] Fama, Eugene F. and French, Kenneth R., A Five-Factor Asset Pricing Model (September 2014). Fama-Miller Working Paper, Available at SSRN: https://ssrn.com/abstract=2287202 or http://dx.doi.org/10.2139/ssrn.2287202

[3] Tensie Whelan, Ulrich Atz, Tracy Van Holt, and Casey Clark, CFA. "ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published Between 2015-2020." NYU Stern Center for Sustainable Business, February 10, 2021. https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf

[4] Ibid.

[5] "ESG should be boiled down to one simple measure: emissions." The Economist, July 21, 2022. https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions

[6] "The ESG Movement: The 'Goodness' Gravy Train Rolls On!" Musings on Markets, September 14, 2021. https://aswathdamodaran.blogspot.com/2021/09/the-esg-movement-goodness-gravy-train.html

[7] Fancy, Tariq. "The Secret Diary of a 'Sustainable Investor' – Part 3, The Danger of Fairy Tales." Medium.com, August 20, 2021. https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-3-3c238cb0dcbf

[8] The current cohort of S&P 500 constituents was used for historic data to control for changes in industry weight and company composition and the inherent impacts on average GHG emissions.

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While diversification does not guarantee against a loss in a declining market, it can help minimize the risk of the decline of a single market.

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