

ESG: The Promise and Pitfalls of Investing for Change

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Teaching Personal Finance Conference
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Starting Point of ESG: Shareholders Or Stakeholders

SHAREHOLDERS

There is one and only one social responsibility of business — **to use its resources and engage in activities designed to increase profits for its owners** so long as it ...engages in open and free competition, without deception or fraud.

--- Milton Friedman

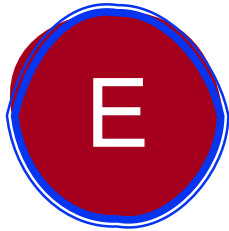
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STAKEHOLDERS

Managers have a duty to both the corporation's shareholders and "individuals and constituencies that contribute, either voluntarily or involuntarily, to [a company's] wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers."

--- Edward Freeman

ESG

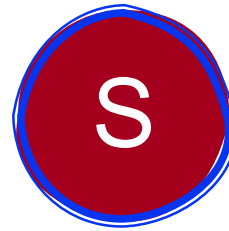


Environment

Impact of production

Carbon emissions

Pollution and waste

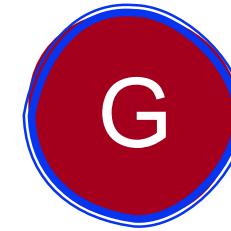


Social

Impact of products

Working conditions

Human rights and
diversity



Governance

Corporate oversight

Management is
responsible for
achieving outcomes

ESG...OR Just Good Business?



“World Without Waste”

Goal of 100% of plastic bottles made from recycled materials



\$1.25bn investment to advance racial equality / economic opportunity

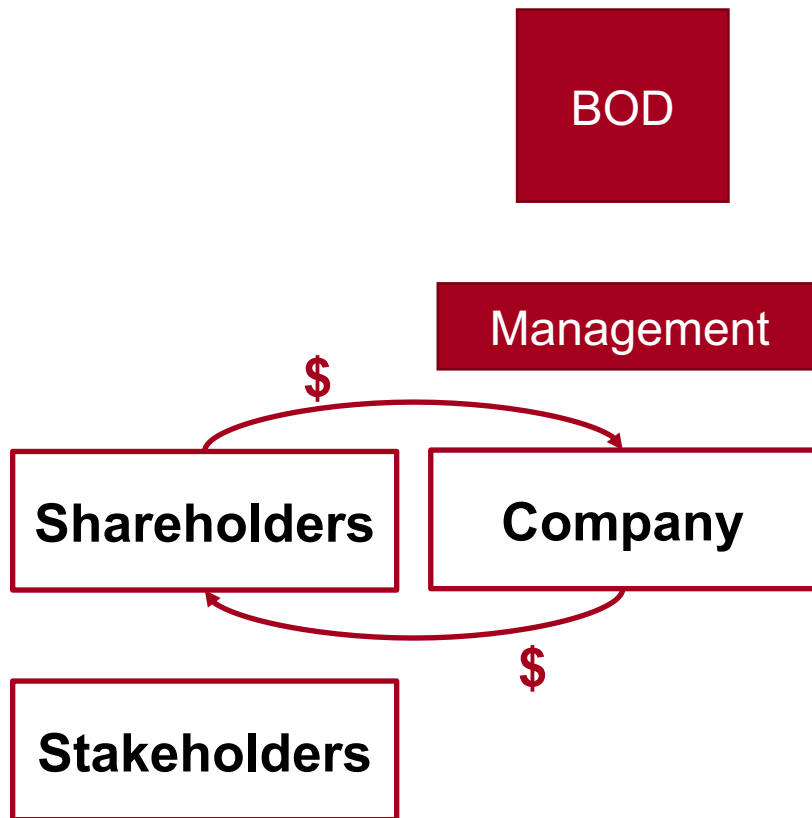
Job training, affordable housing, small business loans



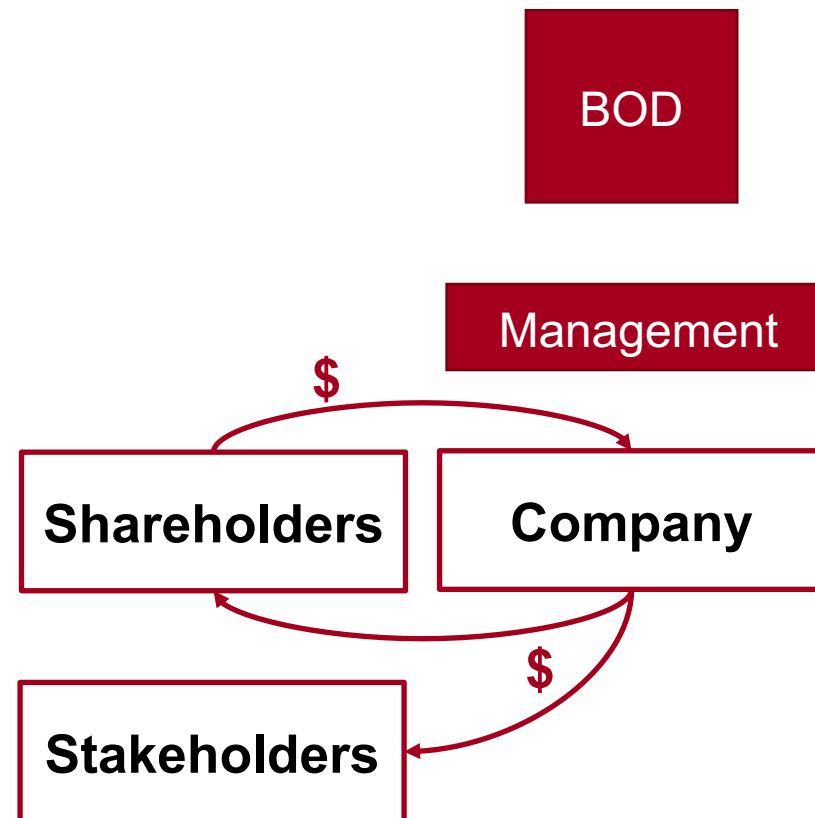
95% of S&P 500 companies have an ESG initiative.

ESG

Shareholder view (traditional)



Stakeholder view (ESG)



Recent Prominence

Business Roundtable updated its Purpose of Corporation in 2019:

*“Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance.... Each version of that document issued since 1997 has stated that corporations exist principally to serve their shareholders. It has become clear that this language on corporate purpose does not accurately describe the ways in which we and our fellow CEOs endeavor **every day to create value for all our stakeholders, whose long-term interests are inseparable.**”*

Larry Fink (Black Rock) Letter to CEOs

“... a company’s ability to manage environmental, social, and governance matters demonstrates leadership ... We are increasingly integrating these issues into our investment process.”

Legal (Fiduciary Duty)

- Boards must evaluate stakeholder needs *even if not in shareholder interests*

Economic

- Corporate executives, boards and markets *are short-term oriented*

Fix through Investing?

DIFFERENT DIMENSIONS OF IMPACT

Socially Responsible Investing

- Socially Responsible Investing (SRI) integrates value-based and ethical factors in investment analysis
- Avoids investing in companies that have negative impacts on the environment or society

Impact Investing

- More active compared to relatively passive SRI
- Concerns investments in companies and/or funds whose mission is to generate social and/or environmental impact alongside financial return

ESG Investing

- Considers impact a given firm's practices have on environment and society
- Combines extent to which firm's managers protect interests of shareholders through various governance mechanisms.

Sustainable Investing

- Investments that achieve sustainability goals, such as those set by UNDP.
- Include environmental goals as well as thinking about impact of firm actions on inequality and other aspects of sustainability.

More ESG: ? ?

	Social Positive NPV	Social Negative NPV
Private (Firm) Positive NPV	✓	?
Private (Firm) Negative NPV	?	X

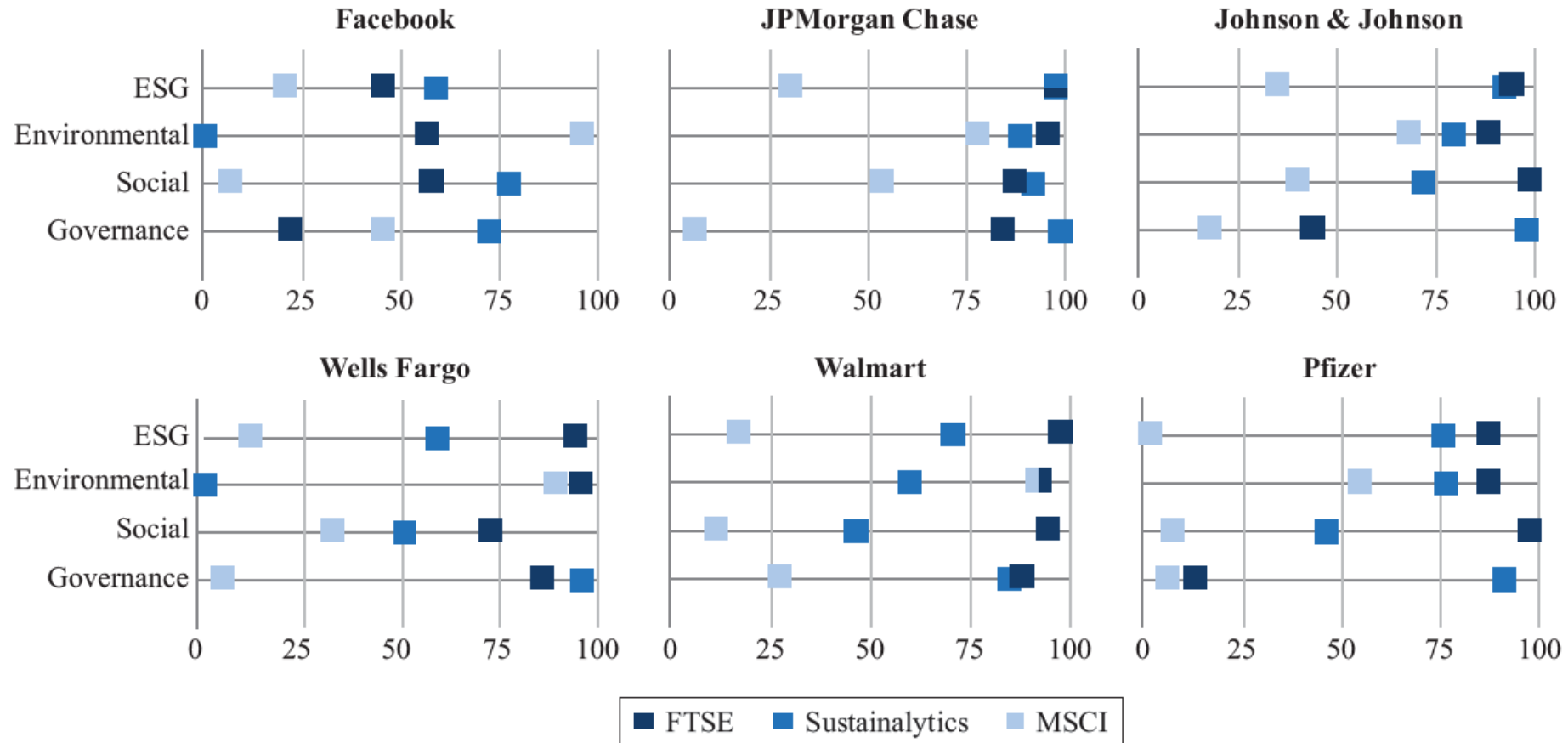
Open Questions

OPEN QUESTIONS AND SIZE OF ESG

Open Questions

Can ESG be defined/measured in ways that is consistent across investors?

ESG... Ratings




Specific companies have vastly different ratings across providers.

ESG... Measurement?

Environment Pillar				Social Pillar				Governance Pillar	
Climate Change	Natural Capital	Pollution & Waste	Env. Opportunities	Human Capital	Product Liability	Stakeholder Opposition	Social Opportunities	Corporate Governance	Corporate Behavior
Carbon Emissions	Water Stress	Toxic Emissions & Waste	Clean Tech	Labor Management	Product Safety & Quality	Controversial Sourcing	Access to Communication	Board	Business Ethics
Product Carbon Footprint	Biodiversity & Land Use	Packaging Material & Waste	Green Building	Health & Safety	Chemical Safety	Community Relations	Access to Finance	Pay	Tax Transparency
Financing Environmental Impact	Raw Material Sourcing	Electronic Waste	Renewable Energy	Human Capital Development	Consumer Financial Protection		Access to Health Care	Ownership	
Climate Change Vulnerability				Supply Chain Labor Standards	Privacy & Data Security		Opportunities in Nutrition & Health	Accounting	
					Responsible Investment				
					Insuring Health & Demographic Risk				

 Key Issues selected for the Soft Drinks Sub Industry (e.g. Coca Cola)

 Universal Key Issues applicable to all industries

APRIL 2018

MARKETS

Don't Choose Ethics Over Profits in Your 401(k), Government Warns

Labor Department notice issued this week could damp prospects for so-called ESG funds in retirement accounts



The Labor Department, headed by Alexander Acosta and which oversees 401(k) plans, issued a notice this week that could damp the prospects of so-called ESG funds in retirement accounts. PHOTO: LEAH MILLIS/REUTERS

By Sarah Krouse

77 COMMENTS

April 27, 2018 9:30 a.m. ET

Funds focused on issues like board diversity, climate change and labor rights are one of the fastest-growing areas of the money management world. But the Labor Department this week warned that these investments may not be appropriate for company-sponsored savings plans.

So-called **ESG funds**, which take environmental, social and governance factors into account when investing, have been touted by financial executives as a growth opportunity across Wall Street. Assets invested in these types of funds grew to \$95 billion in 2017, according to Morningstar Inc., up nearly 60% from the prior year.

JANUARY 2021

BARRON'S

ESG INVESTING

Biden Administration Will Reverse the Department of Labor's Ruling on ESG Funds, Analysts Say

By Lewis Braham Jan. 31, 2021 7:00 am ET



U.S. President Joe Biden signs executive actions in the Oval Office of the White House on January 28, 2021 in Washington, DC.

Doug Mills - Pool/Getty Images

The Biden administration will start walking back a controversial Department of Labor rule that would curb the use of ESG, or environmental, social, and governance, funds in 401(k) retirement plans, though it may take as long as 18 months to undo it completely, analysts tell *Barron's*.

In November, the DOL finalized a rule that made incorporating ESG funds in retirement plans more difficult. The rule,

which took effect Jan. 12, requires plan sponsors and other fiduciaries selecting ESG funds "to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives." The final rule doesn't contain specific references to ESG because there is no uniform definition of the term. Instead, it refers to pecuniary and non-pecuniary factors.

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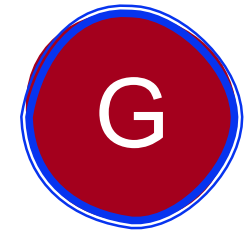
If no tradeoff, why is everyone not doing it and why has it not occurred at a larger scale?

Good **G** → “Win-Win”

	Social Positive NPV	Social Negative NPV
Private (Firm) Positive NPV	✓	?
Private (Firm) Negative NPV	?	✗

Good **G** → “Win-Win”

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Governance

Corporate oversight

Management is responsible for achieving outcomes

Good **G** → “Win-Win”

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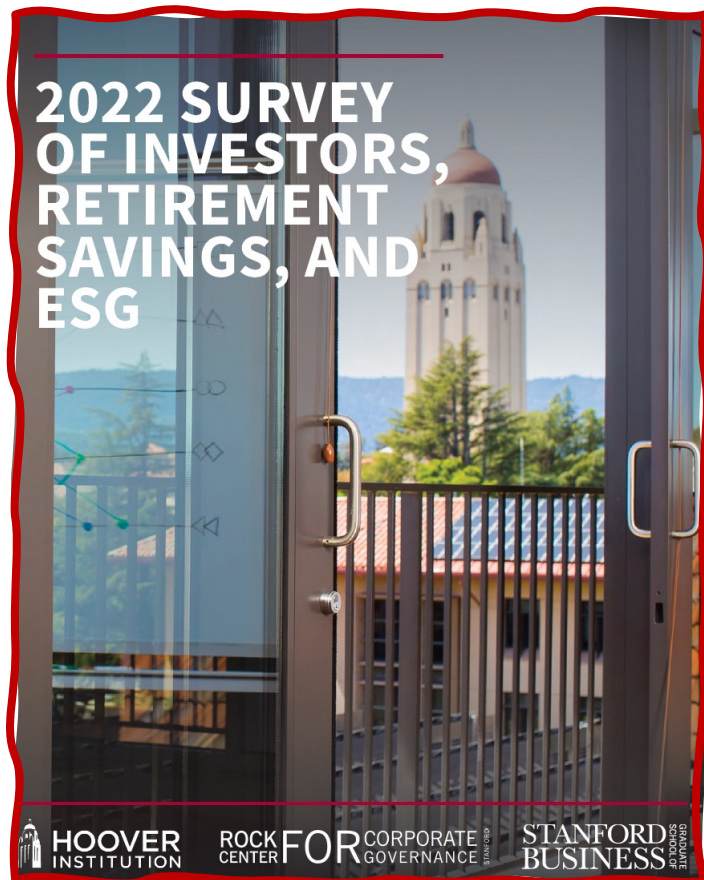
Open Questions

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If no tradeoff, why is everyone not doing it and why has it not occurred at a larger scale?

Whose ESG preferences matter?

Key Findings



Investors have opposing views of ESG and the stock market, based on age.

Young investors (<42)

- ✓ Want fund managers to advocate for environmental and social causes.
- ✓ Claim to be willing to lose 6%-10% of retirement savings to support ESG.
- ✓ Claim to be extremely knowledgeable about markets.
- ✓ Have extremely high expectations for future stock market growth.

Older investors (>58)

- Want fund managers to stick with generating financial returns.
- Do not want to lose any retirement savings to support ESG.
- Claim to have little knowledge about markets.
- Have low expectations for future growth.

Conclusion

❑ Tremendous pressure to incorporate stakeholder considerations into governance of firms

- Do companies make ESG investments that are costly to shareholders?
- Can they do so legally?
- Do these create long-term benefits?

❑ ESG euphoria might be facing a “reality check”

- ESG quality (likely) cannot be measured like a credit rating
- Should large institutional investors have influence on ESG investments by firms? How much?
 - ❖ Heterogeneity of shareholder preferences regarding ESG
 - ❖ Preferences of “uninformed” funds or individuals

❑ Investors in ESG should be prepared to realize lower returns relative to “benchmark”