ESG Investing: A costly distraction*

C.P. Chandrasekhar

ESG investing, or investment that looks to "environmental, social and governance" factors when deciding on potential targets, is much the rage. High net worth investors concerned about human rights, inequality, environmental degradation and climate change have embraced the 'movement', happy to know that they can address these concerns while building a portfolio that guards and enhances their wealth. According to the Global Sustainable Investment Alliance, socially responsible investment has grown to constitute more than $30 trillion, or around a third of professionally managed assets. In the first eleven months of 2020 alone sustainable mutual funds and exchange traded funds (ETFs) increased by $288 billion. Growth of that kind could not occur if the business wasn't lucrative.

As ESG investing opportunities proliferated, the narrative that accompanied the process was that smart thinking can identify targets that not only moved capital away from socially undesirable or high carbon emitting projects, but also performed as well as benchmarks such as the NASDAQ. For investors with a longer horizon, there was an additional bonus. Since they were hedging against climate risks by avoiding projects that would come under official scrutiny and regulation and/or face social boycott, turning into 'stranded assets' as part of the climate policy transition, they would outperform portfolios that included such products. Finally, since there is the risk of abnormal increases in the number of extreme events associated with climate change, working to mitigate carbon emissions, for example, also protects exposure to other assets. In sum, social good can be realised while improving profits and outperforming benchmarks. Tax breaks and subsidies from governments for such projects would only amplify those gains. The hype persuaded many.

To those sceptical of capitalism's claim that it was not predatory or socially damaging, there was one reason to be wary of the ESG craze. The movement was a creation of a financial system that had hugely damaged its reputation following a series of crises in emerging and developed markets (like Japan), culminating in the 2008 financial crises that besieged the metropolitan core. More recently, however, doubts about the claims being made in support of ESG are being heard expressed on Wall Street as well, by financial market insiders. Those murmurs are growing louder and are reaching a crescendo.

Among the voices leading the insider attack is that of Tariq Fancy, who served as global asset manager BlackRock Inc.'s chief investment officer for sustainable investing from late 2017. His book, seductively titled "The Secret Diary of a 'Sustainable Investor'", in which he is to lay out in full his apostatic view of the ESG movement and its real character, is due for release in August 2021. The book is much awaited. BlackRock is among the world's largest investment managers, with close to $9 trillion in assets. In a concentrated sector, it contributes to setting the standards for the investment industry. And a chief investment officer should know what he is talking about. In sum, Fancy is a rare whistle blower who needs to be taken seriously.

The main arguments being advanced by Fancy are available in a series of recent articles and interviews authored by or featuring him. When not mincing words, his view is that the financial services industry that has promoted ESG investing, persuading environmental and social activists that big business can do good for the planet and redress inequality without damaging corporate bottom lines and depriving finance of lucrative margins, is “duping the public”. The damage is not merely the failure to deliver on promises made to ethically concerned investors and the activists who lobby them. It is also to the climate cause itself, because the ESG movement is “a deadly distraction”, holding back on needed state action and regulation in the belief that an ethical corner of the market would substantially deal with the crises on the climate, environment and social fronts that are crying for urgent attention. The financial industry is finding it difficult to dismiss this view completely. In response to queries from the Financial Times (13 August 2021), a BlackRock spokesperson reportedly said that because it too “believes greenwashing poses a risk to investors”, it had called for ESG regulations. But the respondent added: “Investors, including BlackRock, are allocating capital to companies and technologies that are reshaping the world through the reduction of carbon in the production of renewable energy.”

Fancy’s financial case against ESG is strong. To start with, he says he discovered early into his term at BlackRock that many projects that were actually ESG-goals conscious were not all that profitable. The implication would be that if the funds claiming to go into ESG conscious projects were profitable, as they were, investments were possibly not really going to targets that can make a real difference on the ground.

If that were true, an elaborate charade was needed to keep the gravy train moving. ESG funds are talked up for the good they can do. Non-standardised ratings that provide ESG compliance scores to funds and projects are used to back claims of pursuing and realising social and climate goals. The success of the ESG fund in delivering higher-than-benchmark returns, that delivers profits to Wall Street and bonuses to fund managers, is presented as success in pursuing ESG goals. To top it all, “these funds and the marketing messages around them are misleading the public and lowering the likelihood that governments, who have the systemic tools and democratic legitimacy required to address large-scale crises, such as COVID-19 and climate change, will act.” More directly: “For companies, the most efficient maximisation of profits aligned with their incentives, which are skewed toward the short term, is going to be to market yourself as being green to fend off taxes and regulation. This is actually trying to convince people that the system doesn’t need to be changed.”

This is surprising. An ESG fund that stays clear of high carbon emitting projects and chooses low carbon emitters, will benefit from a carbon tax. That is ESG investment gains from regulation and state action, and should not serve as an alternative to it. Even when the investment from ESG compliant funds seem to be doing the right thing, it may not be achieving much. If an ESG fund moves capital out of fossil fuel companies, for example, it does not mean that all investment is withdrawn or that carbon emission is reduced. It may even be the case that while the same financial intermediary builds a portfolio without fossil fuel stakes for an ESG-designated fund, it may be investing in those companies through other funds it manages. Or what may be happening is that the fraction of the ESG fund diverted to fossil fuels may be lower. Finally, when a fund buys shares in a company with higher ESG scores, the money may not be flowing to support investment by the company concerned. The shares may have been exchanged in the secondary market, with the new funding going to an existing owner who may turn to a firm with lower ESG scores.

Moreover, there was a problem in using financial intermediaries like asset managers and hedge funds to do the hard work to make the world a better place. The investment business was built as one in which managers and finance professionals competed to prove they were capable of delivering higher yields. Even if some investors with clout were demanding better ESG outcomes, there would many others looking to higher returns that would turn their back on socially oriented funds offering lower returns. That puts pressure to privilege profit above climate and social uplift.

The argument is not that there are no wealth holders with a conscience who are looking to put their money in projects that do least damage or even do some good. Nor is it that there are no individual fund managers who are fired by a passion to make the world a better place. It is merely to recognise that a highly concentrated financial system that is geared to maximising returns has found ways of dipping its hands into the ESG investing pot, diverting large sums to projects that yield money but possibly pollute more, or at least not less. Wall street gains, while mankind does not get the promised social benefits.

It is true that there are efforts underway to improve disclosure and data reporting standards, develop better and standardised ESG scores, and make outcome assessment independent. But as of now there isn't enough progress to see this form of private finance as being of significance. The UN-sponsored Principles for Responsible Investing (PRI) was launched in 2006 and was expected to become the leading standard for sustainable investing. Though voluntary, most of world's leading pension funds and asset managers signed on. Emboldened by the response, the PRI made the process of reporting compliance to its standards more stringent. This did not work, and the launch of new reporting requirements has been postponed to 2023. Those in charge have admitted the changes were "too ambitious" and apologised for the "mistake".

The report from Working Group 1 of the Intergovernmental Panel on Climate Change has declared that current science suggests that mankind can avoid the catastrophe that would follow from global temperature increases of 2 degrees centigrade or more only if it adopts drastic action in the coming years. Such action would cost trillions, with resources required rising higher if other, tied objectives embodied in the United Nations' accommodative set of sustainable development goals are considered. Private returns from spending driven by social and climate conscious objectives are likely to be lower than elsewhere, though social benefits of such spending would undoubtedly be large. So, while governments may be persuaded to sacrifice some or much profit to realise social outcomes that are not traded and priced in markets, the private sector with an eye on the bottom line can at best be a minor, supporting player. In those circumstances, misleading hype about ESG investing that rides on public concern to garner private profit is hardly what we need. It can, as Fancy says, prove a costly distraction.

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