ESG Does Not Mean Impact

Private investors are increasingly interested in aligning their investments with their values and using their wealth to make a positive impact on society. In response, asset managers have raced to offer investors a wide range of ESG and socially responsible investment strategies to serve and profit from this growing area.

At the end of 2019, there were over 800 ESG mutual funds and ETFs according to the US SIF Foundation. Product launches continued to explode in 2020 as BlackRock alone launched 93 new strategies last year. Net flows of $51 billion in 2020 were more than double the total for 2019 and nearly 10 times more than in 2018 according to Morningstar.

While some ESG advocates and asset managers claim a performance advantage for ESG, we believe the data is inconclusive and it is a mistake to make any blanket assumptions about whether ESG as a category will outperform or underperform in the future. For this paper, we assume there is no ESG “alpha” or performance impact, positive or negative, associated with ESG investing.

Before impact-minded investors decide to put their money into ESG funds, we believe they should consider the fees associated with ESG strategies and whether these strategies really represent their personal values.

1) ESG Strategies = Higher Fees

Most ESG strategies run 5 to 30 bp more than comparable non-ESG strategies. That means an impact investor with $10 million could pay an additional $5,000 to $30,000 in fees to his money manager each year.

While paying that extra money for an ESG strategy is an option, an investor may also want to consider making a direct and measurable environmental or social impact by donating that extra money to a charity of his choice. For example, thirty thousand dollars in extra fees can go a
long way towards alleviating hunger or restoring land. It covers the cost of planting 30,000 tree seedlings or serving 300,000 meals to the hungry according to the US Forest Service and Feed America.

### Potential Opportunity Cost of Extra ESG Fees

Data for $10 million account

<table>
<thead>
<tr>
<th></th>
<th>5 bp Increase</th>
<th>30 bp Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extra Management Fee</td>
<td>$5,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Trees Planted</td>
<td>5,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Meals Provided</td>
<td>50,000</td>
<td>300,000</td>
</tr>
</tbody>
</table>

Rather than pay ESG fees, an investor could plant 30,000 trees or pay for 300,000 meals.

2) **ESG is Not the Same as Ethical**

It is expedient to believe that highly rated ESG companies are “good” companies. While this holds true in some instances, to assume this connection is an error.

The purpose of ESG scores is to measure companies’ resilience to long-term, financially material, investment risk across the environmental, social, and governance factors. These investment risk ESG ratings use hundreds or even thousands of different pieces of information across environmental, social, and governance dimensions to create a single ESG score. **These ESG scores are designed to help investors evaluate financial risk, not to rank or judge the ethics of a company.**
Here are some examples of companies that have average to high ESG scores, but are controversial from an ethical perspective:

**Philip Morris International**

S&P Dow Jones has recognized Philip Morris International for its ESG efforts by adding it to its Sustainability Index. ESG providers like S&P Dow Jones have credited the company with investing in lower risk tobacco products and running its business responsibly on most ESG dimensions.

The problem with Philip Morris is its existing business model. The company profits from addictive and harmful products, which can negatively impact the physical and mental health of its customers while taxing health systems. Given the externalities associated with cigarettes, many ethically oriented investors are uncomfortable with the idea of owning and profiting from them.

**Nike**

Nike is a highly rated ESG company (A rating from MSCI) and is largely well regarded for its environmental efforts.

However, there are serious questions about the company’s ties to forced labor. The Congressional-Executive Commission on China, a bipartisan group of lawmakers, has listed Nike as a company with suspected links to forced labor in Xinjiang, China. While ratings providers like MSCI loosely capture Nike’s supply chain issues, they have limited impact on its overall ESG scores.

Since Nike is a highly rated ESG stock, it will likely be an overweight position in standard ESG strategies.

**Amazon**

Amazon has been widely criticized for questionable practices including the treatment and safety of the company’s labor force, tax avoidance, and monopoly-like behavior that hurts small businesses. Despite all the controversies surrounding the company, it maintains an average ESG rating, which means it is likely to be present in most core ESG strategies.
The fact that some controversial companies have high ESG scores or are held in ESG strategies is not a failure of ESG rating providers or money managers. It is simply a reflection of the complexity involved in assessing companies across a wide range of issues that include everything from diversity initiatives, climate change disclosures, treatment of shareholders, product quality and so on.

3) **Investors “Do Good” Priorities May Differ from ESG Money Managers**

Most large investors are focused on environmental issues like climate change and governance concerns like corruption, board composition, and executive pay. These issues will influence their portfolio positions.

A recent survey of money mangers from the US SIF Foundation illustrates how managers are increasingly focused on climate change with $4.2 Trillion in assets incorporating climate and carbon into the investment process.

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**Top ESG criteria for money managers in 2020**

<table>
<thead>
<tr>
<th>Category</th>
<th>Increase vs. 2018</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Climate Change/Carbon</td>
<td>39%</td>
<td>$4.2T</td>
</tr>
<tr>
<td>Anti-Corruption</td>
<td>10%</td>
<td>$2.4T</td>
</tr>
<tr>
<td>Board Issues</td>
<td>66%</td>
<td>$2.4T</td>
</tr>
<tr>
<td>Sustainable Nat. Resources/Agriculture</td>
<td>81%</td>
<td>$2.4T</td>
</tr>
<tr>
<td>Executive Pay</td>
<td>122%</td>
<td>$2.2T</td>
</tr>
</tbody>
</table>

SOURCE: US SIF Foundation
Although the issues above matter and present financial risk to investors, they may overshadow critical social issues like human rights, the treatment and dignity of workers, and conduct towards customers, governments, and communities.

**Conclusion**

It is a mistake for well-intentioned investors to automatically assume that they are doing “good” or maximizing their positive impact on society by investing in ESG strategies. There is often a direct financial cost and ethical trade-off for investing in these strategies. Before committing money to an ESG strategy, it pays for investors to reflect on their values and how they want to incorporate them in investment and giving decisions. There is no one right answer to the question of how impact minded investors should allocate their money. The key is for investors to articulate their values and beliefs and align their wealth management decisions with them.