AMSA

Evaluating the Returns and Ethics of ESG Investing

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Yuki Yamamoto

AMSA

Index

Introduction p. 1

The Returns p. 1

The Ethics p. 4

Selection Process p. 4

The Issues with Selection p. 4

Conclusion p. 6

References p. 7

Introduction

With global shifts towards achieving sustainability to combat inhumane and environmentally unfriendly actions, many investors have altered their investment thesis to suit this current trend. This was a catalyst to the popularization of environmental, social, and corporate governance (here referred to as ESG) investing. ESG investing refers to investment decisions made based on the ethical considerations for the environmental and social aspects. In fact, $30.7 trillion is currently a part of the sustainable investment funds, and further growth is predicted to come with time (ADEC Innovations). Hence, the growing interest for capital allocation into ESG emphasizes the necessity to dig further.

When ESG investing is promoted, there are many justifications that are brought up. More precisely, there are two benefits that are dominantly indicated: higher returns and good ethics. The former is supported by some statistically significant evidence that suggest higher returns for these investments, such as a report presented by the European Securities and Markets Authority (ESMA, 2022). The latter factor is simply a logical argument, stating that sustainable investments is more ethical and virtuous. These are convincing points that aligns with the preferences of most investors.

However, research has started to suggest that many ESG funds are possibly less ethical than it presents itself, and to make matters worse, returns are suggested to be quite low. In this report, we look at the critiques of ESG funds, and check the validity of the counterarguments.

The Returns

In this section, we will first investigate various existing literatures regarding ESG returns to obtain consensus of expert opinions.

Fortunately, some research has expressed news that is favorable for many investors. For instance, a paper from New York University has collected and analyzed more than 1,000 relevant research papers published between 2015 to 2020. Their evaluation has depicted that 58% of corporate studies have shown a positive relationship between ESG and financial performance, and merely 8% have shown a negative relationship. The rest showed either neutral or mixed results. Moreover, the paper highlights one research that indicated a better return in the long-term

for ESG stocks than in the short-term (Whelan et al., 2021).

Like the New York University research, an analysis by J.P. Morgan Asset Management division has indicated positive relationship between ESG-integration and stock returns during 2020 to 2021. They justify these inferences by change in consumer sentiment, cost of capital and disclosure rules. In addition, they specifically emphasize that the political environment has taken a huge role in their results. Governments and central banks have acted in ways that provide monetary incentive to sustainable firms, which may have contributed to better market sentiment and stock price. (J.P. Morgan, 2021)

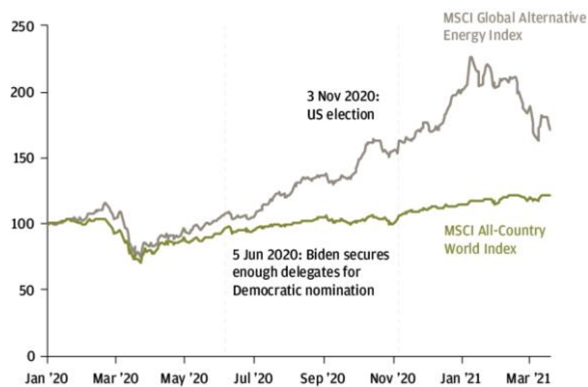

Figure 1 Source: J.P. Morgan, 2021

However, not all research were good news for investors. For instance, several University of Chicago researchers have analyzed more than 20,000 mutual funds, their returns, and their respective Morningstar sustainability rating during the years of 2015 to 2017. Their analysis suggests that there is no evidence that suggests that higher ranked funds outperform the lower ranked counterparts (Hartzmark & Sussman, 2019).

Likewise, research from Lund University measured the impacts of ESG rating on stock performance between 2005 to 2018 for US companies. Their findings have suggested that stocks with low ESG scores have outperformed the medium and high ESG scores. Moreover, only the low ESG has outperformed the market. Interestingly, even during financial crises like the Great Recession in 2008, low ESG scores seem to perform better (Breitz & Partapuoli, 2020).

One possible difference in responses could be due to the timeframe observed. From this small sample of chosen studies, we can insinuate that older data points will indicate underperformance of ESG stocks, whereas more recent data points will indicate overperformance. To test this, we created a basic return analysis of different ESG ETFs (lines with different shades of blue) and the S&P 500 ETF (red line). As speculated, the returns of ESG funds generally started to

outperform more recently – around the beginning of the COVID-19 market crash.

The important question then arises: is outperformance derived from an increase in value of ESG or is it due to temporary and exogenous impacts like good macroeconomic environments and government regulations? This is important because we need to understand whether there is fundamental value in companies' pursuit to ESG. In other words, will companies enforcing ESG yield high cash flows in the future?

Unfortunately, only time will tell regarding the true answer to our question. That said, outperformance of ESG funds has been evident in recent times. However, ambiguity exists regarding the sustainability and source of this outperformance.

Research by Scientific Beta seems to believe that the outperformance was due to non-ESG related issues. They found that three-quarters of outperformance was a result of "quality metrics" like high profitability and conservative investment (Johnson, 2021).

Figure 2 Source: Yahoo Finance, 2021

The Ethics

To some investors, returns can be comprised, given that their capital is directed towards ethical firms. However, an important question must be asked: are ESG stocks beneficial for society as a whole? This section dives into the 'ESG-ness' of the firms, and looks at many examples and data of non-sustainable ESG stocks to suggest skepticism when investing in ESG funds.

Selection Process

Although there may be a wide range of ways in which investors, mutual funds and ETFs select ESG stocks, a common way is to explore different ESG ranking websites. Examples of this would be MSCI, Sustainanalytics, or the S&P Global Ratings. An important aspect to realize is that great subjectivity and biases exist in this ranking, which will be explored further.

The Issues with the Selections

The problem with subjectivity and the difficulty in quantitative measurement is that the selection of ESG stocks tend to not reflect their true progresses towards sustainability.

A great relevant and recent example is the recent exclusion of Tesla from the S&P 500 ESG ETF selection. Despite their continuous effort to create electric vehicles, it was controversial that it did not make it in a list of 300 companies, despite ExxonMobil being in the top 10 (Barry, 2022).

The evidence of subjectivity and problematic selections do not end here. In the figure below, we see the ratings provided by 3 popular ESG-rating companies for 6 of the largest US companies. It is extremely evident that there lacks consensus in this agreement (Damodaran, 2020).

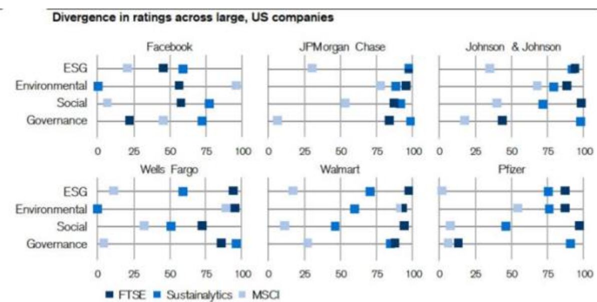

Figure 3 Source: Damodaran, 2020

Despite a larger amount of public information that is available for larger companies, such variability in ratings were seen between just three different rating companies. Henceforth, for small and medium sized companies, which are majority of the companies, we should expect a larger disagreement of these scores.

Damodaran (2020) provides more supporting data for this point. The figure below shows

that, on average, there seems to be moderate correlation between the scores of different components of ESG and the complete ESG across the different measurement service companies. The correlation is especially bad for the minimum ratings, which is slightly concerning as, logically, 'bad companies' should be obvious, and one would expect consensus for this.

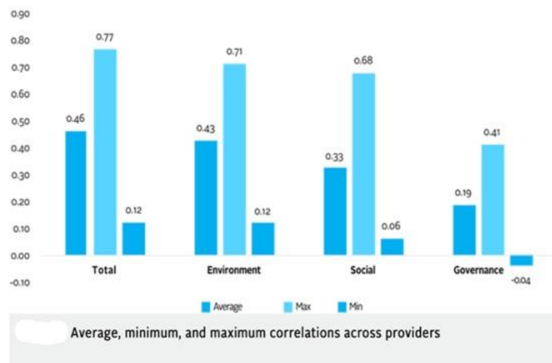

Figure 4 Damodaran, 2020

Moreover, many ESG ranking websites have ranked higher ESG for companies with Russian activities, as opposed to firms with European activities. Although this has been changed in hindsight, it does show that ESG ranking is not a good estimator of a "true" ESG of a firm, simply due to the large necessity of subjectivity. (Damodaran, 2022).

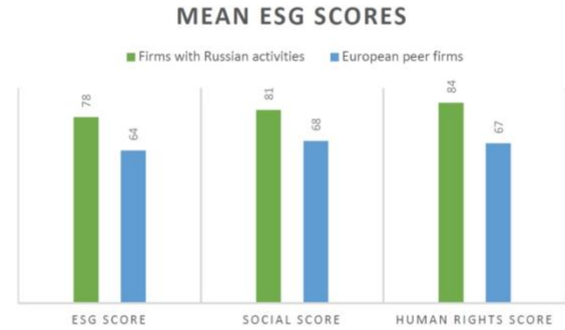

Figure 5 Source: Damodaran, 2022

To make matters worse, many firms take advantage of the subjectivity in this domain by greenwashing, which is the act of looking sustainable, rather than being sustainable. A survey by Google Cloud showed that 58% of executives have admitted to engaging in greenwashing, mainly by exaggerating their efforts to limit environmental damages in their company reports. Another survey by Harris Poll showed that 35% and 29% of US and worldwide executives, respectively, have admitted to treating sustainability as a PR stunt, instead of goals to make a difference in the world (Tyson, 2022).

These findings are not meant to generalize that all aspects of ESG rankings are inherently wrong. In fact, the term 'wrong' is difficult to measure and assess in this domain. In contrast, this section was to indicate the potential deceptions and faultiness of ESG investing. As investors that want to focus on making a difference, it is important to ensure

that the invested companies are truly trying to do so. We want to emphasize to be skeptical and conduct research before selecting any ‘ESG-stocks’.

Conclusions

This paper investigated the associated returns and ethics with investing in ESG. We found that the relative performance of ESG stocks have started to outperform the market since COVID. However, the reason for this outperformance is slightly ambiguous, and thus, investors should also be ready for a potential underperformance. Moreover, investors need to also worry about the ethics of investing in ‘ESG stocks.’ Our findings have suggested that, due to the subjectivity manner of ESG, many selected firms do not actually execute sustainable measures.

From these findings, we believe that ESG investments can potentially yield high returns and make good returns if strong research is done beforehand, like with any other stocks. ESG is simply a component of stock screening, and we recommend investors to still verify the fundamentals and the financial strength of the company. Moreover, doing more research on the business can help ensure possible sustainable impacts that your investments will have.

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