ESG: Do We Need It and Does It Work?

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I. Do We Need ESG?

A World Without ESG: Friedman (1970)

- "The social responsibility of business is to increase its profits …"
- "… focusing totally on making money, and forgetting about any concerns for employees, customers or society"
  - Steve Denning, Forbes

A World Without ESG: Friedman (1970)

- "It may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill"
- "… while conforming to the basic rules of the society, both those embodied in law <u>and those embodied in ethical custom</u>"
- ".. so long as it stays within the rules of the game, which is to say, engages in open and free competition without <u>deception</u> or fraud"

A World With ESG?

- "We share a fundamental commitment to all of our stakeholders. We commit to:
  - Delivering value to our customers
  - Investing in our employees
  - Dealing fairly and ethically with our suppliers
  - Supporting the communities in which we work
  - Generating long-term value for shareholders"
- "The more your company can show its purpose in delivering value to its customers, its employees, and its communities, the better able you will be to compete and deliver long-term, durable profits for shareholders"

Where Friedman (1970) Fails

- "What Stakeholder Capitalism Can Learn From Milton Friedman": view Friedman not as a doctrine, but a theorem (like Modigliani-Miller)
- Three critical assumptions

1. Serving society is zero-sum (e.g. charitable donations)
   - But companies may have a comparative advantage
2. Assumes government intervention is effective
   - But many factors are difficult to regulate
3. Assumes that shareholder value can be maximized instrumentally
   - True with risk, but not with uncertainty

II. What Is ESG?

VENTILATOR
CHALLENGE
UK


whisperflow


ETHER
WHISPERFLOW


WHISPERFLOW

UCL
HEALTHCARE ENGINEERING

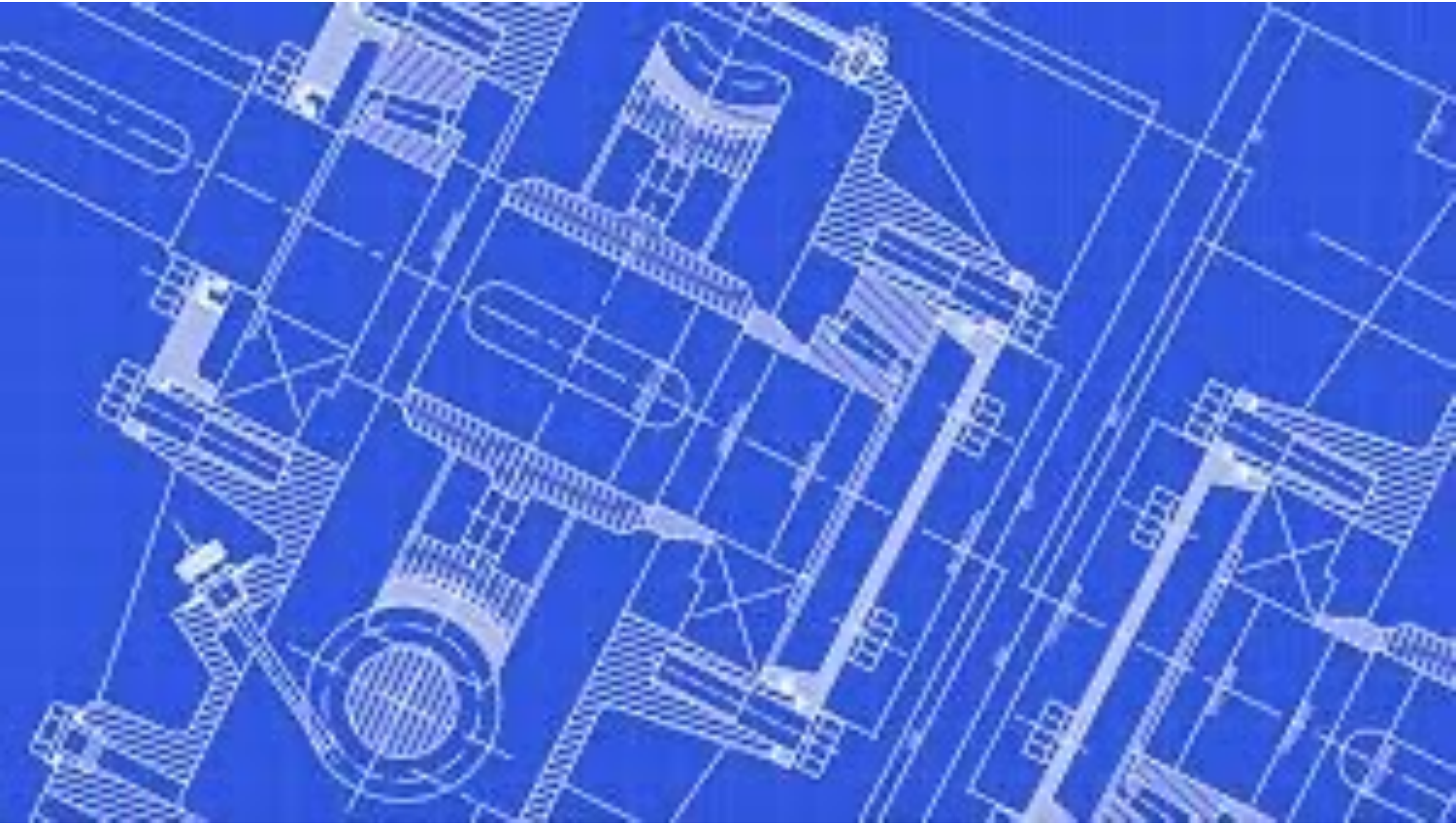
UCL
Mechanical Engineering

NHS
University College London Hospitals
NHS Foundation Trust

MERCEDES AMG
HIGH PERFORMANCE POWERTRAINS

Photo Credit: James Tye (UCL)

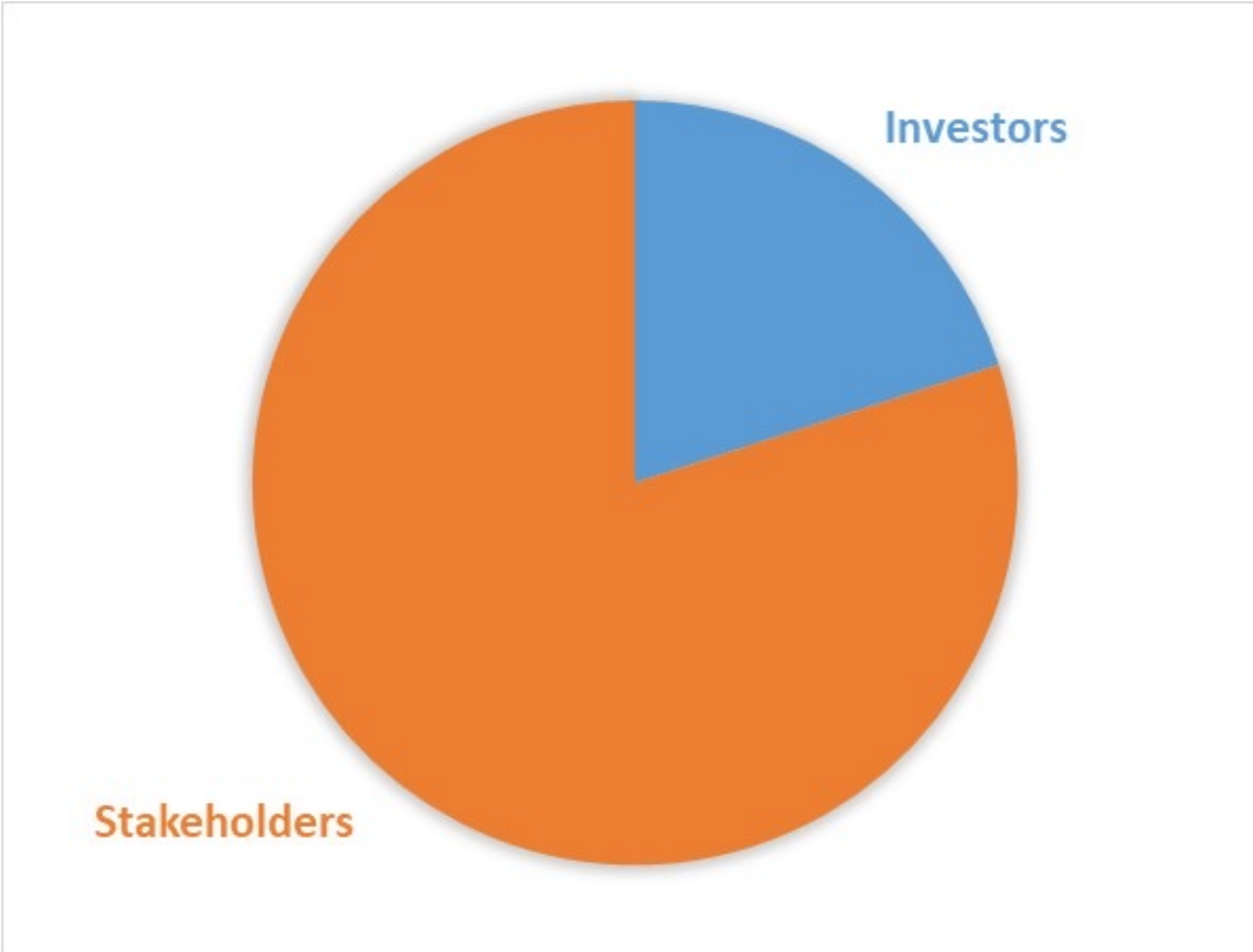

MIKRON



Mercedes

- How did Mercedes' involvement in UCL-Ventura improve its ESG scores?
- What reputational hit would Mercedes have suffered had it not been involved in UCL-Ventura?


Investors
Stakeholders


Investors
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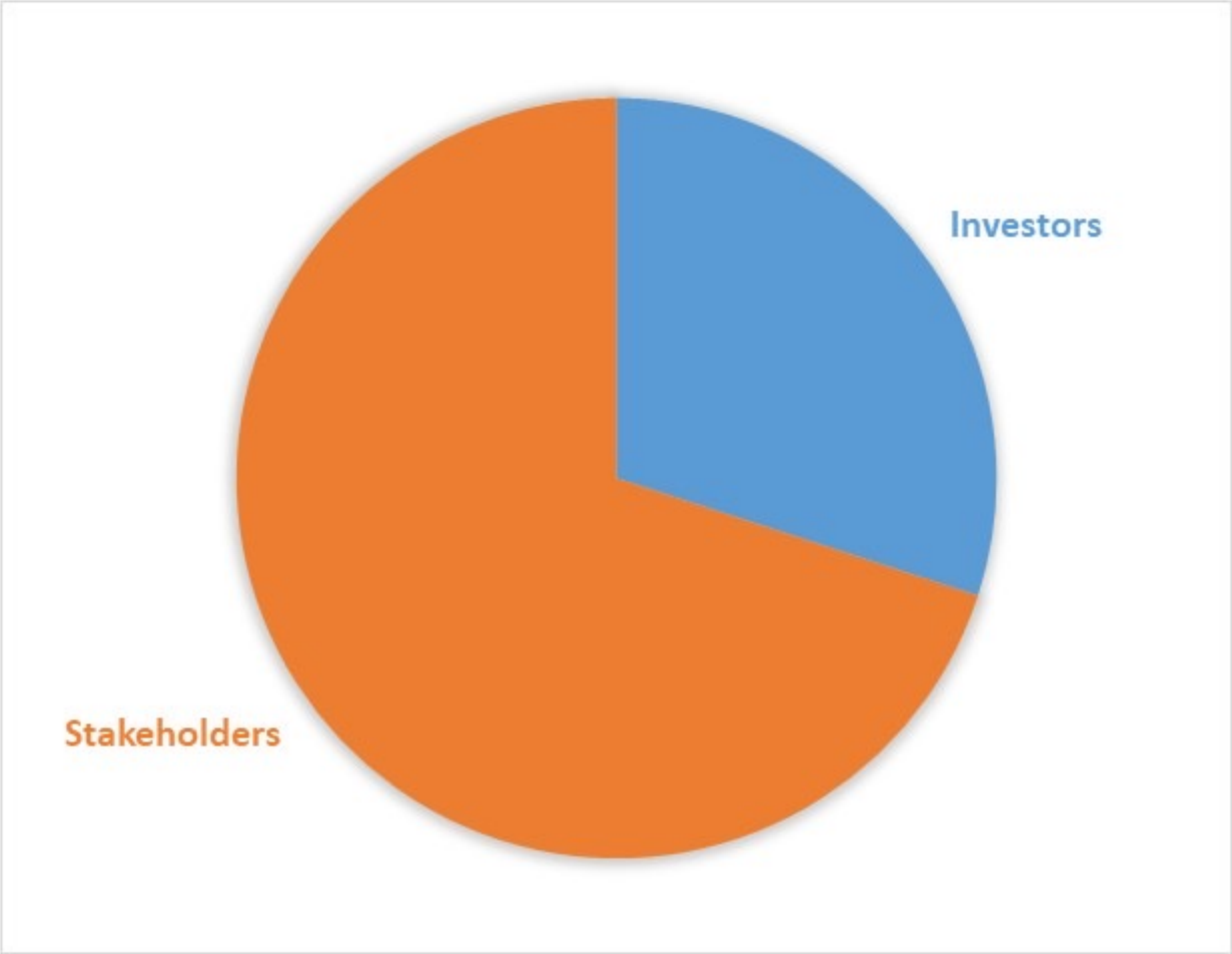
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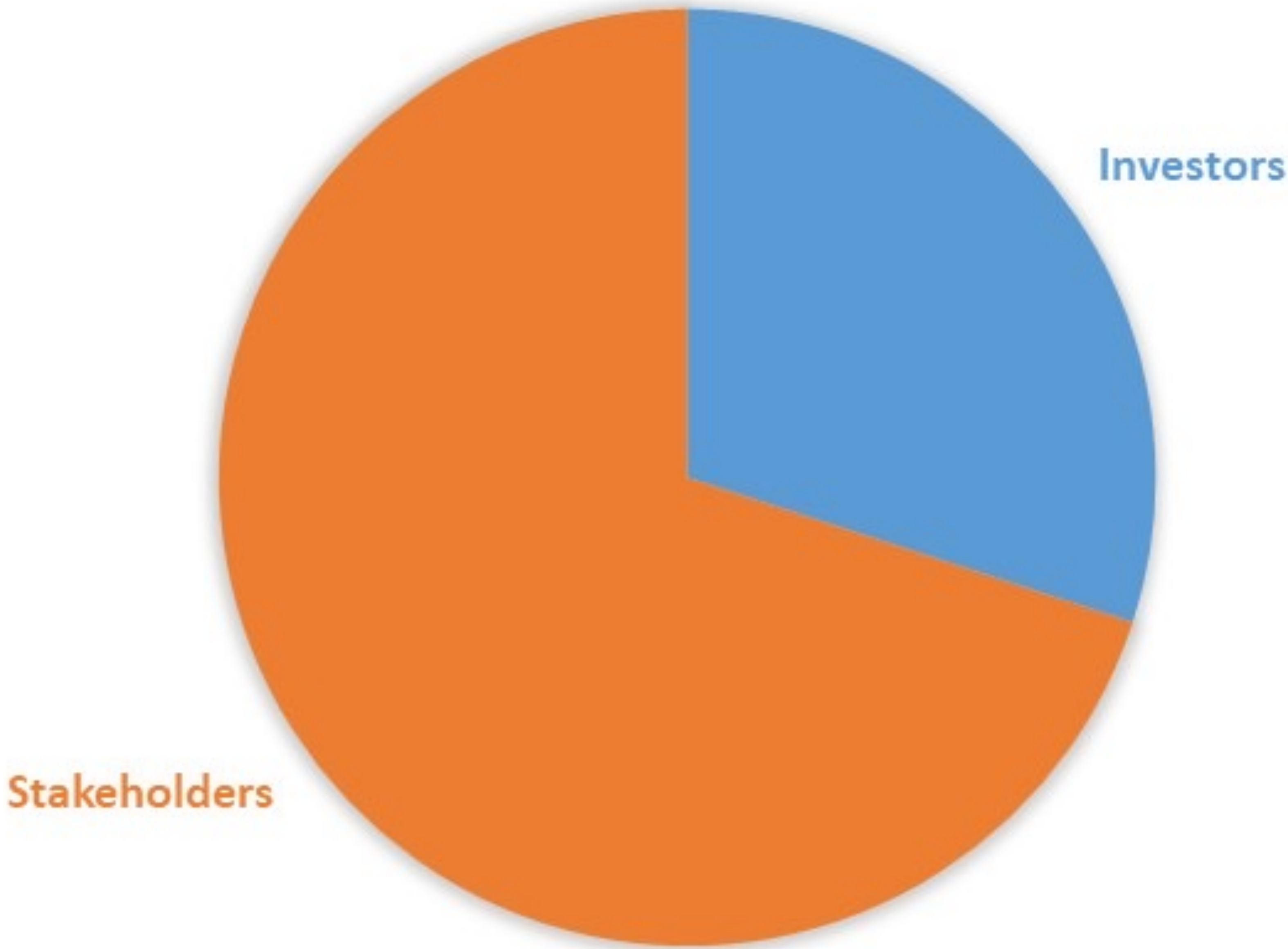
Investors
Stakeholders

III. Does It Work?

Beware Confirmation Bias

- People accept "evidence" if it confirms what people would like to be true
  - A particular issue with ESG investing

Does ES Pay Off?

- How to measure ES?
- Study output, not input
- Edmans (2011, 2012): 100 Best Companies to Work For in America
  - Outperformed peers by 2.3-3.8% over 1984-2011 in total shareholder return (89-184% cumulative)
  - Systematically beat analyst earnings expectations
- Boustanifar and Kang (2021):
  - Replicated successfully for 1984-2011
  - Continues to hold until 2020
  - Robust to new factors (e.g. profitability, quality) and risk models

		Extractives & Minerals Processing	Financials	Food & Beverage	Health Care	Infrastructure
Dimension	General Issue Category ⓘ	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand
Environment	GHG Emissions					
	Air Quality					
	Energy Management					
	Water & Wastewater Management					
	Waste & Hazardous Materials Management					
	Ecological Impacts					
Social Capital	Human Rights & Community Relations					
	Customer Privacy					
	Data Security					
	Access & Affordability					
	Product Quality & Safety					
	Customer Welfare					
	Selling Practices & Product Labeling					
Human Capital	Labor Practices					
	Employee Health & Safety					
	Employee Engagement, Diversity & Inclusion					

Sustainability Accounting Standards Board Materiality Map

The Importance of Materiality

- Khan, Serafeim, and Yoon (2016):
  - ESG data from KLD (now MSCI ESG)
  - Firms that score high on all issues outperform by 1.5%/year, insignificant
  - Firms that score high on material issues and low on immaterial issues outperform by 4.83%/year

IV. ESG Investing in Practice

Divestment / Exclusion

- Divest / exclude based on objective screens, e.g.
  - "Sin" industry (tobacco, energy)
  - Low board diversity
  - High pay ratio
- Commonly-stated rationales
  - Alignment with social norms
  - Deprive firms of capital
    - But many excluded firms have poor investment opportunities; indeed, this is why they're out of favour
  - Change behaviour
    - But needs to be contingent on behaviour[1]

1. Edmans (2009)

Integration

- Incorporate ESG factors alongside financial factors
- "Net Benefit Test": Does the company provide a net benefit to society?
  - Holistic approach: "bads" can be outweighed by "goods"
- Considers excellence
- Considers comparative advantage
- Considers materiality

Further Reading

- "Grow the Pie: How Great Companies Deliver Both Purpose and Profit"
  - Financial Times Business Books of the Year, 2020
  - https://www.growthepie.net/teaching-materials/ contains teaching materials