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MSCI ESG Now Podcast

"ESG Is Becoming Polarized – It Doesn't Need To Be"

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Bentley Kaplan

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects, and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

And on today's show, we are going to get into some of the questions being raised about ESG-related investing in the US. This is because we've seen a ramp up of legislative efforts to either discourage or encourage the use of ESG data in investment decisions. So firstly, we're going to talk about what is actually happening in the space. Then we'll dig a little deeper into the backlash against ESG investing, by starting with two of the main points being made by some critics. And then we'll try to figure out how investors can potentially navigate this increasingly complex situation. Thanks for sticking around, let's do this.

First up, a quick note. This episode follows on from a previous show that Mike hosted called "Everyone Hates ESG". In that episode, Mike and our colleague Meggin Eastman dug into criticisms of ESG that were mostly about how to define it or what people believe is the correct way to do it, and other perceived shortcomings in the models or the data or the various investment approaches. It's a very helpful explainer of the state of the ESG investment world and if you're interested in finding out more, please do go check it out at the end of this episode.

Now today's show is going to kick off by looking at a backlash against ESG investing, particularly in the US. One where at least some of the participants object to the idea of considering environmental, social or governance information in investments at all. If you read some of the headlines, it's easy to be distracted by the rhetoric that sometimes accompanies the debate about ESG. Instead, today we're going to put that to one side and talk through some recent developments and explain our view of ESG and the role it can play.

So things are kind of happening at two levels. At the state level, we're seeing a patchwork of proposed legislation that is either trying to incorporate ESG considerations in the investment process, or looking to exclude it where it is non-material. In some states, there are proposed bills that aim to compel state pensions to divest from funds or fund managers that engage in ESG investing. But on the flip side, other states have proposed bills in favor of either including ESG considerations in investing, or at least making it optional.

And it's also a little more complicated than that, because ESG-related investing might be regulated in different ways, depending on how it's interpreted, or what specific areas of ESG investing are being focused on. Restricting investment in fossil fuel-related activities is very different to say, compelling companies or investors to report on their climate emissions, but both of these are tied to ESG and ESG investing, albeit in different ways, which we'll come back to a little later.

And then, at the federal or national level, we're seeing this same sort of push and pull, where there are those advocating for the use of ESG data in investment decisions, and those that are against it. And this push and pull was highlighted, following the November 2022 decision of the Department of Labor to implement a rule called "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights", which falls under the Employee Retirement Income Security Act, or ERISA.

And in essence this new rule allows plan fiduciaries, the managers of things like 401(k) funds, to quote "consider climate change and other environmental, social, and governance (ESG) factors when they make investment decisions and when they exercise shareholder rights, including voting on shareholder resolutions and board nominations." It's worth noting that this rule does not compel these fiduciaries to use ESG data, or mandate its use – but rather allows for its inclusion in investment decisions. In response to this new rule from the Department of Labor, in January this year, 25 states filed a federal lawsuit, stating that the rule quote "prioritizes woke Environmental, Social and Governance investing over protecting the retirement savings of approximately two-thirds of the U.S. population." And in late February and early March, a bill that sought to overturn the Department of Labor's new rule passed through both the house and senate. It was unclear at the time of recording whether President Biden would ultimately veto this bill.

So with increasingly polarized headlines and growing legislative pressure, the first thing we wanted to do was to consider two key criticisms that are being put forward by those who have made clear their anti-ESG stance. And I'm going to put these criticisms to my colleague, Meggin Eastman, Head of New ESG Research Solutions, who will be joining me through this discussion and is someone who has seen the decades-long evolution of responsible investment through its many iterations and acronyms. So Meggin, thanks for joining. Let's start with the maybe more controversial criticism – an assertion that ESG, writ large, is being used to impose liberal ideologies onto companies, investors and their employees…

Meggin Eastman

OK, we do hear that in some of this criticism. But there's really nothing subversive going on here. Let's back up a little for a minute. As I mentioned on the previous episode, there are lots of different ways that investors can use ESG data or ratings in their investment process. And different reasons to do it as well. The most common reasons are financial – taking whatever information might help deliver better returns, reduce risk, etcetera.

Some investors also have non-financial goals, like mitigating climate change, or protecting human rights, or avoiding activities that aren't compatible with their religious faith.

And I think that some of the questions around ESG are can be traced back to confusion about these two concepts, financial and non-financial goals. Critics of ESG might be looking at the first category and assuming it's actually the second, or they might be looking at the second thinking that it's somehow being foisted onto investors without them knowing or wanting it.

I'll come back to ESG for financial goals in a second, but I want to dig in a little more on that second category – using ESG information to target non-financial goals in investments. This is a thing people do and have done for a long time, back several decades to the early days of this industry, especially for faith-based investing. If you want to make sure you're not investing in companies that sell tobacco, you can use ESG data to do that. Or if you want to target investments in companies that are providing essential services to underserved markets, you can do that too. Or just focus your investments on companies that pollute less and treat their workforces better. And plenty of investors have goals like this alongside their financial goals. We've got years' worth of evidence now that it is possible to do both, that there are ways to target non-financial goals without compromising on the financial goals – sometimes it even helps. So maybe the question isn't whether investors are doing this sort of thing, but rather why they might do it.

If you think about the basics of the investment ecosystem, you've got individuals like you and me who own assets, basically our savings. You've got institutions that own assets, like pension funds, on behalf of beneficiaries. And you've got managers of assets who deal with the day-to-day management of it all in exchange for fees. Managers of assets have to attract and retain clients – whether that's my parents or my pension fund. So in one scenario, asset managers might develop strategies or funds with some of these kinds of non-financial goals because they think it will attract clients. But they won't attract those clients if it's not pretty apparent what they're doing. Which incidentally should also mean that potential clients who DON'T want it don't sign on.

The other scenario is that an asset manager does this because it's in the mandate from an asset owner client and they must do it in order to get or keep that contract.

Bentley Kaplan

OK right, so ESG data can be used in efforts to meet non-financial goals. And I suppose that in these sorts of non-financial goals, we're talking about a very wide range of applications. But whether or not investors choose to include these non-financial goals would depend partly on their clients' interests, or the investment mandates that guide their processes.

So then let's maybe talk about the second major criticism of ESG, which is that the use of ESG data, or ratings, or strategies is in direct opposition to maximizing returns over certain time horizons. Meggin, how does that criticism strike you?

Meggin Eastman

Sure, so this argument is not actually particularly new. From the earliest days of ESG, there was always a question of whether it could actually lead to financial outperformance – or whether by definition it would lead to underperformance. As time has passed, there's just a lot more evidence to help answer this question. The upshot is that, first, these things are not inherently incompatible. Considering ESG information doesn't have to hurt performance. But even more than that, we've learned that, if you use it right, it can in fact help.

Anecdotally, there are lots of company examples, right? Think about something dramatic that happens…. A car manufacturer is found to be using devices to cheat emissions tests, or a global mining company has a massive tailings dam collapse, or destroys an aboriginal heritage site. These events have their roots in how the companies were – or weren't - managing environmental, or social or governance matters. And they all had hefty financial impacts - on share prices, company valuations, legal costs, and so on. Having access to ESG data might have helped investors see events like these not as sudden and unpredictable, but sometimes as part of broader patterns and trends. But the really interesting evidence comes from empirical studies looking at large universes of companies over long periods of time.

We've conducted and published quite a bit of this research ourselves, including several studies that have been published in peer-reviewed research journals. As a couple of key examples, I would point to a series of papers on the Foundations of ESG Investing, and then another on Deconstructing ESG Ratings Performance. We found that companies with higher ESG ratings – meaning companies that were doing a better job managing financially relevant ESG issues relative to their industry peers in similar businesses – were more profitable, had higher valuations, and were less likely to suffer major drawdowns than their peers with low ratings. Studies from major asset managers and owners have found similar sorts of results.

All this research contradicts assumptions about underperformance but it's also fascinating in itself, because we're seeing that ESG is not just about avoiding downside, it's about benefitting from upsides as well. And it's not just about avoiding or managing dramatic events, it's also about growing or eroding value over time.

Bentley Kaplan

Right, so in the shape of investing for financial goals, ESG investing is looking to be an increasingly accepted strategy. And as this evidence grows and we learn more about how ESG data can be collected, and structured and applied, we may see ESG take its place alongside other, long-accepted investment tools and philosophies.

Ultimately, Meggin stressed the point that ESG is just information, and financially relevant ESG information can help investors make investment decisions in service of their financial goals.

At the same time this is happening, regulators are focusing on better and clearer disclosure of ESG-related data, including the SEC, which is looking at new requirements for companies to report climate change data. And as more and more companies strengthen their disclosure, ESG data will provide additional insights for investors seeking to meet both their financial and non-financial goals.

And look, we can have this academic debate on a podcast, and pore over findings on ESG investments, but let's maybe turn focus to investors that are currently looking to navigate this challenge. Meggin, are there specific ways in which these investors might think about responding, especially given all of these moving pieces?

Meggin Eastman

It's unquestionably a challenging situation for many investors and investment managers. Perhaps especially for those operating across shifting and increasingly divergent policy contexts. But as we all continue to make our way through this debate and as the environment continues to evolve, there are a couple key points I keep coming back to.

First, ESG data is just information. And information on its own doesn't have an agenda. It's all about how it gets used. Second, markets work better and more efficiently when there's more information available to everyone. That means more information about companies and other assets, and more information about investment products and decision-making. Third, ESG information has proven to be useful for financial purposes. For the achievement of financial goals, it doesn't matter whether you "believe" in the philosophy or not.

And finally, the name isn't the important bit. The utility of the information, and the results you achieve, are what matters.

Bentley Kaplan

And that is it for this week! A massive thanks to Meggin for her take on the news with an Anti-ESG twist.

There isn't usually a dull moment in the world of ESG, and this week is no exception.

Thank you very much for tuning in. We hope we've helped to give some context to this complex topic and that you feel well equipped to wade into the next debate over ESG that happens to crash your next bake sale, coffee date or kids' football game.
If you like what we're putting out there into the world, please do give us some stars on your platform of choice – it always means a lot. And until next time, take it easy and take care.

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