The Downside to Socially Responsible Investing

By Robert Huebscher
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Who wouldn't want a cleaner environment or a more just society? We can all agree these are worthy goals. But it's an established fact that pursuing them through one's investing is costly; environmental-, social- and governance-based investing (ESG) does fine on a gross basis, but loses money net of fees. Now, a recently published paper argues that that ESG is basically a waste of time.

The paper, Misadventures of an Irresponsible Investor, appeared in the fall issue of the *Rotman International Journal of Pension Management*, authored by Jack Gray, a respected scholar at the University of Technology in Sydney, Australia.

Gray wrote from the perspective of a pension plan manager who wants to fulfill his fiduciary responsibilities and invest in the best interests of the plan's members. His forceful logic, though, applies no less to financial advisors managing individual client portfolios.

The central question on which Gray's paper focuses is whether managers can fulfill their duties under the Sole Purpose Test while simultaneously investing in a socially responsible manner. The Sole Purpose Test requires fiduciaries to manage assets solely in the interest of fund participants and for the exclusive purpose of providing promised benefits.

Gray has his dissenters – including, no doubt, some among our readers – but Gray doesn't shy away from their challenges; indeed, he included rebuttals from three investment professionals in his article. I'll cover those counterarguments, but first let's take a closer look at Gray's provocative thesis.

The dark side of being socially responsible

Gray, who has personally served on the boards of a number of pension funds, listed a number of ways in which ESG compromises their fiduciary responsibilities.

"A hallmark of committees is a predilection for avoiding difficult and uncertain tasks by instead focusing on those that make committee members feel good, or those that solve a problem well chosen for its simplicity and immediacy," Gray wrote. "ESG offers scope for both avoidance techniques."

For example, a board might spend time searching for "well-groomed" investment opportunities to fulfill its ESG mandate, and overpay for the privilege of owning what the search turns up, Gray said. He sees boards behaving this way particularly often in emerging-market investing, where opportunities to invest in attractively priced and well-governed companies are bypassed in favor of those that meet ESG criteria.

Gray wrote that some fund managers adopt ESG compliance as a "marketing ploy" to protect their careers, or because they fear losing business if they don't.

But he was even more critical of those who make irrational decisions because they embrace ESG religiously, as the sole and dominant investment issue. He related one experience of a board that wouldn't short a tobacco stock – an action which would have helped their moral cause – because they wanted "nothing to do with tobacco."

The faulty assumptions behind ESG

ESG advocates rely on one major assumption, according to Gray: They believe that their concerns will eventually be priced into the market. For example, companies that pollute must eventually suffer lower profits, once regulators impose costs on the externality posed by pollution.

But that is a heroic assumption. For example, Gray wrote that discrimination against women has been illegal for decades in most developed Western countries. Yet it persists, through lower wages and glass ceilings; anyone who invested in non-discriminating companies 20 or 30 years ago would still be waiting for their competitors to internalize those costs.

Gray cited another example: society's failure to confront the social cost of alcohol and the need to regulate it. The dangers of alcohol have been known for over 4,000 years, according to Gray, yet most societies have made little progress mitigating the damage it can cause.

In short, as long as societal and ESG-based goals do not converge, ESG investors will suffer inferior risk-adjusted returns. That convergence may occur eventually, but it could take generations, as Gray noted: "Much ESG discussion is strikingly naïve about long-term investing, as if it were synonymous with buy-and-hold (it isn't), clearly defined (it isn't), appropriate for everyone (it isn't), and relatively straightforward to get to (it isn't), and as if, once there, it were a land of milk and honey (it isn't)."

Gray attacked the semantic assumptions behind ESG mandates. Calling the practice "socially responsible investing," for instance, implies that those who disagree are irresponsible. But they aren't, according to Gray. One might, for example, see nuclear energy as a viable solution to climate change – a position with which you might or might not agree, but which is hardly irresponsible.

"Sustainability" is another term that troubles Gray. He cited a definition, common among ESG practitioners: "the ability of assets, markets, firms and economies to adapt to and to thrive in changing environments without damaging other assets, markets or economies." Or one can go back to the definition in the 1987 Brundtland Report, Our Common Future: "development that meets the needs of the present without compromising the ability of future generations to meet their own needs." But either definition allows for bad and undesirable companies, which, for example, might produce goods designed to kill and maim.

"Single emotive words like 'responsible' and 'sustainable' may make for good marketing," he wrote, "but only by doing violence to the complexity of the underlying issues."

Gray, in short, does not like where the ESG conversation is headed. "The ESG movement is nudging toward an unhealthy state of political correctness, one that brooks no criticism," he wrote.

Inherent conflicts in the Sole Purpose Test

One view is that a fiduciary's sole goal should be to achieve the best returns for the portfolio. But Gray rejected that idea, and acknowledged that fiduciaries must consider ESG in the context of their broader responsibilities as a public citizen.

"Given the vacuum of government leadership," he wrote, "perhaps it *is* up to trustees and other investors to lead, but *only* if doing so in the best interests of the beneficial owners."

Gray sees other ways that fiduciaries can promote broad social goals than in its selection of investments. He would like to see fiduciaries exert pressure on countries. For example, they could tell governments that unless they act more decisively on climate change, funds will sell their sovereign bonds. But even funds with ESG mandates, however, have typically been reluctant to get involved in politics (unlike Wall Street, which dedicates tens of millions of dollars to lobbying efforts).

But even if fiduciaries act responsibly and lobby governments, they will still face uncertainty when they try to fulfill an ESG mandate, according to Gray. For example, a fund may invest in a timber company (say through an index fund) that denudes an entire forest. The company may earn alpha in the short term, but the index fund's future performance will decrease, due to reduced long-term opportunities.

"Should fiduciaries care?" Gray asked. "After all, the dynamic nature of an index will always see industries die and new ones born. But should they care as fiduciaries if logging denudes almost all the planet's forests?"

Scenarios like this one, according to Gray, illustrate the inherent conflict in fulfilling the Sole Purpose Test as a fiduciary.

Gray's critics

Three of Gray's critics responded to his paper.

Jane Ambachtsheer, a partner and global head of responsible investment with the pension consulting firm Mercer, disagreed with two of Gray's assumptions, staring with the claim that pension funds spend too much time on ESG-related issues. The time they spend, she contended, under-weights the potential value at risk "by a factor of 20."

Nor is ESG a "feel good" exercise, as Gray argued. She wrote that ESG has been "lifted out of a feel-good affair and catapulted into the heart of risk management." According to Ambachtsheer, ESG has elevated the importance of non-financial and non-reported information, encouraging investors to consider real effects they might have on short- and long-term performance.

Nonetheless, Ambachtsheer acknowledged that it is "a relatively common mistake for responsible investment professionals to overemphasize the relative importance of ESG, and effectively end up telling mainstream analysts or investors that they are stupid."

Stephen Davis, an expert in corporate governance who holds positions at the Brookings Institution and the Harvard Law School, disputed Gray's contention that a sole focus on ESG will lead to overpaying for certain stocks, because investors instead can use ESG as a "way to capture value." Besides, Davis wrote, there are very few institutions in the US that consider ESG to be their sole focus.

Davis faulted Gray's critique of "responsible" investing. On the issue of nuclear power, different funds can justifiably arrive at diverging but nonetheless appropriate decisions, aligned with the interests of their constituents. Nothing about that is inconsistent with ESG goals, Davis wrote.

Keith Johnson, an attorney whose practice focuses on sustainability issues for institutional investors, argued that Gray has misread the Sole Purpose Test. It does not require fiduciaries to "maximize short-term returns without regard to the longer-term consequences and system risks generated by their behavior."

Instead, according to Johnson, fiduciaries are legally required to take a "balanced approach" between the short- and long-term interests of fund participants. From a legal standpoint, pension fiduciaries must respond to all risks and manage them in a way that is consistent with the goals of current and future retirees; it doesn't matter if those risks conflict with someone's moral or personal beliefs.

Under the Sole Purpose Test, Johnson pointed out, fiduciaries can consider the broader impact of decisions. The way Johnson sees it, ESG issues (e.g., environmental degradation, water scarcity and air pollution) can be relevant, especially since they have different effects on current and future retirees.

What this means for advisors

Gray's paper illustrates the difficulties inherent in executing a socially responsible investment mandate. Advisors who chose ESG-based funds, either on their own initiative or at the request of their clients, must recognize that their results likely will not be as pure as their intentions.

The managers of ESG-based mutual funds face many of the problems that Gray identified, including some that advisors are powerless to do much about. It is impractical, for example, for advisors to conduct due diligence to know whether ESG fund managers spend too much time pursuing their goals, whether they are passing up better investment opportunities, or even how successfully they fulfill their mandate.

Advisors must be concerned, however, about whether they are paying too much for ESG funds.

As I mentioned at the outset, most of the academic research conducted has shown that ESG-based funds achieve acceptable results on a risk-adjusted basis, gross of fees. But fees on ESG funds can be expensive – as much as 100 basis points.

Moreover, in an email exchange, Gray questioned the validity of that research, suggesting that even on a gross basis ESG funds may lose money. "The one lesson apparent to all is that a single paper based on a single study over a single time period in a single country with a single style is of very thin value, because at least 80% of the data is noise," he wrote. "Only collectively, through a meta-study, can valid conclusions be drawn, and even then only with deep skepticism. We are far from that with ESG." He noted that other papers do show that ESG detracts from risk-adjusted returns.

My concern is that a client's ESG-based concerns may not align with those of a specific fund, especially given that there are so many divergent ways to decide what investments meet ESG criteria. That reality provides an opportunity for advisors concerned about the ESG framework to offer another approach: Rather than choosing a fund that shares only some of a client's goals, advisors can advocate for an index fund and suggest that clients dedicate the fees that they would otherwise pay for an ESG fund to charities or other causes that advance their specific goals.