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A Free Enterprise Approach to ESG — Maximizing Investor Returns for the Benefit of People and the Planet

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KEY TAKEAWAYS

1. *The ESG movement has become a contentious battleground ranging from "woke" finance to corporate greenwashing, and it has become a proxy battle in the larger culture war and against capitalism.*
2. *Government intervention in ESG through heavy-handed mandates and regulations raises concerns for American families and free enterprise, but a more nuanced approach that empowers investors and promotes transparency can drive positive change without stifling market dynamics.*
3. *The growth of ESG investments and funds has been significant, but performance has been mixed, highlighting the importance of balancing fiduciary responsibility and investor preferences while ensuring accurate measurement of outcomes.*
4. *Policy and regulatory actions at all levels have the potential to impact ESG practices, with the need for careful consideration to protect pensions, avoid politicization, empower markets, and provide clarity without excessive prescription.*

EXECUTIVE SUMMARY

The environmental, social and governance (ESG) movement is a lightning rod for companies, investors, policymakers, and the public. While there has always been an intersection of culture and capitalism, the emergence of ESG and regulatory and legislative initiatives has widened the left-right divide.

Criticism of the "E" in ESG investing spans the political spectrum. For some, ESG investing is "woke" finance, with investors and bureaucrats forcing their values on Americans and putting people's hard-earned retirement savings at risk. For others, ESG is corporate greenwashing, as companies use flashy marketing campaigns to persuade consumers the companies care about the planet even if the companies don't do much to change their behavior.

When investments legitimately go green, the left tries to convince the right that ESG is the free market at work.[1] That seldom works, largely because it is hard to disentangle the role of government policy and regulations.[2] Consequently, both major parties are using ESG as an opportunity to score political points because they see it as a proxy battle in the larger culture war as well as a proxy battle in the war against capitalism (or for some, to right the evil wrongs of capitalism).

Government-forced ESG through federal and state mandates and regulations has many flaws and is deeply concerning for American families and for our system of free enterprise. If it is not imposed through heavy-handed government intervention, however, the ESG movement could empower investors, promote transparency, enable more consumer choice, improve social welfare and drive environmental progress. The market can meet the needs, values, and preferences of investors without the government using a one-size-fits-all model to determine what improvements in social welfare should look like (including environmental outcomes), and without using the blunt force of regulations to will it into existence.

Governments will still have contracts with investment firms and managing authority over state pensions and municipal bond underwriting, which can complicate relationships. Still, a more nuanced approach is in order than the current approach of certain states imposing ESG and other states banning it altogether. Forced divestment, government-nudged shareholder activism, and anti-ESG laws are likely to be ineffective and do more economic and environmental harm than good. Federal and state policymakers should implement reforms consistent with free, competitive markets that empower people and maintain fiduciary responsibility.

IMPACT INVESTING AND THE ORIGINS OF ESG

Before digging into the origins of ESG, it is important to differentiate between value-based, also known as process-based ESG, and values-based ESG.[3] Process-based ESG is incorporating ESG data into risk assessment and economic performance, or "integrating financially material ESG factors when evaluating a company's economic prospects."[4] For instance, investors may consider a revolutionary green technology that turns out to be a stock market darling or a more energy efficient process that lowers emissions but makes a company much more profitable. Other environmental factors could come into play. For instance, no matter the cause, investors will always consider how sea level rise affects their assets and businesses in vulnerable areas.

Much of the discussion of ESG in this paper relates to values-based ESG. Professors Robert Eccles and Jill Fisch describe that as "investing according to a set of principles irrespective of any link between those principles and economic value."[5] The two approaches often overlap, but values-based ESG is more analogous to what is historically known as socially responsible investing or impact investing.

Socially responsible investing dates back several millennia and took root several centuries ago, primarily among religious institutions.[6] In the late19th and early 20th centuries, Methodists and Quakers in the United States divested from companies involved in slave trade and illegal activities.[7] These organizations also steered investments away from "sin stocks." America's second oldest mutual fund,[8] the Pioneer Fund, avoided investment in alcohol, tobacco, and gambling for much of its 95-year existence.[9] Social impact investing increased and expanded significantly in the 1960s, 70s and 80s as various social movements grew in size and scope. Concerns over civil rights, the Vietnam War, the environment (including a major anti-nuclear push), labor standards, and apartheid prompted more calls for divestment and ethical investing. Today there are funds that support gender diversity, animal rights, and a MAGA Index, which comprises "the top 150 companies from the S&P 500 Index whose employees and political action committees (PACs) are highly supportive of Republican candidates."[10]

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The creation of ESG emerged from more concerted efforts among international bodies, governments, and the private sector to connect financial investment to activities they considered to be socially good, (rather than the historic trend of steering capital away from companies they saw as connected to socially bad activities).[11] In 1997, a coalition of investors, NGOs and the United Nations Environment Programme launched the Global Reporting Initiative to incorporate sustainability reporting for corporations.[12] The term "ESG" originates from a 2004 UN report entitled "Who Cares Wins." It was produced by 18 major international financial institutions and funded by the Swiss government. Despite a recommendation to keep standards voluntary and market-driven, the regulators and regulated began sowing the seeds for more prescriptive regulations. Large influential firms, working with governments and UN support, had the ability to anticipate and craft what future ESG regulations would look like.

A year later the UN's Environment Programme issued a legal framework for the integration of ESG into institutional investment.[13] At that point, several countries already had ESG disclosure obligations in place. The framework established that ESG factors must be considered if ESG outcomes were the clear consensus amongst beneficiaries and if ESG factors had a material impact on investment performance. The framework also established the ESG "tie-breaker" where ESG consideration could be taken into account if those factors were the difference maker among equally attractive alternative investments.[14] If ESG considerations were voluntary, cut-and-dry, and limited to pecuniary objectives, ESG would be of far less concern. Instead, much of the ESG directive from federal governments and international bodies is prescriptive, subjective and often opaque.

THE GROWTH AND PERFORMANCE OF ESG

In the nearly two decades since the UN report, there has been a flurry of ESG-related activity in the private sector and in government, and that activity is often entangled. There is a blend of private investment driven by intrinsic value and of investors and asset managers following or anticipating regulatory changes. The intertwining of the two makes determining the motivations for ESG-related investments a near impossible task.

In 2020, 88% of publicly-traded companies, 79% of venture capital and private equity firms, and 67% of privately-owned companies had an ESG initiative in place.[15] Many firms showcase ESG commitments to attract and retain talent and to secure access to capital.[16] These initiatives extend far beyond ESG investing. They include activities such as a company reducing its climate footprint and having sustainability goals.

By 2022, globally traded "sustainable" funds grew to $2.7 trillion.[17] The total amount of global ESG-related assets under management is much larger. An October 2022 PwC report estimates that there were $18.4 trillion in ESG-related assets under management in 2021. The report projects that figure will balloon to nearly $34 trillion by 2026.[18]

Unsurprisingly, whether a person approves of ESG as an internal company practice and as an investment strategy varies by age. Younger generations are more likely to favor ESG practices within a company and ESG investing. Some people will even accept smaller returns if a company pursues environmental objectives.[19] ESG is far less favored among Baby Boomers. Many were unwilling to accept any losses to support ESG, perhaps because of their proximity to retirement.[20]

The federal government's footprint is also firmly established.[21] In 2021, the Securities and Exchange Commission published a rule on climate disclosure[22] that has yet to be finalized. The Department of Labor recently finalized regulations on ESG considerations for public retirement plans and pensions. An alphabet soup of federal agencies can supervise or regulate a bank, meaning more climate regulations and guidance could eventually come through the pipeline. The European Union's nonfinancial mandatory reporting requirements for large and listed companies, which include some small and medium enterprises, also applies to American issuers.[23] Critically, the fact that most of the largest asset managers are public funds has inextricably linked federal and state government actions to ESG moving forward. [24]

CONCERNS OVER GOVERNMENT-DRIVEN ESG: GAMBLING WITH OTHER PEOPLES' MONEY

The primary concern among ESG policies and regulations is how they will impact Americans' investment and retirement accounts. As of the end of Q4 2022, public pension assets totaled nearly $5.2 trillion.[25] It is worth nothing that states have laws that mandate asset managers to make investment decisions based solely on the returns of retirees.[26] Depending on what you read and when you read it, ESG investments will cushion retirees accounts or bankrupt them. Reading the Harvard Business Review, at least the headlines, may leave you scratching your head. In 2022 alone, articles include:

- March 2022: An Inconvenient Truth About ESG Investing
- April 2022: Yes, Investing in ESG Pays Off
- December 2022: A Tumultuous Year in ESG and Sustainability

Typically, ESG funds have higher management fees and expenses than conventional funds.[27] Therefore, for public asset managers to make good on their statutory obligation of fiduciary responsibility, ESG funds would need to deliver a higher return. Individuals with private retirement accounts can make this choice on their own. Analysis shows most ESG funds have underwhelming to mixed results compared to non-ESG funds. Sanjai Bhagat reported in the March 2022 Harvard Business review article that: "ESG funds certainly perform poorly in financial terms. In a recent Journal of Finance paper, University of Chicago researchers analyzed the Morningstar sustainability ratings of more than 20,000 mutual funds representing some $8 trillion of investor savings. Although the highest-rated funds in terms of sustainability certainly attracted more capital than the lowest-rated funds, none of the high sustainability funds outperformed any of the lowest-rated funds."[28] In 2022, 8 of the 10 largest ESG funds performed worse than the S&P 500.[29]

However, those results were just for 2022, as other years had ESG funds outperform traditional funds.[30] In 2020, for instance, the Morgan Stanley Institute for Sustainable Investing found: "U.S. sustainable equity funds outperformed their traditional peer funds by a median total return of 4.3 percentage points."[31] Charles Schwab analysts looked at how ESG funds[32] within funds in U.S. equity and international equity asset classes performed over rolling three-year periods from June 2011 to June 2021 and found "on an overall basis and across the three largest asset classes, ESG funds have consistently ranked around the middle of their peer groups—sometimes a bit below the middle, sometimes a bit above, but never dramatically worse."[33] The mixed results speak to the importance of a narrow focus on fiduciary responsibility, increasing shareholder value, and empowering individuals to make choices (including accepting smaller returns for greener outcomes). Even the latter has its challenges, as individuals with private retirement accounts have control but are often disconnected and removed from the decision-making process and entrust choices to financial advisors.[34]

ARE ESG INVESTMENTS LEADING TO BETTER ENVIRONMENTAL OUTCOMES?

ESG's ill-defined definition and subjectivity as to what does and does not fit under the umbrella of "E" presents many problems. As Bloomberg reported, ESG funds had $8 billion in Russian assets (before Russia invaded Ukraine in 2021) and 175 Chinese ESG funds had 15 percent invested in coal.[35] Without transparent and objective metrics to measure performance and outcomes, ESG could impose economic harm while failing to achieve its environmental objectives. Government-derived metrics, on the other hand, could empower bureaucrats to determine what is sustainable and environmentally good.

Should a portfolio that includes American companies that export liquefied natural gas get a lower ESG rating because it includes a fossil fuel investment, or a higher score because it is comparatively cleaner and reduces emissions from Russian-piped gas or coal-fired power plants? Bhagat pointed to another study where "[r]esearchers at Columbia University and London School of Economics compared the ESG record of U.S. companies in 147 ESG fund portfolios and that of U.S. companies in 2,428 non-ESG portfolios. They found that the companies in the ESG portfolios had worse compliance records for labor and environmental rules. They also found that companies added to ESG portfolios did not subsequently improve compliance with labor or environmental regulations."[36]

Government-derived metrics could empower bureaucrats to determine what is sustainable and environmentally good, potentially imposing economic harm while failing to achieve environmental objectives.

In another recent study, researchers at MIT's Sloan School of Management and the Frankfurt School of Finance and Management found that an ESG ratings provider effectively moved the goalposts to make historical ESG scores and returns seem better than they had been. Specifically, the authors:

> *downloaded and compared two versions of the same Refinitiv ESG data for identical firm-years; one version is from September 2018 and the other from September 2020 (both versions cover ESG scores from 2011 to 2017). The methodology change led to large retroactive changes in firms' ESG scores as Refinitiv applied it to newly created and historical scores. The median overall ESG scores in the rewritten data are 18% lower than in the initial data, with the deviations amounting to -44%, -16%, and -7% for the E, S, and G subscores, respectively.*[37]

The authors also emphasize that the data rewriting was not a one-time occurrence but an ongoing issue and stress the importance of necessary due diligence when measuring ESG ratings and their financial performance.

ESG'S BROADER IMPACT ON THE ECONOMY

There are also broader economic implications over how ESG regulations distort markets, threaten investment in certain sectors, and hurt families and businesses through higher prices. Firms will incur regulatory compliance costs, which disproportionately hurt small businesses. In comments filed for the proposed SEC regulations, the National Federation for Independent Businesses said, "Small and independent businesses cannot afford the experts, accountants and lawyers needed to comply with complex government reporting regimes."[38] Depending on what classifies as ESG and how federal and state policies craft regulations, these decisions will dictate how investors allocate their money. Doing so restricts choice and could steer labor and capital away from financially promising and environmentally beneficial endeavors.

In many instances, economic harm trickles down to the consumer. One clear example is the oil and gas industry. In October 2021, Stephen Schwarzman, CEO of the private equity firm the Blackstone Group, warned of social unrest around the world resulting from higher energy prices.[39] Schwarzman said, "If you try and raise money to drill holes, it's almost impossible to get that money."[40] Recognizing the need to act on climate change, he also noted, "how you get from where we are today to a green world is utterly undefined."[41] When JP Morgan Chase CEO Jamie Dimon testified before the House Oversight Committee and a Member asked if his bank would stop investing in new oil and gas projects, Dimon bluntly responded: "Absolutely not and that would be the road to hell for America."[42]

There are many reasons oil and gas capital expenditures declined in the past decade, including:[43] changes in oil prices as demand recovers from the pandemic, discipline, government policy, and the declining costs of alternative technologies. If lenders choose to avoid oil and gas lending, it is their prerogative to do so, but when government actions nudge or force lenders to avoid certain industries, ESG's impact on a system of free enterprise is very troubling.

Other analysts and bank executives warn that divestiture and avoidance of investments in natural gas resulted in countries turning to pricier and dirtier coal, thereby increasing costs and emissions.[44]

SLIPPERY REGULATORY SLOPES

While it may sound enticing for the government to establish and enforce the rules of the ESG game, government intervention introduces several concerns. The activities that fall under "E" or "sustainable" do not fall into a tidy set of definitions. If government agencies control and define the metrics, it further entrenches ESG into a politicized battle and relies on the government to determine what is best for the environment. When considering the environmental effects among all the energy sources and technologies available, there are a broad range of economic, environmental, and social tradeoffs.

Environmental impacts for one product may include impacts on: air quality, water quality, greenhouse gas emissions, land use, water use, and fish and wildlife habitat. There are direct, indirect, and cumulative effects to consider. Some risks are well-known and others less known. Some environmental risks are immediate while others span decades or centuries. There is already a considerable amount of subjectivity and heterogeneity among the preferences of such tradeoffs. Entrusting agencies and international bodies to decide what an appropriate "E" investment is can take preferences away from private actors and could inject political biases into ESG scores.

Jennifer Schulp, director of financial regulation studies at the Cato Institute, wrote:

> *Letting the markets sort out different conceptions of sustainability based on what investors want is a far better course of action. This private ordering may not create a neat or clean solution, but that's to be expected when there's nothing neat or clean about defining what is environmentally friendly or socially desirable.*
>
> *None of this is to suggest that investors should be misled about the strategy that their investment follows. The SEC can combat some greenwashing by enforcing rules already on its books that govern how investment advisers and investment funds communicate with their investors, including anti-fraud rules. Taking regulatory action to ensure that advisers and funds act consistently with their disclosed strategies and objectives is generally uncontroversial and can be particularly important where investors are paying higher management fees for ESG investments.*[45]

While the market is the best place to discipline companies, the government must have high-quality information if it is going to attempt to crack down on greenwashing. That is to say, the government does not have to make judgment calls as to which environmental outcome is better than another (for example, land use vs. emissions), but can provide definitional clarity that gives investors and consumers the confidence to make informed decisions based off high-quality information. Such clarity could improve communication among market participants and help enforce the rules against fraud and greenwashing.

Even so, policymakers must be wary of slippery regulatory slopes. For instance, if material ESG factors and risks are weighed into an investment decision without government dictate or if an investment that performs well by ESG metrics offers higher returns (even after considering higher expenses), no regulatory action would be necessary. Investors and private risk assessors should appropriately weigh and consider environmental risk to the extent that is material. Therefore, regulatory action should not prohibit the consideration of these factors, either.

For instance, the recently finalized Department of Labor regulation still requires fiduciaries to act in the best financial interest of the plan's beneficiaries but allows for the consideration of ESG factors in the event of a "tie-breaker." The question then becomes how easily fiduciaries can bias the process to create tie-breakers in order to have ESG considerations govern the decision. Regulatory actions that crack the door open for additional considerations, even if they are technically in alignment with federal and state statutes to act in the best financial interest of plan holders, could eventually allow asset managers to stretch the limits to justify ESG investments.

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FIGHTING FIRE WITH FIRE ONLY BURNS CONSUMERS

In addition to the regulatory ping pong at the federal level, states are pursuing and have enacted ESG laws and anti-ESG laws. California lawmakers, for instance, have introduced legislation that would force the state's pension system to divest from fossil fuels. Another bill would require larger companies operating in the state to disclose greenhouse gas emission information and prepare climate risk assessment.[46] In response, more states are advocating and passing anti-ESG laws that prohibit state pension and public-school endowment managers from investing in companies that boycott fossil fuel use.[47] Florida would prohibit the consideration of ESG factors by state and local governments. Texas passed anti-ESG legislation that prohibits public entities from entering contracts with banks that boycott fossil fuels and the state will develop and maintain a blacklist of companies that boycott fossil fuels.[48] Seven states have enacted laws or regulations that prohibit or discourage ESG factors[49], and nearly half the states have some form of anti-ESG legislation introduced.[50] While reconfirming the priority of pecuniary responsibility to manage pensions is a worthy endeavor, implementing policies that could in fact run counter to that goal could harm the retirees policymakers are purporting to protect.

The problem with these pro- and anti-ESG policies and regulatory actions is that they could fail to achieve their state economic and environmental objectives by reducing choice and enabling states to dictate which banks, contractors and other businesses can and cannot do business with state and local jurisdictions. Such restrictions could run counter to fiduciary responsibility, contractual obligations, and undermine the ability of asset managers to prioritize risk-adjusted returns, thereby harming retirees. Reducing the number of banks and contractors reduces competition and options for these services, which will consequently increase borrowing costs and increase costs for government procurement projects.

Analysis from financial experts at the University of Pennsylvania and Federal Reserve Bank of Chicago found that the reduction in competition from five underwriters leaving Texas after the enactment of its anti-ESG laws increased interest paid by $300-$500 million, an expense paid by Texan taxpayers, in the first eight months after the l[51]aw. States with similar laws

proposed or enacted would also suffer from higher borrowing costs. Devin Hartman, policy director for energy and environment at the R Street Institute, emphasizes: "Progressives should not expect to fare any better with forced fossil divestment, which harms public pension performance, with earlier ESG mandates lowering returns by tens of basis points. Plus, the literature shows such tactics are rarely effective at inducing managers to change firm behavior." [52]

In addition to financial risks to retirees and broader economic harm to a state, a bifurcated policy and regulatory system of public pension management and government contracting is emerging. This is increasing regulatory compliance costs and heightening the risk for litigation for many large investment companies. There will be little sympathy for them, given the heavy hand many of the major investment firms have had in creating and shaping the regulatory foundation, perhaps not anticipating the amount of policy and regulatory backlash. Appeasing state lawmakers simultaneously in Texas and in California is an unwinnable strategy for investment firms and a losing outcome for hardworking Americans who depend on their retirement accounts. Policymakers must commit to protecting pensions from politicization and government intervention and focus on what is in the best interest of retirees.

Protecting Americans' investment and retirement accounts should be a top priority for lawmakers and a noncontroversial one.

PRINCIPLES FOR POLICYMAKERS

As policymakers deliberate how to address ESG, several principles should guide their thinking.

- **Protect pensions and investments from politicization.** Protecting Americans' investment and retirement accounts should be a top priority for lawmakers and a noncontroversial one. While part of the solution is merely following existing federal and state laws with respect to fiduciary responsibility, lawmakers could reaffirm the priority of pecuniary objectives and refrain from ESG and anti-ESG policies that could ultimately undermine the efforts of asset managers to accomplish this objective. If public asset managers violate their fiduciary responsibility, states should take the necessary litigative action to address it.

- **Refrain from mandating or banning ESG consideration.** If ESG factors are material to public or private asset management, firms should be able to consider them. But they should not be mandated to do so. Forced climate-related disclosure requirements for activities and metrics that are difficult to measure and have questionable materiality could mandate the disclosure of economically immaterial information that could be based on poor data quality or unreliable modeling.[53] If the disclosure is based on little more than an educated guess, it is worse than doing nothing for investors because the requirements "obfuscate rather than inform."[54] Furthermore, one-size-fits-all mandatory disclosure ignores the diversity of the market and the ways risk may differ across firms. It would impose high costs on financial institutions, passed on to their customers. Notably, mandated disclosure requirements increase the cost of capital formation, which harms entrepreneurs, start-ups and small businesses.

- **Empower markets to assess climate-related risk.** Risk assessment is a powerful climate tool. Risk assessment is by no means perfectly accurate, but when businesses accurately price risk, it better informs investments and decisions. To the extent that government policy distorts risk, it exacerbates the challenge of accurately pricing it.[55] The potential risks and costs from extreme weather, natural disasters, policy changes or a rapidly changing industry can all impact future invest-

ment decisions. While they may change in their level of importance, these are not new concerns. Greater reliance on private risk assessors to communicate material climate-related risks using the best information and tools available will help address the unique needs in a heterogenous market without the drawbacks, costs, and unintended consequences of government mandates.

- **Provide definitional clarity without being overly prescriptive.** The value of ESG and the potential for ESG to be a useful tool to benefit society and improve the environment will be best achieved through the preferences of individuals, not the government. ESG metrics that are voluntary and driven by the market will best determine its value and more efficiently correct the existing flaws with ESG quality and consistency. To the extent the government defines what fits under the "E" umbrella, it should do so in an objective, transparent manner.[56] While what society classifies as green or sustainable is often ill-defined and subjective, informational clarity could provide more certainty and quality to ESG-related actions. The government can also play a limited but valuable role in combating false advertising that misleads investors and consumers, which it already has the authority to do. For instance, the Federal Trade Commission and the Securities and Exchange Commission protect against fraud. [57] In addition, the private sector has an incentive not to greenwash with transparent, measurable, and verifiable information as greenwashing risks reputation harm and could subject companies to lawsuits. The FTC Green Guide contains many definitions that provides information to consumers to ensure a company is not misleading them.

The value of ESG will be best achieved through the preferences of individuals, not the government.

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