
ESG, INVESTING, AND CORPORATE FINANCE: SOME BASIC QUESTIONS

Bradford Cornell^{a,b}

This paper is devoted primarily to asking questions about the implications of the growing focus on ESG (environment, social and governance) for investing and corporate financial policy rather than offering answers. Many of the questions raised here were anticipated by Milton Friedman in his classic New York Times article. Although many critics now dismiss Friedman’s article as stogy and dated, I argue that the critical questions he raised remain unresolved today and lie at the core of much of the debate regarding ESG.



1 Introduction

This paper takes a different approach. It does not develop a new theory or present empirical tests of an existing hypothesis. Instead, it is devoted primarily to asking questions about the implications of the growing focus on ESG (environment, social and governance) for investing and corporate financial policy rather than offering answers.

Many of the questions raised here were anticipated by Friedman (1970) in his classic New York Times article. Although many critics now dismiss

Friedman’s article as stogy and dated, I argue that the critical questions he raised remain unresolved today and lie at the core of much of the debate regarding ESG.

Throughout this paper, I assume that ESG ratings can unambiguously distinguish “good” and “bad” companies. This is a counterfactual assumption. Li and Polychronopoulos (2020) report that as of year-end 2019 they had identified 70 different firms that provide some sort of ESG rating. Fish *et al.* (2019) document that more than 600 ESG ratings were produced in 2018. This multiplicity of ratings would not be a problem if all the ratings were effectively similar, but this is not the case. There is a substantial literature documenting the divergence of ESG ratings for the same firms which includes Berg *et al.* (2019) Chatterji *et al.* (2016), Dortfleitner *et al.* (2015), Semenova

^aAnderson Graduate School of Management, UCLA, Los Angeles, CA, USA.

^bCornell Capital Group, CA, USA.
E-mail: bcornell@ad.ucla.edu.

and Hassel (2015) and Li and Polychronopoulos (2020). Despite this issue, the point of this paper is to raise questions about the implications of ESG assuming that it can be reasonably measured, so I do not address the measurement issue further.

Finally, it is unclear why governance, a measure that has historically been defined in research in terms of responsiveness of managers at publicly traded companies to their shareholders, is bundled with environmental responsiveness and social consciousness, two concepts that often require managers to put the interests of other stakeholder groups ahead of shareholders. It may be that the governance that is incorporated into the ESG concept is different from the conventional governance measures, but that is an issue beyond the scope of this paper. Consequently, I focus here on the E and S components of ESG.

2 ESG and Investing

Using criteria based on ESG considerations has become an increasingly common aspect of investment decision-making, particularly for high profile institutional investors. Bloomberg reported on February 8, 2019 that Europe alone has “some \$12 trillion committed to sustainable investing.” Fish *et al.* (2019) state that sustainable assets under management worldwide were approximately \$30 trillion by 2019. On the corporate side, there has been a growing awareness of the need to be—or at least appear to be—socially responsible, either to fend off pressure from interest groups and media, or to market themselves to customers. A statement published by the Business Roundtable (2019), and signed by CEOs major companies, announced that “*While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders.*” In a follow-up letter to CEOs, Lawrence Fink, the CEO of Blackrock,

stressed that a company’s prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders.

Much of the enthusiasm for ESG is based on the implicit assumption that investors can tilt their portfolios toward ESG stocks without foregoing risk-adjusted return. Is this true? If it is not true, how is one to explain the outperformance of many highly rated ESG companies in recent years? The bad news is that in equilibrium the risk-adjusted expected returns on highly rated ESG stocks are almost certain to be lower and the recent outperformance is the result of confusing a transition period with market equilibrium.

Fama and French (2007) develop a simple framework that can be applied to determine how investors’ preferences for good companies affect expected returns. They show that when utility functions for at least some investors include variables other than future consumption, prices deviate from the standard predictions of conventional risk and return models. In particular, if a subset of investors prefers to invest in good companies, the expected return from investing in those companies will be lower, with the magnitude of the effect depending on how much money they have to invest. In effect, the market is equilibrating not pecuniary risk-adjusted returns, but total risk-adjusted returns including the non-pecuniary return from investing in good companies. As a result, the pecuniary risk-adjusted return on bad companies will be higher than that on good companies. As an illustration of this effect, Hong and Kacperczyk (2009) and Dimson *et al.* (2015, 2020) report that returns on “sin” stocks, i.e., companies involved in businesses such as producing alcohol, tobacco, and gaming, have higher average returns than otherwise comparable stocks. More recently, Barber *et al.* (2021) find that dual-objective Venture Capital funds (those with explicit ESG objectives)

earn 4.7 percentage points lower ex-post internal rates of return than traditional VC funds.

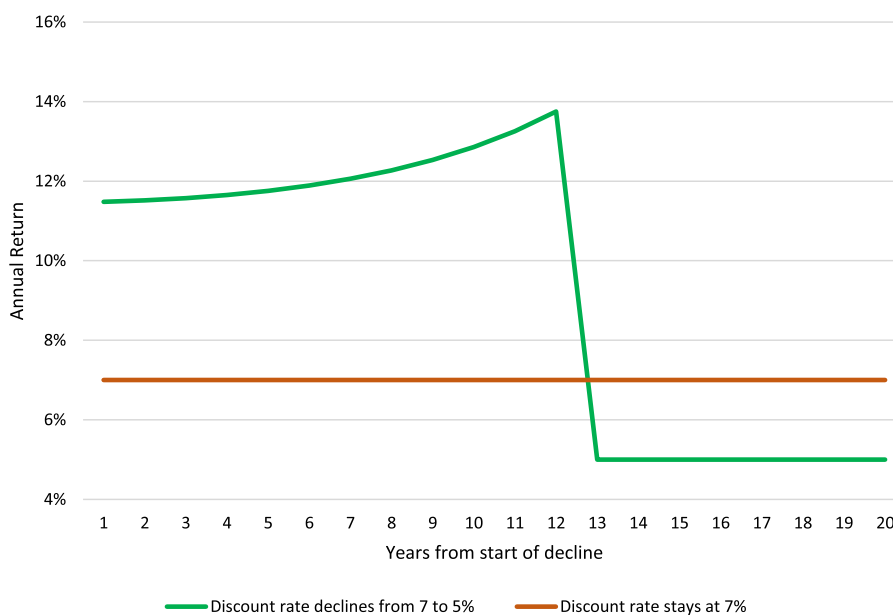
Why then have good stocks apparently outperformed in recent years? The answer is confusion of a transition period with market equilibrium. A simple hypothetical example illustrates the issue. Assume that before ESG became a popular issue the required return on both “good” and “bad” companies was 7%. As a result of a growing non-pecuniary preference for ESG stocks, over the course of the next 12 years the required return on good companies drops from 7% to 5% in equal annual increments while the required return on bad companies remains 7%.¹ Exhibit 1 calculates the theoretical returns on both good and bad companies over the 12-year transition period and beyond. During the transition, the observed returns on the good companies exceed the equilibrium returns because of the drop in the discount rate. Once the transition is over, however, the expected returns for the good companies are 5% compared to an expected return for the bad companies of 7%. As Cornell (2020a, 2020b) notes, confusion arises because media coverage

has tended to convey the notion that impressive performance of good companies during the transition is indicative of future outperformance; however, the opposite is in fact true.

It should be noted that lower risk-adjusted pecuniary returns for good stocks may well be socially beneficial. The lower expected return translates into a lower cost of equity for good firms. This will make it value enhancing for them to take on projects, say switching to renewable energy, that would be rejected if the cost of equity remained at 7%.

However, this idea raises a tricky question for institutional investors. Whereas some final investors may be willing to give up expected pecuniary return to subsidize good companies for personal moral reasons, others may disagree. How is the investment manager to weigh these competing objectives? To date, there is no clear answer to that question. Furthermore, the old standard of simply trying to maximize risk-adjusted return has much to recommend it. It eliminates the potential conflict between clients

Exhibit 1 Impact of Declining Discount Rate for Good Stock.



because final investors who are proponents of ESG can then take their returns and donate them to environmental and social projects as they see fit.

There are two other fundamental issues related to risk, expected return, and ESG that have been widely discussed but are still worth reiterating. The first is the tautological point that any constrained maximum can at best be equal to an unconstrained maximum. If the constraint is binding, then the constrained optimum will be inferior. This immediately implies that if ESG considerations lead to a binding constraint on portfolio construction the long-run result will be a lower risk-adjusted rate of return on the constrained portfolios.

The second is the observation that ESG may be a risk factor itself. This is easiest to see in the case of the environment. For example, Engle *et al.* (2019) developed an algorithm for constructing what they call climate change hedge portfolios, which are equivalent to factor mimicking portfolios. They find that the hedge portfolio has a negative risk premium. They conclude that “*This lower expected return corresponds to the insurance premium paid for the climate hedge portfolio.*” This conclusion is not surprising, assuming that the market is reasonably efficient and factor risks are properly priced, alpha will be unrelated to ESG rating. Good companies may have lower climate-related risk, but that reduced risk translates into lower expected returns.

To conclude, investors who favor using ESG criteria when choosing investments cannot expect to have their cake and eat it too. Tilting portfolios toward higher rated ESG securities is almost certain to reduce risk-adjusted returns in the long run. This has not been observed in the short-run historical data because a transition to lower required returns for highly rate ESG companies has led to greater ex-post returns during the transition

period. However, once the transition ends and equilibrium is restored, the risk-adjusted expected returns will be lower. What is more, if exposure to environmental or social risks is a priced factor, then good companies should also have smaller risk premiums than bad ones.

3 ESG and Corporate Finance

Corporate finance theory begins with assumption that the proper objective function for managers is the maximization of shareholder wealth. Of course, managers may not actually pursue that objective because of agency issues, but again, that traditional governance issue is not addressed here. The newer ESG directive recommends that management *should* pursue objectives other than shareholder wealth maximization. This recommendation is at the heart of a group of thorny questions originally posed by Friedman (1970).

Before turning to those questions, it is worth noting that there is an intermediate step that can be called enlightened value maximization. According to this viewpoint, the problem from an ESG perspective is not value maximization per se, it is the failure of managers to accurately assess all the factors that affect shareholder value. For instance, in the context of ESG, they may fail to take account of the long-run costs associated with customer dissatisfaction or properly weight the costs of government regulatory responses related to a company’s impact on the environment. As another example, companies may fail to appreciate all the benefits provided by a more diverse work force. The implication of this viewpoint is that companies need to spend more time understanding all the long-run ESG-related forces that affect value. Such a prescription is hardly controversial. Even Milton Friedman would agree that it is critical for companies to rationally assess all the long-run costs and benefits of their activities. If they do so, then according to this interpretation

there is no reason to dispense with value maximization, it just needs to be enlightened.

But enlightened value maximization is not what is envisioned by most ESG advocates. They propose a more radical approach in which environmental and social goals are pursued even at the expense of a reduction in shareholder value. It is this more hard-line approach that raises a host of thorny questions.

3.1 *A simple thought experiment*

A simple thought experiment is useful to set the stage for what follows. Imagine a food delivery company analogous to Grubhub or DoorDash. The only decision being considered is whether to use gas powered or electric vehicles to deliver the food, everything else is held constant. The company has a financial model that allows it to compute the net present value cost of both alternatives. The question is what type of vehicle should the firm choose from the perspective of both ESG and shareholder wealth maximization? In this context, consider three scenarios.

Scenario 1: The cost of the electric vehicles is less.

In this scenario there is no dispute between ESG and value maximization. The firm should choose the electric vehicles.

Scenario 2: The government has levied a tax equal to the social cost of carbon. Even so, the cost of the gas vehicles is less.

Once again, there is no dispute. The firm should choose the gas vehicles. This is clear from the standpoint of shareholder wealth maximization, but at first blush it seems inconsistent with ESG. The resolution to the apparent contradiction is that ESG includes both environmental and social components. By choosing the less expensive gas

vehicles the firm makes a social contribution by being able to pay higher wages, deliver its product more cheaply, and earn higher returns for shareholders. These “typical” social benefits provided by firms—employing people, making socially useful products, providing socially useful services, and creating wealth for investors—are often taken for granted in the ESG context which focuses on a more restricted set of social benefits such as limiting environmental damage. However, without these typical benefits provided by millions of firms most of us would be hard pressed to survive. Finally, the environmental cost associated with using the gas vehicles is covered by the tax revenue the government collects which offsets the externality and could be used to finance other emission reducing activities.

Scenario 3: The gas vehicles are less expensive, but there is no carbon tax.

This scenario is the closest to current conditions and is one in which the ESG and shareholder wealth maximization objectives may diverge. If the externalities associated with the provision and usage of competing forms of energy are not priced, then private decisions will not be socially optimal. In particular, if there is no carbon tax, then the food delivery company may choose to use the gas vehicles even if the total social cost of so doing is greater than that for the electric vehicles. The question is what should be done about it? In the context of ESG, this question becomes what should private entities such as corporations and investment firms be asked to do and what should be left to the government? If ESG as popularly conceived is to have real content, it must be case that the E and S objectives are pursued at the cost of reducing shareholder wealth. It is in this context that Friedman’s questions take center stage. To simplify the presentation, I break down the E and S components into separate parts, starting with E.

3.2 Questions involving the environment

The food delivery company provides a useful starting point. Suppose that as part of a carbon neutral objective the delivery company chooses to use the electric vehicles even though the net present value cost exceeds that of the gas vehicles. The result is a reduction in the value of shareholder wealth equal to the difference in present values.² In effect, the shareholders are being taxed by management in order to promote a social goal. This leads to Friedman's first fundamental question. He asks,

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money.

Friedman is not saying that the goals being pursued are not worthy, in fact they may be sufficiently worthy that taxing corporations to fund them is worthwhile. Friedman readily admits many social activities, such as providing for national defense, require support via taxation. But that does not mean that corporate executives should be setting tax policy. Assuming that managers do decide to tax shareholders to support a social goal how are the extent of the support and the level of taxation to be determined? That leads to Friedman's next observation.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. Here the businessman—self-selected or appointed directly or indirectly by stockholders—is to be simultaneously legislator, executive and jurist. . . This justification disappears when the corporate executive imposes taxes and spends the

proceeds for "social" purposes. He becomes in effect a public employee, a civil servant, even though he remains in name an employee of private enterprise. On grounds of political principle, it is intolerable that such civil servants—insofar as their actions in the name of social responsibility are real and not just window-dressing—should be selected as they are now. If they are to be civil servants, then they must be selected through a political process. If they are to impose taxes and make expenditures to foster "social" objectives, then political machinery must be set up to guide the assessment of taxes and to determine through a political process the objectives to be served.

Putting aside questions of due process, asking managers of private companies to make decisions regarding complex environmental issues raises many of the incomplete information issues so eloquently described by Hayek (1945). As Cornell and Welch (2021) stress, the proper response to environmental damage arising out of energy provision, including global warming, involves a host of complex tradeoffs. To provide few prominent examples: (1) How are the costs and benefits related to climate change to be shared across generation (in other words, what is the proper social discount rate? (2) How is current growth to be traded off against reduction of carbon emissions, particularly in poor countries? (3) How is mitigation of emissions to be traded off against adaptation to warming? In addition to these big picture items, there are dozens of more detailed tradeoffs regarding every aspect of climate policy. For instance, what role should solar radiation management, that is seeding the atmosphere to reflect more sunlight, play?

In this context there is a fundamental practical question—how are managers tasked with the job of running a software company, or a railroad, or a drug company supposed to find the time to understand the science and economics of climate policy and to deal with all the tradeoffs? After teaching several courses and writing a book on the climate change, I recognize how complex

the subject is and how much study is required to grasp the fundamental issues. Once again, Friedman anticipated the problem associated with incomplete information problem when he asked:

On the one hand, suppose he could get away with spending the stockholders' or customers' or employees' money. How is he to know how to spend it? He is presumably an expert in running his company—in producing a product or selling it or financing it. But nothing about his selection makes him an expert on inflation (read climate policy).

The incomplete information problem also implies that different managers, relying on different information interpreted from a different perspective, will generally reach different conclusions as to what should be done. The result, therefore, is likely to be a cacophony of different, and perhaps contradictory actions, by different firms. What is worse, as Cornell and Damodaran (2020) note, a strict focus on environmental virtue may lead some companies to engage in public relations greenwashing exercises in the place of taking meaningful long-term steps. In short, because the response to climate change requires a coordinated response, fairly applied to all parties, it is hard to see how turning policy decisions over to private companies is the appropriate response.

3.3 Questions involving social goals

Social goals can be interpreted as a superset which includes the environmental issues discussed above. For that reason, basically all the aforementioned comments apply and there is no need to repeat them. It is worth reiterating that when talking about social issues there is a tendency to forget about the main social contribution that companies make—the production of goods and services and the associated employment. Without the goods and services provided by specialized companies most of us would starve in relatively short order. Therefore, any impact on the productive efficiency of companies must

be kept in mind when analyzing the impact of higher-level social goals.

There is one aspect of social goals that does not have a companion in the environmental space. That is the effort to promote what has come to be called “diversity and inclusion.” This effort raises new questions because there are two ways to think about diversity and inclusion with regard to the shareholder wealth maximization objective. The first can be called the Martin Luther King (MLK) approach which says, following Dr. King, that every individual should be evaluated according to his or her character and professional qualifications to perform the job at hand, regardless of race, gender, and sexual orientation. The second can be called the “pro rata” approach. The goal here is to move the fraction of employment in the direction of pro rata representation of each group in the overall population.

As Becker (1957) observed long ago, the MLK approach is not only consistent with shareholder wealth maximization, but also shareholder wealth maximization should be a positive force for overcoming historical discrimination. Becker notes that firms that practice discrimination, rather than seeking to hire the most qualified people, will underperform competitors who do not discriminate in the long run, thereby destroying shareholder value.

The same can be said of the pro rata objective if moving in the direction of proportional representation increases company efficiency. But in that case, the shareholder wealth maximization and the pro rata representation objectives coincide. There is no need to have a special ESG objective. The only time a meaningful question arises is when movement toward proportional representation would reduce shareholder value. In that context, all the issues discussed with regard to the environment come into play again, but there are a few new issues as well. In a society

in which mixed race individuals are becoming more common how are groups to be defined? Are there groups, such as say fundamentalist Christians, to whom the pro rata objective does not apply? Should economic variables be used to define groups? For instance, should pro rata representation also extend to peoples with different incomes? How will the pro rata objective be fairly applied to all companies so that one firm cannot use it to get a competitive advantage over the other? How will the objective be applied to international operations? The reader can no doubt think of added questions that will need to be addressed. The list is not meant to be comprehensive or dismissive. Nonetheless, these examples highlight the fact that pro rata representation is not easy to define, let alone implement.

3.4 Disclosure requirements

Aside from implementing policies related to E and S, there is also the issue of how ESG risks should be disclose. For example, in March of 2020, the SEC issued statement saying:

Now more than ever, investors are considering climate-related issues when making their investment decisions. It is our responsibility to ensure that they have access to material information when planning for their financial future. Ensuring compliance with the rules on the books and updating existing guidance are immediate steps the agency can take on the path to developing a more comprehensive framework that produces consistent, comparable, and reliable climate-related disclosures.

Although more disclosure sounds as though it would be an obvious benefit to investors, there are caveats. First, as a general matter, disclosure is costly. Added costs are a detriment to investors. Those costs are likely to be particularly large in the case of climate change due to both complexity of the subject and the fact that climate changes plays out over decades, or even centuries. Second, most companies use a vast number of inputs in production; labor, batteries, steel, cement, etc.

Should companies have to disclose the climate impact associated with the production of all the inputs provided by suppliers? Third, and somewhat ironically, over shorter time horizons the main environment-related risks that most companies face are not related to the impact their actions will have on climate or how climate will affect their operations, but how government policies designed to combat climate change will affect them. This means that risk disclosures will require assessments of what future government policies might be. That is no easy task when a presidential election can lead to a pronounced shifts in policies. Finally, while large companies might be able to establish a division related to analyzing and disclosing the impact of their operations on climate, small companies might be overwhelmed by such disclosures that could be prohibitively expensive in relation to their total revenues.

4 Summary and Conclusions

The bottom line is that much of the enthusiasm regarding ESG fails to answer the basic questions posed by Milton Friedman more than 50 years ago. As long as ESG objectives are consistent with enlightened shareholder wealth maximization there is no dispute and the entire debate is a tempest in a teapot. However, if the managerial pursuit of ESG objectives reduces shareholder wealth then all the questions Friedman raised regarding issues related to due process, fairness, incomplete information, information, and taxation without representation remain unresolved. In addition, the view that investment firms can impose ESG constraints and still earn higher, or at least equal, risk-adjusted returns does not stand up to scrutiny. The recently observed superior returns for highly rated ESG companies are most likely due to adjustment of investor discount rates and does not reflect what can be expected going forward. Finally, mandating further disclosure is not necessarily a panacea. It will impose

significant costs on companies which will be difficult for small firms to bear. Furthermore, it is still far from clear the scope and nature of information that should be disclosed. Perhaps the greatest risk that company should disclose regarding ESG is how future government policies will affect their operations. But it hardly seems reasonable for the government to require companies to predict what the government is going to do. The bottom line is while advocates of ESG-oriented investing may aspire to lofty ideals, the questions raised here demonstrate that good intentions are not without risks of unintended, and potentially counter-productive, consequences.

Notes

- ¹ It is assumed that each year's drop in the required return is unexpected.
- ² There also may be costs to other parties such as customers and employees depending on the competitive nature of the market, but for simplicity I assume that all the costs are borne by shareholders.

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