

## ESG Investing: Unpacking the Controversy

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The topic of environmental, social, and governance (ESG) investing has become increasingly popular over the last two to three years, sparking many discussions and questions. What is, at its core, a simple attempt to make better investment decisions, has surprisingly caused quite a bit of controversy. So, what are we talking about when we discuss ESG investing, and what is fueling the debate?

### The ABCs of ESG

First, let's start with the basic ESG standards themselves. Environmental, social, and governance standards can certainly all be interpreted as politically oriented, but why? Taking them out of order:

- Corporate **governance** means being responsive to shareholders. This is what any investor should want.
- **Social** means taking account of a business' impact on society. This certainly affects the appeal of that business to customers and, therefore, can also affect the financial results.
- **Environmental** also has a perception impact, as well as an impact on whether the business can be run sustainably over time. For example, slash-and-burn agriculture may be more profitable in the short run as long as there is always more jungle. But properly managing farmland is more sustainable—and likely more profitable over time.

ESG doesn't replace the financial metrics but gives a more complete picture of them. There's nothing here that implicitly should be a problem, as they are simply analytical tools.

### The Debate

Once we understand the basics, the question often raised is: how are these tools being used? The worry seems to be that asset managers are running their businesses with a goal to change the world in certain ways. This appears contrary to what investors see as the goal: to do whatever is maximally profitable.

### The Main Concerns

Investors seem to have two complaints about ESG investing. The first one is that investors are suffering as companies are being forced by institutional asset managers to run their companies in a suboptimal way. On the contrary, asset managers typically get paid based on a percentage of the asset value they manage, so they have a significant incentive to get the highest returns they can. Those same asset managers are, as fiduciaries, subject to legal requirements to do the same. So, the asset management industry is motivated to seek out the best possible financial returns by both potential rewards and potential negative consequences.

To believe that asset managers are not trying to maximize returns is to conclude that they are willing to hurt their own paychecks *and* take meaningful legal risks to change the world. Does this seem likely? Think about this: with billions of dollars on the table, if there was any real evidence of asset manager slanting, wouldn't there already be lawsuits in play?

The second complaint is that institutional asset managers are forcing companies to drive outcomes that the investors don't support. That's not to say some fund managers aren't trying to change the world; some are. But those funds are typically very explicitly marketed as such to investors looking for that kind of impact. Since those funds are looking for a specific type of investor, asset managers have a clear incentive to make their orientation obvious—and their self-interest and fiduciary requirements point very clearly in that direction.

For the remainder of the industry, ESG may be a marketing strategy or simply incorporated in their standard investment practice. This makes sense for purely financial reasons, as we noted when we covered the basic standards. Those products are out there and, for those who want them, are easy to find.

## Is There Reason to Worry?

ESG investing is a set of analytical techniques designed to further inform the financial analysis and investment decision. Those tools can, of course, then be used to implement value-based judgements and to drive desired impacts from that investment, just as with other value-based investment processes. Investment managers should use all the tools available to improve their results, but they have clear incentives (both positive and negative) to disclose both how they are applying those tools and the results.

Is this something to have on your radar? Yes, for reasons both positive and negative. As always, please reach out to our office to discuss your current plan and any concerns.

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