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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

THE ESG CONUNDRUM

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Sustainability has dramatically reshaped the landscape of investing over the past decade. The surge in Environmental, Social, and Governance (ESG) investments reflects a growing awareness among investors of the importance of sustainable and ethical business practices. ESG-focused institutional investments are projected to reach \$33.9 trillion by 2026, representing an 84% increase from \$18.4 trillion in 2021 and accounting for 21.5% of total global assets under management (AUM).[1] In the U.S. alone, the ESG-oriented AUM is expected to more than double from \$4.5 trillion in 2021 to \$10.5 trillion by 2026. These numbers illustrate the profound commitment of funds to ESG investing and the increasing importance of sustainability considerations in investment decisions.

Amidst the ongoing appetite for ESG investments, Eve has been tasked with drafting the investment thesis for her firm's next ESG Fund ("NextGen CO_2–"), a task which appeared straightforward at the outset. After all, the purported objective of these funds is seemingly simple: i.e., to incentivize firms to prioritize environmentally and socially sensitive business models, thereby promoting a sweeping shift toward achieving global sustainability objectives. Along this regard, investment managers can employ different investment strategies and differing degrees of shareholder activism in corporate actions to integrate ESG principles into their portfolios.

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On the right end of the spectrum, an ESG fund can directly effectuate ESG-positive outcomes by investing in and actively transforming a non-ESG firm's policies and business practices. Although this extent of active ESG engagement is not as common among ESG funds, there are some notable examples. For instance, the victory of Engine No.1 in its proxy fight to transform ExxonMobil provides an excellent case in point as to how ESG investing can be leveraged to compel non-ESG companies to reconsider how their business practices contribute to climate change.[2]

Given that her firm lacks the capital, connections, and risk appetite to successfully execute massive corporate turnarounds, Eve knows that their NextGen CO_2– fund's strategy will have to follow the more common approach of investing in ready-made ESG, or more specifically, to invest or maintain positions in firms that are already perceived to be sufficiently "green" (i.e., those that have lower carbon footprints) and avoid or divest of positions in firms that are perceived to be "brown" (i.e., those that have higher carbon footprints). The rationale of this strategy is that by providing so-called green firms greater access to capital at a lower cost relative to brown firms, all firms are generally incentivized to prioritize business models that fit the necessary ESG profile to attract investors. However, upon further research and reflection, Eve is increasingly concerned with (i) issues inherent in how to distinguish so-called green firms from brown firms and (ii) the more difficult question of how to determine whether a fund's ESG investment criteria are truly impactful.

That is, one concern lies in the accuracy and veracity of ESG practices and initiatives purported by firms and ESG funds, which could render ESG compliance and investment criteria meaningless. As ESG investing gained traction, so did the phenomenon of "greenwashing," where companies and investment funds exaggerate or fabricate their ESG efforts to appear more environmentally and socially responsible than they actually are. This deceptive practice has led to significant backlash from investors, regulators, and the public in recent years.[3] Following the increased regulatory scrutiny and political pressure over ESG efforts, greenwashing tendencies gave way to the newer phenomenon of "greenhushing," where companies make concerted efforts to be evermore conservative and even outright avoid the once widely used ESG acronym even when describing ESG-friendly initiatives. Indicative of this trend, the number of S&P 500 companies citing "ESG" on earnings calls rose steadily until 2021 and has declined consecutively since.[4,5] While greenhushing might protect companies from heightened scrutiny and criticism from authorities and investors, the practice nonetheless reduces transparency and impedes informed investments and decisions.

Misinformation aside, Eve's other more nuanced concern lies in whether investing only in properly identified ESG firms would even make a material impact on the main objective—i.e., to substantially reduce net global emissions over time. Recent evidence suggests that current ESG investment criteria fail to motivate green companies to meaningfully improve their greenness. Even worse, evidence suggests that the resulting increase in the cost of capital for brown firms induces behavior that results in even greater carbon emissions.[6] Inherently lower-emission businesses have low emission variability, and accordingly, have little opportunity to meaningfully improve their emission count. Conversely, inherently higher-emission businesses have greater emission variability, and accordingly, have greater potential to materially reduce their emission count or increase their emission count, particularly if doing so saves money at a critical time when they face greater difficulties in raising capital.

Overall, ESG investing suffers an apparent identity crisis, leaving Eve unsure as to whether and how to manage the firm's launch of its anticipated NextGen CO_2– fund.

Questions

- As the manager of an ESG fund, how would you react to the current ESG landscape?
- How might the use of AI facilitate or hinder Eve's ESG investing problem?
- What high-level investment criteria would you define for the NextGen CO_2– fund, and how would you determine whether the fund has met its objectives?

Notes

[1] See PwC, "Exponential Expectations for ESG," Asset and Wealth Management Revolution, 2022, accessed at https://www.pwc.com/gx/en/financial-services/assets/pdf/pwc-awm-revolution-2022.pdf.

[2] See Cai, Ye, and Seoyoung Kim, "Passive Versus Active ESG Investing: How a Small Hedge Fund Converts an Oil Giant,", *Journal of Investment Management*, 2022.

[3] See Cai, Ye, and Seoyoung Kim, "ESG Greenwashing and Recent SEC Actions," *Journal of Investment Management,* 2022.

[4] See Wall Street Journal, Jan 9 2024, "The Latest Dirty Word in Corporate America: ESG", accessed at https://www.wsj.com/business/the-latest-dirty-word-in-corporate-america-esg-9c776003.

[5] A similar trend is confirmed by market intelligence firm AlphaSense, finding a steady decline of mentions of ESG, diversity, equity and inclusion (DEI) initiatives and sustainability on U.S.-listed companies' earnings calls, and a survey conducted by consultancy South Pole found that nearly half of the 1,400 participating companies reported increased difficulties in communicating their climate goals compared to the prior year, and several hundred companies said they were talking less about their net zero goals. See Forbes, June 21, 2023, "Green Hushing In The Corporate World: Why ESG Is No Longer A Topic of Discussion," accessed at https://www.forbes.com/sites/moorinsights/2023/06/21/green-hushing-in-the-corporate-world-why-esg-is-no-longer-a-topic-of-discussion. See also Wall Street Journal, Jan 16 2024, "More Companies Decide Silence Is Golden When Going Green", accessed at https://www.wsj.com/articles/more-companies-decide-silence-is-golden-when-going-green-2f0fae9f.

[6] Shue and Hartzmark (2023) argue that, despite its good-for-the-planet intentions, the strategy to invest only in ready-made ESG firms is counterproductive, providing suggestive evidence that this investment strategy motivates brown firms to move further away green initiatives while failing to motivate green firms to improve. Similarly, Heath *et al.* (2023) show that although socially responsible investment (SRI) funds buy firms with green characteristics, their investment policies fail to produce any material impact on green behavior.

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