The ESG Trap

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While Australians have been distracted by the Voice to Parliament, nuclear submarines, and the Budget, ASIC recently followed through on its threat to crack down on superannuation funds engaged in the esoteric offence of ‘greenwashing’, launching its first prosecution.

Greenwashing is the (apparently) deceptive practice whereby business organisations, or investment funds, claim that their products or services are environmentally friendly, when they are not. This is especially a problem when investment funds – say superannuation funds – claim to be pursuing so-called ESG, environmental, social and governance, investment strategies.

At face value it seems that ASIC is being sensible – greenwashing sounds like fraud. The sad reality, however, is that any investment fund claiming to pursue ESG investment strategies will always be vulnerable to allegations of greenwashing.

ESG investing is a straightforward case of what the late UCLA economist, Harold Demsetz, has described as ‘nirvana economics’. In plain English – it is wishful thinking.

Nirvana economics builds upon three logical fallacies: that there can be a free lunch; that the grass is greener on the other side; and that people could be different.

The free lunch is good intentions. In ESG investment the argument is that companies will be rewarded for their ‘good deeds’ by having access to deep pools of finance. Conversely, companies will be punished for their misdeeds by being starved of capital. And, it follows, investors will earn higher rates of return by investing in those companies that only perform ‘good deeds’.

That sounds all very well and good, but it raises some tough questions. What is it precisely that constitutes a good deed? Who gets to decide? In response, various information providers have created indices and checklists as to which companies perform good deeds. The plethora of information providers and the lack of any standardisation has led to great confusion and a check-a-box mentality in the industry.

It gets worse.

Once an information provider has generated its ‘naughty and nice’ list, how does one go about making investment decisions? Many people seem to think that ESG investing is a form of divestment – don’t buy stocks on the ‘naughty’ list. But that is only one of six ESG-consistent investment strategies identified by the OECD. Funds could legitimately invest in the least worst performing ESG stocks, or buy the most improved ESG performer, or buy the most likely to improve ESG performer, and so on.

Next is the ‘grass is greener’ fallacy. This is the notion that alternative investment decision making strategies are somehow superior to existing strategies. Consider, for example, the incentives that fund managers face. They are directly remunerated on performance. If ESG criteria outperformed traditional investment tools, portfolio managers would have adopted them already.

But there is a more profound problem.

ESG investment criteria suggest that money and profit are not good mechanisms for establishing value and priorities. One of the functions of money is to serve as a unit of account. Money is, by definition, the socially agreed and approved mechanism for measuring value. That is why we worry about problems such as inflation – it distorts money’s ability to act as a unit of account. Similarly, profit is how we measure the utility of decision making. Those decisions that result in profit are good decisions, those that result in losses are bad decisions.

ESG investing would have us believe that it is possible to substitute another mechanism for money, prices, and profit – yet that is an experiment that has been tried numerous times and has always failed.

Finally, there is the notion that ‘people could be different’. The idea here is that ESG providers are somehow acting in the best interests of society. But the fact is these people work for hefty fees, and portfolio managers providing ESG portfolios do so at a cost to underlying investors who

should simply pursue a diversified buy-and-hold strategy.

Rather than being a win-win strategy where everyone gets to invest profitably while feeling good about themselves, ESG investing sets people up to fail. For example, forthcoming research by the Institute of Public Affairs, looks at how the application of ESG principles by industry superannuation funds constitutes a hidden tax on the retirement income of Australians.

Companies and investment funds are often pressured to adopt ESG principles by activists and are then sued by those same activists and regulators for failing to deliver on the ESG principles. This creates employment opportunities – even careers – for activists and regulators, but fails to actually improve the world while shareholders and investors foot the bill.

The ESG trap is a consequence of unrealistic expectations and the pressure generated by activists. Rather than indulging the wishful thinking of economic illiterates, it is time for business to refocus on traditional wealth generation mechanisms and yardsticks.

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