California Management Review

COMMUNICATION

Do Red and Blue States Walk Their Politicians' ESG Talk?

by Shivaram Rajgopal, Anup Srivastava, and Rong Zhao

Image Credit | Joshua Hoehne

Political rhetoric around ESG lacks economic substance.

INSIGHT | OPINION 28 May 2024

A stark contrast exists between the stated preferences of politicians in the so-called blue states (Democrats) and those in red states (Republicans) on Environmental, social, and governance (ESG) matters. Democrats support new regulations to require additional ESG disclosures and to curb firms' polluting activities, because they consider sustainability "**a vital component of successful long-term investing**." Republicans oppose such steps, arguing for less regulation in general. This ideological battle on ESG matters has unfolded at the state level and shaped legislations related to the investments of state-level public funds. In **2023**, twenty-two laws and six anti-ESG resolutions made it through 16 state legislatures. Red states such as **Florida** and **Texas** have attempted to prohibit the consideration of ESG factors in state investment strategies, through legislative action. In stark contrast, **Maine**, a blue state, became the first state to enact a law requiring public pension systems to divest from investments in fossil fuel companies. Legislators from red states and blue states both claim that their legislations are consistent with "fiduciary obligations" to the states' pension members. Whether this important debate between the two political parties is mostly empty rhetoric or whether it reflects substantive economic policy differences remains unclear. In a new **academic** paper, we shed light on the issue.

RELATED CMR ARTICLES

"CSR Needs CPR: Corporate Sustainability and Politics," by Thomas P. Lyon, et al.

The context of our study is the response of asset management companies (AMCs) to the increasing demand for ESG investing, over the last decade, by the launching of numerous ESG funds. In selecting which stocks to invest in, these funds ostensibly consider ESG factors such as investee companies' carbon emissions, sustainability concerns in supply chain selections, and diversity and inclusion issues. This development is consistent with the stance of blue states that increasingly require or promote ESG consideration, at least as expressed in communiqués, in state's investment strategies. This new wave of attention to ESG by one segment of the society has led to an anti-ESG backlash in other segments of the society. A common claim made by red state politicians, represented by a Kansas state attorney general statement, is that by engaging in ESG investing, financial institutions such as BlackRock "**use the hard-earned money of our states' citizens to circumvent the best possible return on investment**." West Virginia treasurer, Riley Moore **said**: "We cannot allow institutions that seek to destroy our state's critical energy industries and the economic activity they generate to also profit from handling the very taxpayer dollars they seek to diminish," in an announcement to make the following institutions **ineligible** to provide banking services to the State: Citigroup Inc., TD Bank, N.A., The Northern Trust Company, HSBC Holdings, PLC., BlackRock Inc., Goldman Sachs Group Inc., JPMorgan Chase & Co., Morgan Stanley, and Wells Fargo & Co.

We use a recent Texas law as a representative and bellwether case for the ongoing political discourse, because numerous other red states are considering similar resolutions. As a response to ESG and net zero proclamations by AMCs, the Texas legislature in June 2021 passed legislation that would add Chapter 809, entitled "Prohibition on Investment in Companies That Boycott Certain Energy Companies," to the state government code. Subsequently, on August 24, 2022, Texas comptroller's office announced a list of specific asset management companies including BlackRock and funds that putatively boycott energy companies. The law requires state pension funds to divest any actively or passively managed investment fund that boycotts energy companies. The Texas Permanent School Fund recently pulled its **$8.5 billion investment** from the asset-management giant BlackRock on Tuesday, saying its internal governance policies are "harmful to the state's energy industry."

We summarize key words and sentences from the Texas act, Texas politicians' speeches, and official documents issued before or after implementation of the new law. The act stated that if an asset management company "continues to boycott energy companies, the state governmental entity shall sell, redeem, divest, or withdraw all publicly traded securities of the company." The word "boycott" was defined as "refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations with" an energy company. A supplementary criterion for exclusion in another document was expressed as a question: "Does the financial company adhere to a broad prohibition on financing oil, gas, and coal?" The Texas controller claimed that AMCs use "their financial clout to push a social and political agenda shrouded in secrecy" and that the aim of the bill was to "create some clarity for Texans whose tax dollars may be working to directly undermine our state's economic health."

Using the setting of Texas sanctions, we investigate three research questions:

1. Do ESG funds, banned by Texas politicians, boycott the energy sector?

We began by comparing two aspects of banned funds' and control funds' portfolio holdings–value-weighted sectoral allocations and top equity security holdings. Control funds are those not banned by Texas but have similar assets under management as banned funds. We focus on investments in the energy sector. We find that banned funds, on average, invest a lower percentage of net assets in equity securities from the energy sector (3.5%) compared with control funds, on average, during our study period.

To dig deeper, we analyze the top 20 holdings of the banned funds and compare them against the holdings of the control funds. Both types of funds invest heavily in technology giants (Alphabet, Apple, Amazon, and Microsoft) throughout the sample period. The remaining top holdings are primarily large companies such as JPMorgan Chase, Mastercard, and Procter and Gamble. Consistent with this observation, the weighted-average percentage holdings of an individual security held by banned and control funds (weighted by each fund's total net assets) are highly correlated with each other (83%), as well as with the security's market value of equity (75%). Of note, fossil fuel giants Chevron and Exxon Mobil appear in the top 20 holdings of control funds but not for banned funds as a group. Nevertheless, banned funds do not have zero investment in these companies—they invest, just not by as much as benchmark funds.

We leave it to readers to draw their own conclusions from these findings. For those who interpret terms such as "boycott," "refusing to deal with," "terminating business activities with," and "prohibition" as zero investments, a significant positive number of 3.5% investment in the energy sector may come as a surprise. Merriam-Webster defines "boycott" as "to engage in a concerted refusal to have dealings with (a person, a store, an organization, etc.) usually to express disapproval or to force acceptance of certain conditions" and "prohibition" as "an order to restrain or stop." Some may wonder whether a 3.5% difference was worth the political rhetoric. After all, it is almost costless to build a mimicking portfolio by using a mix of banned funds with approximately 2% to 3% investments in funds that hold only energy stocks. Those who consider the boycott to mean lower investments, by any amount, would find that results confirm their beliefs.

2. Do the banned ESG funds generate lower returns that hurt the financial interest of states' beneficiaries?

A question arises as to whether the political push for or against ESG investing serves the financial interests of states' investment beneficiaries. One may argue that reducing any investment option would hurt beneficiaries—whether by excluding fossil fuel industries or by excluding funds that take ESG considerations into account. For example, professional investment advisers **warned** the Kansas Public Employees Retirement System's board of trustees that banning financial institutions such as BlackRock or Mellon could diminish the state pension system's bottom line.

We evaluate the performance of banned funds before the announcement of Texas law. We estimate risk-adjusted returns, that is, alphas for four-factor model (controlling for market, size, book-to-market, and momentum). Banned funds outperform control funds in nine out of 43 quarters, under-perform in three quarters, and report similar performances in the other quarters. This outperformance is largely because of the run-up in technology stocks in the period from 2013 to third quarter of 2021 before Texas legislature added Chapter 809. Yet, the outperformance of banned funds in the prior period seems contrary to the allegation that banned firms, by taking ESG considerations, harm financial interest of states' investment beneficiaries.

3. Do pension funds from red states invest more in energy sector equities compared with banned funds and pension funds of blue states?

It remains unclear whether red and blue states' public pension plans invest in ways that are consistent with ESG resolutions proposed or passed by their state politicians. For example, the Teacher Retirement System of Texas and the Employees Retirement System of Texas **voted** in support of ESG resolutions 97% and 85% of the time, respectively, during the 2021 proxy season, which is contrary to their politicians' proclamations. On the other side of the coin, the question is: blue state pension funds exclude energy companies from their investments? We investigate whether pension funds from red states differ from banned funds in their energy investments, consistent with their politicians' stances. We find that red state pension funds do invest a higher percentage in the energy sector compared with blue states, but that difference is just about 0.6% in our sample period.

Notably, pension funds from both red and blue states reduced their energy sector holdings over time, while increasing their investment in technology stocks. The investing levels and trends in the energy sector between red states and blue states are indistinguishable from each other. Blue states invest in Exxon Mobil just like red states, in small amount. Exxon Mobil, headquartered in Texas, does not even make it to the top 20 holdings of Texas pension funds as of December 31, 2021. Red states' holdings in just one stock—Apple or Microsoft—exceed their aggregate holdings in the energy sector in recent period.

To summarize, we find nuanced evidence on the economic substance behind the recent Texas anti-ESG sanctions. Banned funds hold lower investments in the energy sector than control funds, but that is just 2% to 3% of total asset value. There is no evidence that banned ESG funds generate lower returns that hurt the financial interest of states' investment beneficiaries. On the contrary, investors holding banned funds would have serendipitously benefited from banned funds' higher focus on technology stocks, because of runup in technology stock prices. Public pension funds from red states invest more in the energy sector compared with blue states, but that difference again is less than 1%. Both states' funds, irrespective of political or ESG affiliation, maintain or have increased their technology focus by at least 10 times that difference.

Our findings may surprise some, confirm priors of some others, and may be considered immaterial by the others. In our interpretation, differences in investments of blue and red states' pension funds do not correspond with dramatic differences in their politicians' rhetoric. Our evidence leads us to conclude that the term "ESG" has become weaponized to generate news headlines and to appeal to voter bases, at both ends of the ideological spectrum. The economic substance behind politicians' ESG assertions seem highly ambiguous.

Shivaram Rajgopal

Shivaram Rajgopal is the Kester and Byrnes Professor of Accounting at Columbia Business School. He is a leading expert on measuring how well managers serve as responsible stewards of the corporation's resources. Shiva's extensive body of work covers a wide range of contemporary issues in financial reporting, fiscal responsibility and corporate governance.

Anup Srivastava

Anup Srivastava holds Canada Research Chair in Accounting, Decision Making, and Capital Markets and is a full professor at Haskayne School of Business, University of Calgary. In a series of Harvard Business Review articles and California Management Review posts, he examines the management implications of digital disruption. He specializes in the valuation and financial reporting of digital and knowledge-intensive companies.

Rong Zhao

Rong Zhao is an Associate Professor of Accounting at Haskayne School of Business. Her research has been published in leading academic journals and top practitioner outlets. She won the prestigious Deloitte Foundation Dissertation Fellowship for her PhD thesis and is a recipient of SSHRC Insight Grant and several CPA Alberta research grants.