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SUSTAINABILITY

ESG's Complicated Story

by Muhammad Asif and Cory Searcy

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From political battlegrounds to financial frontiers - Complexities and opportunities in sustainable investing

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ESG, the evaluation of environmental, social, and governance factors in investing, has sparked political and ideological conflict. Some US states have pro-ESG laws, such as California, New York, Colorado, Illinois, Maryland, and Maine. Conversely, other states have anti-ESG laws, including North Dakota, Utah, Florida, West Virginia, and Indiana. A clear partisan political divide is also observable among policymakers, with differences in ESG legislation reflecting broader ideological splits.

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Opponents of ESG argue that it promotes progressive values and represents unnecessary interference in government and corporate affairs. They also question the science behind climate change and environmental issues, which they note is evolving. They believe that focusing on ESG factors will drive up costs and harm small business competitiveness, while also negatively impacting the oil industry, increasing energy costs, and reducing energy independence.

These concerns are not always unfounded, but they undervalue the business case for ESG. ESG's business case is complicated and imperfect, but it is strong over the long-term.

A **review** of over 1000 studies found ESG can improve financial performance over the long-term, provide downside risk protection, and support greater innovation.[1] Another **analysis** of over 2000 studies found strong support for ESG's business case, with a large majority reporting a positive relationship between ESG and financial performance.[2] In another example, a **McKinsey report** outlined five ways ESG creates value: top-line growth, cost reductions, regulatory and legal benefits, productivity improvements, and investment and asset optimization.[3]

While critics may argue that ESG doesn't prioritize short-term financial returns for investors, companies pursuing it can become better at managing risks and avoiding regulatory penalties or reputational damage. ESG focused companies are often more efficient in using energy and resources. Further, they can be attractive to investors seeking what they view as socially responsible investments. Studies show that companies with strong ESG practices have better employee retention, productivity, and relationships with customers and other stakeholders.[4]

Technological advances are also helping to further strengthen the business case for ESG through improved transparency, efficiency, and stakeholder engagement. For example, the use of advanced technologies in manufacturing can bring a reduction in waste and energy consumption, as well as improve the safety and working conditions of employees. According to the **International Energy Agency**, renewables will become the largest source of global electricity by early 2025, with solar photovoltaics projected to be the largest source of power capacity by 2027.[5]

The business case for ESG is, however, nuanced and there are some inconsistencies. Some **studies** show neutral, mixed, or negative correlations between ESG and financial performance.[6] ESG investment funds do not necessarily outperform non-ESG funds. Further, ESG disclosure alone rarely drives financial performance. Moreover, companies generally not viewed as ESG aligned, such as tobacco or weapons companies, can be very profitable.

Another nuance is that different ESG rating schemes, such as MSCI's ESG Ratings and Sustainalytics measure ESG practices differently, drawing on hundreds of data points and performance indicators. As one **study** shows, different measurement, scope, and weight, contribute to very different results in the various ratings schemes.[7] The same study found the correlations between six well-known ESG ratings to be an average of just over 0.5.

These differences can lead to confusion and frustration. To take one prominent example, in May 2022, Tesla was removed from the S&P 500 ESG index, in part due to a lack of a low-carbon strategy and code of business conduct. As a bewildered Elon Musk tweeted, "Exxon is rated top ten best in world for environment, social & governance (ESG) by S&P 500, while Tesla didn't make the list!"

The intense focus on ESG investing makes sense given the trillions of dollars in assets worldwide being managed using its criteria. ESG investment funds are now widespread, with **Morningstar** reporting five-fold growth over the past decade and $357 billion in sustainable fund assets at the end of 2021 - four times the total from three years prior.[8] In the first quarter of 2024, **global sustainable funds** acquired nearly US$900 million in net new money.[9] **The Brookings Institution** estimates that ESG investments will reach $50 trillion in assets by 2025, underlining their huge potential.[10]

Different investors reasonably have different goals, but ESG does not need to be viewed in opposition to well-established financial factors. ESG underscores the importance of considering environmental, social, and governance factors together with financial factors. ESG investing does not overlook the importance of profits, which are critical, and it is not a replacement for financial factors. Rather, it aims to balance financial returns with responsible stewardship. ESG factors can have important financial implications, especially over the long-term.

ESG investing is imperfect, but that doesn't mean we should abandon the concept. Key concerns, such as the clear challenges in ESG measurement, scope, and weight, require further work. Counterevidence should be acknowledged and explored, recognizing that the business case for ESG is strongest over the long-term and for investors who prioritize environmental and social stewardship. This will provide the best chance of realizing ESG's potential in strengthening analyses and investments based on financial metrics.

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Muhammad Asif Follow

Muhammad Asif is an Associate Professor of Management and Business Analytics at Northeastern State University, Oklahoma. His research focuses on ESG, sustainability, and Industry 5.0. He aspires to advance sustainability and ESG research through innovative use of emerging technologies.

Cory Searcy Follow

Cory Searcy is a professor of industrial engineering at Ryerson University, Toronto, Canada. He currently serves as the Vice-Provost & Dean of the Yeates School of Graduate Studies, as well as a corporate sustainability section editor at the Journal of Business Ethics.