

ESG

## Doing Good by Doing Well? The Chicken And Egg Problem in the ESG Alpha Debate

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*ESG scores do not change in a vacuum.*

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# ESG Performance and Stock Returns

**What is the association between ESG performance and stock returns?** This critical question arises as investors and firms increasingly recognize that ESG issues can materially impact corporate value creation. Our study examines this amid the rapid growth of global ESG investing, now a multi-trillion dollar sector, and a widening divide between major US asset managers facing domestic political pressure and their European counterparts engaged in ESG-focused coalitions. This shift comes with increased scrutiny and regulatory challenges in the US, where some states have acted against firms perceived as boycotting fossil fuels. Globally, asset managers are reevaluating climate advocacy participation. Recently, JPMorgan Asset Management and State Street Global Advisors left Climate Action 100+, with BlackRock reducing its involvement, weakening the initiative which lacks full support from the top five asset managers, as Vanguard and Fidelity had not joined.

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## The Material ESG Alpha Narrative

The need to identify material ESG issues has fostered an ecosystem of standard-setting organizations, rating agencies, and index providers. The Sustainability Accounting Standards Board (SASB) developed a materiality framework and industry-specific disclosure standards, now overseen by the International Sustainability Standards Board (ISSB). Starting with Khan, Serafeim, and Yoon (2016), research applies SASB’s framework to distinguish financially material from immaterial ESG issues, finding that portfolios of firms with improving ratings on material issues outperform selected pricing factors. This

research argues that changes in a firm's material ESG score contain 'hidden information' about future performance not yet priced in. When pooling material and immaterial issues, this information is drowned out by noise. The idea that material ESG scores embed hidden information that could help investors select stocks with higher future abnormal returns has proven effective for marketing ESG scoring models and indices. Index fund managers and providers, such as State Street and Bloomberg, often cite evidence of material ESG alpha as proof of SASB's materiality framework value.

## Material ESG Alpha: Fact or Fiction?

Sorting out causation from correlation is critical in the debate on the source of material ESG alpha. Material ESG scores do not change in a vacuum; companies with improving scores differ fundamentally in ways related to subsequent stock performance. Our original study published in *The Accounting Review*, "**Material ESG Alpha: A Fundamentals-Based Perspective**," provides insights into why firms with improving ESG scores seem to outperform. Financially established firms—those that are larger, have lower growth rates, and higher profitability—are more likely to both develop material strengths and address material weaknesses in their ESG scores. Examples include Apple, Microsoft, Johnson & Johnson, Pfizer, and Procter & Gamble, all of which have earned higher stock returns. The link between fundamental characteristics and ESG scores suggests that the benchmark model should account for these determinants before attributing outperformance to ESG improvements. Our evidence shows that portfolios with improving ESG scores do not generate alpha once profitability and growth factors are considered.

## What is the Value Added of ESG Scores?

Our evidence does not disprove the potential for sustainability investments to generate value for shareholders and positively impact other stakeholders. Instead, it highlights the issue of correlated omitted fundamental factors in the debate on ESG alpha. Our study questions the incremental relevance of commercially available ESG scoring models in uncovering hidden information beyond simple fundamentals-based stock characteristics. We show that a simple portfolio sort based on fundamentals can mimic the return

performance and overall ESG score of companies with improving material ESG scores. This implies that investors could target an overall ESG score by selecting stocks based on fundamental characteristics. Furthermore, our evidence suggests an opportunity to develop alternative ESG scoring models that provide decision-useful information beyond what is reflected in corporate financial statements.

## ESG Alpha and the Efficacy of Sustainability Standards

Portfolio alphas measure wealth transfers among investors, not social welfare creation. In sustainable and impact finance, social welfare involves directing investments toward companies and projects that benefit society and the environment. Therefore, portfolio alphas are not a good measure of sustainability standards' efficacy. It's essential to evaluate corporate sustainability reporting's real effects on mobilizing capital for a sustainable economy. The absence of alpha in the SASB materiality framework does not negate its role in coordinating sustainability comparisons over time and across peers. SASB standards have evolved to meet the market's need for a common baseline of corporate sustainability disclosures. With the SEC's renewed focus on climate-related disclosures (Release [33-11042](#)), the demand for accepted sustainability reporting standards is set to grow. Frameworks like SASB's can help establish a global baseline for corporate sustainability measurement and reporting.

## SEC Proposed Rules on ESG Disclosures

Our study highlights the need for investment advisers and fund managers to ensure transparency in the performance and ESG characteristics of portfolios marketed as sustainable, compared to properly identified benchmarks. This relates directly to the SEC's proposed rules on ESG disclosures (Releases [IA-6034](#) and [IC-34593](#)), aimed at combating greenwashing, released on May 25, 2022. If adopted, ESG-focused funds would need to disclose the ESG factors they consider, the criteria and data used, and specific details

about their strategies. The proposed rules also require transparency on how a fund's methods align with its name. Integration funds considering ESG factors no more significantly than other factors cannot use ESG-related terms in their names.

## Aiding the SEC to Identify Greenwashing

Our study gets to the core of these proposed rules, providing a fundamentals-based framework to identify when ESG factors are no more significant than non-ESG factors in investment selection. We emphasize the need for transparency regarding benchmark portfolios, so Main Street investors can understand the raw and benchmark-adjusted performance, ESG characteristics, and fundamental traits of ESG-focused funds. Our evidence supports clarifying rules around investment company names and enhancing ESG disclosure requirements. This approach can help Main Street investors make informed capital allocation decisions aligned with their values. We agree with SEC Chair Gary Gensler's [statement](#) that enhancing transparency in ESG investing aligns with the SEC's mission.

### AUTHORS' NOTE

We based this synthesis on our original study, "Material ESG Alpha: A Fundamentals-Based Perspective," in response to requests for a concise overview of our key findings and practical insights. Our original study is forthcoming in *The Accounting Review* and the working paper version is available on [SSRN](#). The views expressed here and in original study are those of the authors and not necessarily those of Dimensional Fund Advisors, their employees, or directors.

## References

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