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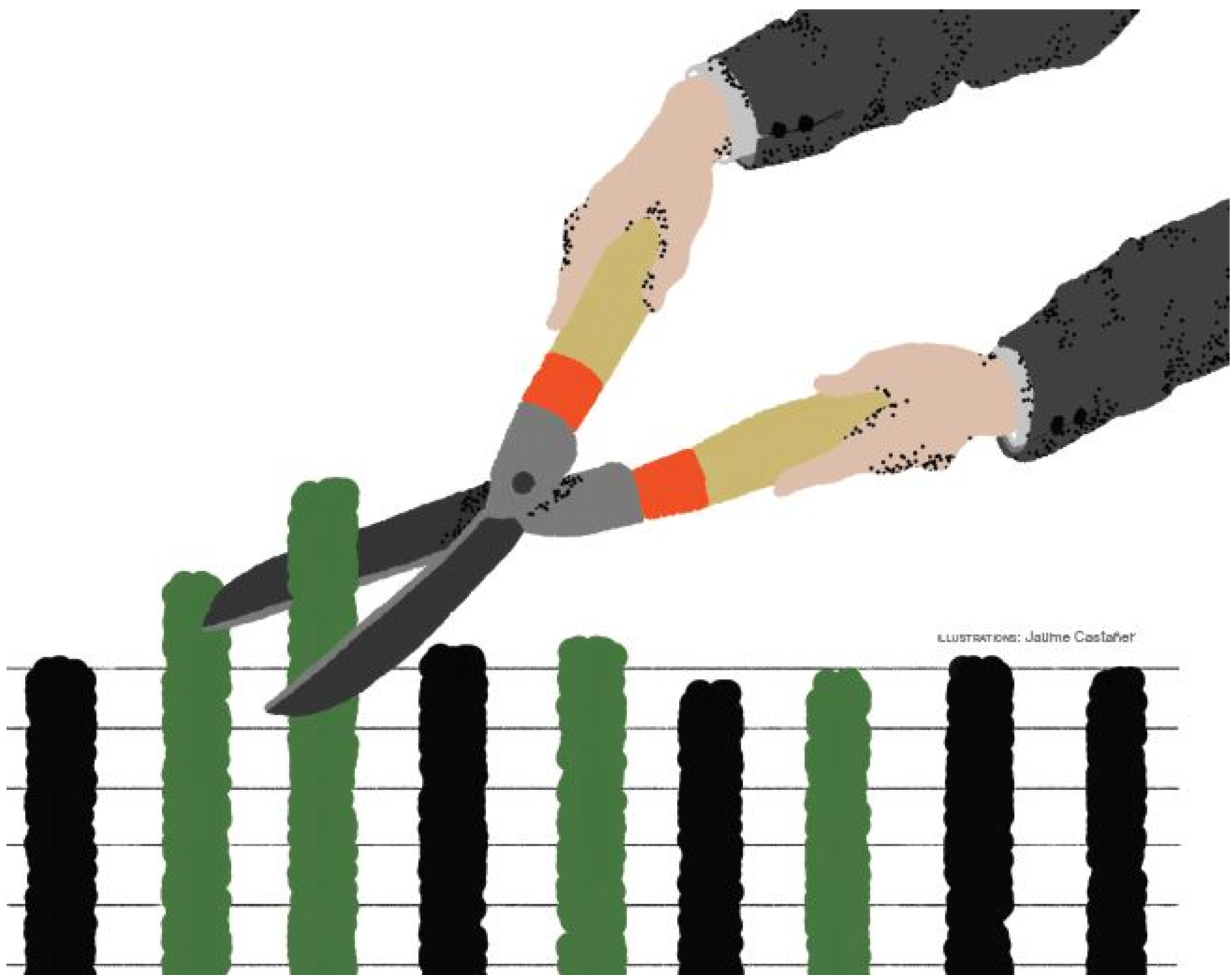
ESG is dead, long live ESG

ESG factors are so important, which is an argument for why they shouldn't be treated as anything special. Fabrizio Ferraro digs into the debate with Alex Edmans.



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IESE's Fabrizio Ferraro in conversation with Alex Edmans

A decade ago, in his *IESE Insight* article "Responsible investing takes root," IESE professor Fabrizio Ferraro wrote about the mainstreaming of environmental, social and governance (ESG) considerations in investment practices. At the time, interest in the field was growing, especially in Europe following the 2008 global financial crisis. Ferraro urged managers "to start asking themselves how responsible investing will affect their companies … Much remains to be done to build institutions that can handle this historic shift."

It was with this in mind that Ferraro was intrigued to read a new paper by London Business School professor Alex Edmans, a known ESG advocate, provocatively titled "The end of ESG." Making the most of Edmans' attendance at the IESE-ECGI Corporate Governance Conference in October 2022, Ferraro sat down with Edmans to find out more.

Fabrizio Ferraro: You state that ESG is "nothing special" and that "companies shouldn't be praised more for improving their ESG performance." Could you explain what you mean by that?

Alex Edmans: My inspiration for writing "The end of ESG" was an article by the Nobel prize-winning economist Richard Thaler who wrote a paper called "The end of behavioral finance." By that, he meant behavioral finance should no longer be seen as niche and that we need to understand psychology, not just cashflows and discount rates, to fully understand asset classes. Similarly, I'm saying ESG doesn't need a specialized term, as that implies it's niche, rather than it being something so critical to the long-term value of a company that any fund manager or executive, regardless of whether they have ESG in their job title, should be taking it extremely seriously.

The flip side of ESG being important is that it should not be treated as special. As it is now, companies and investors have put ESG on a pedestal, and you get more brownie points for improving your carbon footprint than you do for, say, innovation, productivity, customer retention or strategy. One might argue this is because carbon has such a huge effect on wider society. But if a company isn't innovative, that can also have a huge effect on society — such as when Kodak went bankrupt, 150,000 employees lost their jobs. So, I would say that ESG is no more or less special than other intangible assets that drive long-term value and create positive externalities for wider society.

FF: But might it be premature to call time on ESG? When you look at the data, while some investors and asset managers are decarbonizing and integrating ESG,

there is still a large number who clearly aren't. Is there a danger in saying too soon, "Let's stop talking about ESG and just talk about long-term value creation in general"?

AE: I look at it differently. People will point to investors not supporting ESG proposals as evidence they're not doing it. For example, in the U.K., there was quite a lot of backlash for investors not supporting the living wage campaign at the supermarket chain Sainsbury's. But people don't take account of the tradeoffs involved. In a recessionary environment with tight margins, paying higher wages might mean you would have to put your prices up, charging customers more during a cost-of-living crisis. Doing what might seem like ESG on the surface might, in the long run, not really be ESG.

Many people will also point to investors and asset managers still holding fossil fuel companies as proof that there's still a lot of work to do on ESG. Yet there is research suggesting that the best way to decarbonize the economy is to hold onto these companies and engage. I have another paper called "Socially responsible divestment" which suggests that it's not good to completely exclude an industry, because then you have no incentives for an oil and gas company to reform. We suggest a better way, called tilting.

FF: Can you elaborate on tilting?

AE: Sure. If you're an investor and you want to decarbonize the company, some might say the best way to do it would be to drive down the stock price of a polluting company, making it harder for them to raise capital and expand. Yet, if you adopt a blanket strategy of never holding a fossil fuel company in your portfolio, then how are you ever going to incentivize a fossil fuel CEO to reform? We suggest a more forgiving strategy, which is the idea of tilting: We will lean away from the fossil fuel industry, but we won't exclude it. Why? Because if you are a best-in-class company with a credible transition plan, and there is evidence that you are putting it into practice, then we would still want to be investing in you and encouraging you to continue along that path.

Does all this mean everybody is doing ESG perfectly? Absolutely not. But I do believe that a way for people to do ESG better might be not to see ESG as special but to consider ESG alongside other important long-term factors.

FF: I agree that some investors can get unfair criticism — by not divesting and choosing to engage instead — but one thing we're starting to observe, particularly in the U.S., is the growing politicization of ESG. So, something that shouldn't be

especially controversial for investors is now becoming part of a larger culture war.

AE: Unfortunately, I do see this happening, much in the same way that climate change and the greenhouse gas effect started off as just being about science, and now those issues are linked to a political identity.

Some activists label Republicans as climate-change deniers to score points by ridiculing them. This actually backfires. Research from Yale's Cultural Cognition Project shows that the more you associate something with a cultural identity, the less persuasive you are. Mocking Republicans as climate-change deniers suggests that, in order to be a true Republican, you must be a climate-change skeptic, so even if you bring them rock-solid evidence, they may ignore it. The same is happening with ESG. One well-known professor has labeled ESG skeptics "Taliban" and "Flat Earthers."

I strongly believe that climate change is a serious threat, but skepticism about ESG is healthy. Not all ESG factors improve long-term firm performance. Some intangible assets — such as innovation and great leadership — can have a larger effect on society than ESG. We should be able to have a healthy debate about what factors are most material for both financial and social value without getting shut down. This was another reason for me writing "The end of ESG," to highlight that everybody should want companies to create long-term value, regardless of our political persuasion — and we should welcome, and try to learn from, different opinions on how best to do this.

FF: You mention materiality. Some ESG factors might not be financially material for a company but could still have a big social impact, which could very well be material in terms of creating a systemic risk for the company. This is the essence of new EU reporting requirements coming into effect in 2023, which would require companies to disclose not only direct financial impacts but also *potential* nonfinancial impacts on people, society and the environment. Can you speak to this concept of "double materiality"?

AE: Yes, "double materiality" is a useful principle for getting companies to think more broadly about their responsibilities. Take a tech company: It might get a huge PR boost by banning all business flights to reduce its carbon footprint. But far more material factors — for both its financial success and its impact on society — might be misinformation, cybersecurity and cyberbullying. We need to think about materiality in terms of each individual company rather than just applying blanket rules, as I mentioned earlier.

FF: In your 2020 book *Grow the Pie*, you talk about this us-versus-them mentality, which is increasingly infecting business and society, and you call for a more nuanced approach. How can we shift our thinking?

AE: If you have a pie-splitting mindset, you think the only way to make me better off is to make somebody else worse off. So, to stand up for the environment, you think the only way to do this is to heavily regulate companies. Or you think the only way to make more money for your company is to exploit the environment.

But a pie-growing mentality is about viewing both sides of an argument and finding positions that can be in support of each other, rather than framing everything as a zero-sum game and fanning the flames of the angry person on the street. This is an issue that extends far beyond the current debate over ESG.

I would apply this to business education, too. Some say we should be teaching "climate solutions" in all our classes, but if I'm teaching a course on team dynamics, "climate" is not material, whereas team dynamics *are* hugely material for society. People say, "But the climate is so important!" I agree. In fact, I think it's so important that it should be left to people with the expertise rather than a professor looking up some Wikipedia article just to fulfill some arbitrary teaching requirement.

FF: So how should we, as educators, be teaching MBA students and executives to best prepare them for integrating ESG?

AE: First, I would say our job as professors is not to teach ESG but to teach our subjects well. We need great teaching, not *just* ESG teaching, based on solid academic research and relevance for the real world.

Second, to the extent we do teach ESG, we need to realize that ESG factors, as with corporate culture, cannot be easily measured, and trying to reduce them to quantitative metrics is problematic. We should be comfortable with and embrace a certain degree of subjectivity for ESG and evaluate it through surveys, talking to employees and other qualitative assessment methods. Recognizing that fact is not harmful to the field but is actually quite helpful.

FF: Your 2021 paper on CEO compensation makes a related point: not everything that matters can be easily quantified; we need to dig deeper.

AE: Exactly. A rational economist would say it takes effort for a CEO to improve firm value,

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and the only way anyone is going to make the effort is through more pay. We refer to executive *compensation*, and that word implies we are compensating somebody to do something they wouldn't have done anyway. But is that always so? First, the CEO may already be well off and not need more money. Second, this assumes there is no intrinsic motivation or reputational reason for effort.

What we did in the paper — unusually for an academic paper — was not to crunch data in some ivory tower but we surveyed directors and investors about why they do what they do. And we found they talked about pay in terms of reward. Think about it in these terms: If I found a lost child, while I might be given a reward of $5,000, it wasn't as if I wouldn't have bothered to save that child's life unless I got paid; I would have wanted to find that child anyway. But it's still fair to give the reward as a thank you, even though I didn't need it to incentivize me. Likewise, if a CEO has created a lot of value, then for most ordinary people it simply seems fair to show some recognition and to reward the CEO by letting them share in some of the value they have created.

Interestingly, this fairness logic also applies to the downside. Say something happens outside the CEO's control, like the pandemic, and they don't cut their pay on the basis that it wasn't their fault. To most ordinary people, that's not fair. Workers have been furloughed, investors are losing money, stock prices are down. The CEO should suffer because everybody else is suffering, too.

So, whether it's pay or the extent to which you embrace ESG standards, it's always worth remembering there's more going on than meets the eye. Do we follow ESG reporting requirements simply because we're being forced to do something we wouldn't do otherwise? Or are there other business dynamics at play? Complex intangibles cannot be reduced to simple quantitative metrics.

One of my admin colleagues is leaving and I'm giving her a nice bottle of champagne. Why? I might never work with her or even see her again, so on that basis, why bother giving her anything? But some things just feel right, regardless of the rational economics.

READ MORE: "The end of ESG," SSRN Working Paper (2022).

"Socially responsible divestment," SSRN Working Paper (2022).

"CEO compensation: evidence from the field," SSRN Working Paper (2021).

Grow the pie: how great companies deliver both purpose and profit (Cambridge University

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Press, 2020).

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Fabrizio Ferraro

Professor and Head of the Strategic Management Department at IESE Business School. He received his PhD in Management from Stanford University. His current research explores the emergence of responsible and impact investing in the financial sector.

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