00:07

Rumi
Hello everyone and welcome to Theory Meet Practice, our video series about academic research into sustainable finance and the lessons investors can take from it. I'm Rumi Mahmood, Research Director at the MSCI Sustainability Institute. Could jettisoning the acronym ESG in favor of a term better attuned to the practice of investing hold the potential to create long term value for shareholders and society? Alex Edmonds, my guest today, argues that it can. He's a professor of finance at London Business School.

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and has proposed the term rational sustainability as an alternative to ESG, which he says should be scrapped. Rational sustainability, Professor Edmonds writes in a recently published paper, considers all factors that create value regardless of whether or not they fall under an ESG label. Rational sustainability is rational, he says, by recognising diminishing returns and trade-offs, a benefit that offers the advantage of questioning sustainability rather than

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in irrational sustainability bubbles. The paper isn't the first by Professor Edmonds that has sought to cut through confusion with clarity. He has detailed, for example, why ESG doesn't need a specialised term at all. Considering long-term factors isn't ESG investing, Professor Edmonds argues, it's just investing. In a paper published last year, Professor Edmonds untangled another acronym, DEI, short for Diversity, Equity and Inclusion, finding that a multifaceted view of DEI

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correlated positively with key measures of future profitability and innovation, but no link between DEI and risk-adjusted stock returns. As the examples suggest, Professor Edmonds has sharpened the practice of sustainable investing by amassing evidence amid the noise. Professor Edmonds earned a PhD from MIT as a Fulbright Scholar and was previously a tenured professor at Wharton and an investment banker at Morgan Stanley. His latest book may contain lies,

02:01
how stories, statistics and studies exploit our biases, and what we can do about it will be released this May. I'm thrilled to be in conversation with Professor Edmunds today. Welcome, Alex. So let me start by asking you, what happened with ESG in your view to create so much consternation about something so seemingly a part of everyday fiduciary investing?

Alex
I think there's two main concerns. The first is that some ESG advocates have been pursuing some relatively flimsy ESG research.

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which claims that certain ESG factors improve long-term financial returns, but they don't disentangle correlation and causation, they might measure ESG in rather flimsy ways. The second is that some investors put ESG on a pedestal above other factors that might be more important for a company's long-term performance. So right now if you're an investor you get more brownie points if you engage on ESG rather than other issues such as capital allocation, productivity and innovation.

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And so that also leads to some pushback is that ESG is seen as a priority for some potentially more important drivers of performance.

Rumi
So we know that investors use ESG data in different ways. Some aim to align their investments with their values. Others aim to create measurable environmental or social impact. And many aim to assess financially relevant industry specific ESG risks. How do you think about these varied applications? And does their rolling up within the acronym ESG contribute to confusion between financial and non-financial goals?

Alex
Yeah, so I think there's two issues which you correctly highlighted in the question. So the first is the fact that you will recognise that those three different objectives might conflict with each other. So some people think if I am to achieve financial return, that also is achieving societal impact and also expressing my values, but there might be some conflicts. Maybe the best way to have societal impact is to invest in ESG laggards.

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and engage with them to improve their ESG performance. So this might be investing in a tobacco company and getting it to develop less harmful products. However, there are some people who think it's my values that I will never want to invest in a tobacco company, I just don't want to ever receive dividends from such a firm. Another nuance that you correctly recognise is that ESG shouldn't necessarily be combined with each other.

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So on the one hand you might think governance and some social factors ultimately do affect a company's long-term financial returns. If you treat your employees badly they will be less productive and less motivated. Whereas unfortunately some environmental issues are similarities where there is an effect on a wider society but that effect might not ultimately come back to you as a company. So it may well be that you can invest in some emitting firms which generate a lot of carbon emissions.

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this ultimately does improve your returns rather than being at the expense of returns. Why? Because we don't yet have sufficient government action on climate change.

Rumi
In your paper, The End of ESG, you argue that ESG is both extremely important and nothing special, that any practitioner should care about the drivers of long-term value, especially if those drivers are mispriced by the market. And I think that's as good a statement as any for why investors do care about ESG when viewed.

In a new survey by the MSCI Sustainability Institute and researchers at Stanford Business School across large institutional asset owners and managers, we found that more than three quarters of them say that integrating ESG criteria can reduce tail risks, and the majority consider ESG in the context of optimizing risk-adjusted returns, and most practitioners appear to have a grounded, data- and evidence-driven approach to this. So where in the chain do you think the phenomenon of irrationality emerges from?

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Is it in the data, practice or policy or some amenable three?

Alex
So if you refer to the response in the survey that they consider ESG factors, that could encompass a wide range of things. So on the one hand, considering ESG factors might involve blanket exclusion. And one of the issues with that is then the ESG factor overrides any other investment decision. For example, it could be that you're excluding a sector, let's say Fossils Yield, because of the ESG risks.

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But any investor knows that you have to consider risk in the context of pricing. It may well be that a company is exposed to transition risk, but because the price already incorporates that, then it doesn't necessarily make it a bad investment. The second concern might be, well, how are you incorporating ESG performance or ESG factors? Are you only looking at quantitative data, or are you supplementing it with qualitative analysis as well? For example, if you were to study diversity equity inclusion...

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Some people only look at gender and ethnicity, that ignores cognitive diversity, that ignores socioeconomic diversity, and it also ignores the extent to which a company designs a culture in order to include these people rather than just to hire them.

Rumi
Speaking of DEI, there's also been a lot of scrutiny directed at DEI. In a paper published last year, I believe, you found that specific measures of DEI correlated positively with future earnings surprises and higher valuation ratios, yet no link between DEI and stock returns. Can you tell us a bit more about the findings and how much significance in your view they hold for corporates and investors broadly?

Alex
Thanks very much for asking about that. So first, how do we measure DEI in that paper? And that is really important. So typically people look at demographic diversity and this is nearly always only gender and ethnicity. Now that could be important. Certainly as an ethnic minority I do believe that racial diversity is important.

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but to reduce the totality of a person to just their gender and ethnicity, I think is really reductive. That suggests that a white male can never add to the diversity of a company. So what we took was the list of the 100 best companies to work for in America. That is the list that I previously used in my own research to show that employee satisfaction matters. And importantly, we're not just studying those 100 companies, we study any company that applied for list inclusion.

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So, to be included in the list, you survey employees at all levels on 58 different dimensions, and 13 of them were related to DEI. For example, a question might be, people here are treated fairly regardless of their sex. And so that's quite different from the proportion of people who are women in the workforce. There could be a lot of women, but they could not be treated particularly well. And so what we found was that our measures of DEI, holistically defined, had little correlation.

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with traditional demographic diversity measures. And although our measures were much more predictive of future financial performance than just demographic diversity. And so I think this is an important result because it suggests that as an investor or even as a company or even as a policymaker, if you consider DEI as important because it's linked to firm performance, we need a much broader set of measures than the demographic diversity measures that are typically focused upon.

Rumi
Coming back to rational sustainability, in the paper, you remind readers of the value of challenging and questioning. You cited a proposal last year by the UK's Financial Conduct Authority to regulate the diversity of companies' workforces as a means to ensuring fair provision of financial services to customers. And I think your point was, and correct me if I'm wrong, that if the goal is the fair provision of financial services to customers, they should regulate that and not the diversity of a company's workforce. And I suspect plenty of readers and viewers may agree.

09:37
Do you have any views on whether and how regulators and policy makers might have contributed to misperceptions about ESG and DEI and are there any areas where you think standardisation and common definitions could help?

Alex
Yeah, thanks very much. Let's start with why do we need regulation to begin with? So regulation is not needed to get companies to do things which are good for themselves because a company already has an incentive to do things which are good. So you don't need to regulate to make a company more innovative or to try to reduce its costs. You already have sufficient incentives. So the reason for regulation, if there is an externality which affects one way to society and does not affect you, because then you might not take this into account as a company. And indeed, provision of services to customers might be something that you don't fully take into account. Maybe it's not profitable to provide financial services…

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certain segments of the population, but maybe as a regulator you want to ensure equal access. But if so, exactly you say, Rumi, you want to measure and regulate the fair provision of financial services, which is quite different from employee diversity. You could have a majority white male set of employees to understand the importance of fair provision, and they make sure that this provision is indeed equal.

10:59
So why is it that these two things, which are quite different from each other, provision of financial services to customers, and employee diversity on only demographic dimensions to the company, were linked? It's often people see that diversity as a panacea, so a lot of people right now, nearly everybody, wants to be seen as pro-diversity. It would be a brave person to call themselves anti-diversity, and so you think this is the solution to everything. This is the solution to not any third performance.

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Some people say it's the solution to climate change. Now people say it's the solution to provision of products to customers. And this is in part based on some flimsy research, which I alluded to in my answer to your first question, claiming based on some weak correlations that demographic diversity is linked to all of these beneficial outcomes.

Rumi
On research and data, in general, consensus is that markets work better and more efficiently when there is more information.data available to everyone. Yet amid the proliferation of ESG information, from a competitive industry of providers to regulatory disclosure and even the rise of social media, it seems at times that market forces have produced more, not less confusion. What can we learn from the market of ESG and sustainability data, and do we need to unwind back to a time of less data and parameters to consider?

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Alex
Yes, this is an interesting question because if you thought rationally about it, information can never have negative value, because you can always choose to discard information, it's sort of a

free good. But in reality, this is not how things happen. So we have information on quarterly earnings, and that sometimes leads investors to focus too much on quarterly earnings, even if this is not that predictive of a company's long term financial performance.

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Similarly, when schools release their standardized test scores, it can be that you fixate too much on those test scores at the expense of a broader education. So actually information is not just free, information does lead you to focusing more on the factors which are being measured and disclosed at the expense of other things. So this is why in some cases it may well be that we want less information rather than more. This might seem bizarre for me as a finance professor to say because

13:13
We want data and use data for our research, but if it is something that people then fixate on too much at the exclusion of so many other things, you can be a company who doesn't care at all about diversity, equity, inclusion, but you put a few token minorities on the board to tick the box. And if you know that time pressed investors will go for that simple measure, rather than an analysis of a holistic variable, then that's something where you are able to manipulate that particular measure to look good.

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Rumi
In our recent poll of the largest institutional investors globally, 77% of them said that ESG performance is industry specific, that water stress for example might matter more to a manufacturer of semiconductors than to an insurance company. How do you think about industry specificity and financial materiality for returning ESG to a footing of rationality?

Alex
I think this is definitely a good development. So what this suggests is that the factors which are material will differ from industry to industry. So we're going to look at it on a more granular basis than the rather umbrella one-size-fits-all approaches. But unfortunately, even to go within an industry, there's going to be even greater stills and granularity. So within, let's say the retail industry, there's some companies which might be more luxury companies which care more about product quality and innovation. Others might care more about cost control or throughout different stages of the life cycle of a company, different factors might be more important.

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Actually, maybe if you're an early stage company, it could well be that you can't really quote afford to focus too much on ESG factors because survival is more important. So I think even if, so it's certainly a start to look at things on an industry basis rather than an aggregate basis, but I think even within a particular industry, there might be certain factors that matter more to some business models rather than others.

Rumi
So shifting gears a bit to politics,

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There's been a rising backlash to climate-focused investing as political division in the US has grown. Several states, as you know, have blacklisted asset managers with public sustainability commitments and introduced new legislation aimed at limiting the ability of financial institutions to include ESG considerations in investment strategies. How would you explain or characterize the differences in attitude to ESG in the US versus in Europe?

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I think in the US, both sides are to blame I'm afraid, so we always like to say the anti-ESG people are politically motivated and uninformed, but I do think that the pro-ESG practitioners also should shoulder some of the blame. Why? Some of them will try to present themselves as radical as possible, saying that we are such enlightened people, we are prioritising ESG factors above financial returns. So in France, Danone,

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was saying we were toppling the statue of Milton Friedman by incorporating ourselves as an entreprise d'amission by saying we've got objectives other than shareholder value. When if in fact the reason for using environmental and social factors is to improve long-term shareholder returns, that's something that a Republican should not be able to disagree with. If you're saying here the long-term performance of my company depends on having a positive impact on society.

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and this is why we are doing this and it's backed up by some research which is rigorous and shows the relationship between these variables, then the republican attacks don't really have a leg to stand on because they're then trying to ban you from using information which is financially material. So I think to the extent to which we can highlight that these things are supportive of capitalism rather than saying let's be a destroyer of capitalism in order to present ourselves as radical, I think that would reduce the pushback.

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Rumi
So we only have a few minutes left, Alex. I'll conclude with two questions. Was ESG ever rational? Did it lose its way or is rational sustainability a part of an evolution of ESG? Do you think RS should be the new acronym?

Alex
Yes, I think when things start, they all started for rational reasons. So how did I ever get into ESG? I never set out to be an ESG person. I wanted to look at what creates long-term value within companies. And while my colleagues at MIT where did my PhD, were focusing on tangible factors, I wanted to look at the human side of enterprise. In my first paper, which is still

my most cited paper on employee satisfaction, it never mentions the term ESG once, it mentions in tangible assets, long term value creation. And so initially the birth of ESG was the recognition that these things matter for long term value. But then when people get overly excited and they say, well, everything called ESG improves long term value,

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irrespective of materiality, or we think it's even more important for long-term value than these other factors. So we are going to cancel a fund on social media because invested in a poor ESG company, but we would never cancel a fund for investing in a mismanaged company. And so that's when we get overly excited about it. And it's just like the hype with anything. So if you think, say, artificial intelligence is good and you use that, that's great, but then it completely replaces human judgment.

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and we make decisions that say hiring decisions only based on psychometric tests, and people will naturally have a push back against that. And so what we need to do is to recognise that there is potential, and that's what led to the original interest, but also recognise that the potential is limited and not get too carried away. And I don't mind whether rational sustainability becomes the term that replaces ESG, or never even becomes a term, but just people know that when they practice it, they practice it in a rational way.

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then I think we will have achieved that way.

Rumi
To conclude, I'll ask you something a little bit different. If you were on a desert island and could have one paper on sustainable finance other than one of your own, what would it be and why would you want it apart from using it to start a fire, obviously?

Alex
I would take any type of survey paper. So what an academic survey paper does is it's a bit like a systematic review. And so what this does is it takes the big literature of work and draws out the points of consensus and agreement and disagreement.

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and this avoids too much weight being put on one single study. So there was one nice paper by Pedro Matos who is a professor at the University of Virginia which was commissioned by the CFA Institute. There was also a presidential address by Laura Starks which she gave when she was president of the American Finance Association. So I think both of them are really good sources which not only would I take to a desk island but I think also your viewers might find these useful bits of information as well.

19:43

Rumi
Thank you Alex for your very thoughtful and candid insights, and shining clarity and untangling these highly conflated issues. I look forward to seeing more of your research, and also reading your new book that comes out next month.

Alex
Thanks so much Rumi, really enjoyed this conversation.

Rumi
Viewers, you should sign up for our email list on our website. We'll let you know when new episodes drop, and our huge thanks to Professor Alex Edmonds. Until next time.