Will ESG Investing Solve Our Pressing Problems?

By Lily Fang , INSEAD

ESG or sustainable investing suffers from a principal-agent problem. Far more impact will be achieved when business leaders incorporate sustainability into business decisions.

ESG investing is arguably one of the hottest trends in the financial markets in the past years, with funds purportedly aligned with environmental, social and governance goals hitting **US$3 trillion by the end of 2021**.

The strong demand for ESG-related funds in the capital markets is driven by the twin virtues often promised for ESG investing: These funds are expected to deliver not only positive ESG impact as their labels suggest, but also **superior financial returns**. Doing well and doing good at the same time is a strong value proposition that makes investors feel great.

The empirical question is whether ESG or sustainable investing delivers both the desired financial and environmental results in practice. An increasing body of research casts doubt on these claims.

The principal-agent problem in ESG investing

Fundamentally, there is a principal-agent problem in ESG investing. This is because investors – be it institutional or retail – delegate investment decisions to portfolio managers who are supposed to be superior not only in picking stocks that will outperform the market but also at assessing firms' ESG credentials.

Yet, anyone familiar with modern portfolio theory would know that picking stocks that consistently outperform the market is fiendishly difficult. On top of this, the requirement to (credibly) assess ESG credentials compounds the difficulty of achieving the twin goals.

If investors are simply attracted to the ESG label but have no real ability or time to make sense of the myriad of ratings, reports and principles (which is often the case), investment professionals have the opportunity to package and sell an attractive product – ESG funds – which is more lucrative than conventional funds due to the higher fee structure. Moreover, the lack of clear regulatory guidelines in assessing which funds qualify as an "ESG fund" or a "sustainable fund" means that these funds are often simply self-labelled.

This means that in the context of ESG investing, a host of intermediaries (agents) act as gatekeepers who wield significant influence on the flow of funds: Fund managers who declare to be ESG-focused curate companies in their ESG-oriented portfolios; and rating agencies and consultants label companies and funds deemed ESG-aligned (or not). Although there is **no standard measure of ESG** in today's capital markets, Wall Street and the likes have the power to dictate ESG standards and norms.

Fund-flow patterns clearly indicate that investors prefer "sustainable" funds despite their higher fee structures. A **study** shows that mutual funds categorised as "high sustainability" receive net inflows of more than US$24 billion, while those categorised as "low sustainability" experience net outflows of more than US$12 billion.

Time- and attention-strapped investors depend on ESG labels and reports. However, self-labelled ESG funds sometimes hold portfolio firms with worse compliance track records for labour and environmental laws than those held by non-ESG funds, according to a **study** in the United States from 2010 to 2018. Portfolio firms held by ESG funds receive higher ESG scores on average not because of better compliance records but simply higher volume of ESG disclosure.

Another **study** on institutional investors explored if signatories to the Principles for Responsible Investment (PRI) – a United Nations-supported initiative to develop a more sustainable global financial system – have better ESG scores at the portfolio level. The authors found that signatories in the US do not score better compared to non-signatories, which points to virtue-signalling instead of genuine interest to do the right thing.

The conclusion from these recent studies is that while ESG investing has certainly been a *commercial* success for the fund management industry – or the agent – it has often not delivered on the twin promises of "doing well and doing good" made to the investing principals. Needless to say, it has done little to effect real desired change – that businesses would tread more lightly on the planet.

What can businesses do?

Ultimately, it is the businesses in the real economy, not investment vehicles in the financial market, that have a real impact on ESG and the sustainability of our planet. To create long-term value for business and society, businesses cannot afford to take an agent approach to ESG and sustainability issues. Instead, they must take a principal's – or owner's – approach. In other words, they need to exercise leadership based on sound economic and financial principles while integrating ESG considerations.

Examples abound of good business decisions and good ESG practices going hand in hand. For example, in an **article in *The Wall Street Journal***, the CEO of IKEA shared the company's relentless focus on reducing packaging of its furniture. As a result of the redesign of just one piece of furniture, a three-seat sofa bed, IKEA was able to reduce its fleet by 7,600 trucks globally, streamline its supply chain and save costs. Clearly, such changes not only improved business performance, but also reduced IKEA's carbon footprint.

In his book, David Cote, the former CEO of Honeywell, explained how empowering the right ideas from bottom up can be a win-win for both profits and the environment. Solutions that emerged from the factory floor led to reductions in chemical waste, energy and water, and resulted in considerable savings for Honeywell. Under his leadership, Honeywell significantly outperformed General Electric, its close competitor.

In a new INSEAD study, my colleagues and I explored if firms that do well on the ESG front exhibit good fundamental (operational) and market performance. We found that better ESG performance goes hand in hand with better operational performance. This increased return on invested capital not only directly translates into improved business performance, but also more productive efficiency – getting more goods and services out of less capital input. This is how businesses tread more lightly on our planet.

Interestingly, the relationship is not causal – that is, we do not argue that a firm's proclamation of its ESG goals leads to better returns on invested capital. Rather, firms' performance along both the ESG and the financial dimensions results from the same underlying factor: superior leadership that drives value creation.

Therefore, the integration of ESG into business operations should be seen as simply part of good business management. It could start with setting the right KPIs and the CEO's readiness to empower every employee to contribute sensible ideas. It could be the COO working with the CFO to identity possible tangible improvements. With the relevant insights, leaders can refocus on the nuts and bolts of good business management and lead by encouraging collaboration and empowering ground-up solutions.

The principal's approach to ESG and sustainability

Since ESG investing does not always deliver on its promise, the responsibility of achieving ESG goals cannot be put solely in the hands of investment professionals who serve as agents allocating funds. Instead, business owners and leaders who own and use capital – as principals in the productive economy – must take charge.

Within organisations, sustainability should not be delegated and relegated to a designated "sustainability officer". The moment this happens, the principal-agent problem resurfaces: when others in the organisation think that someone else is taking care of sustainability, it's as if the box is checked and the job is done. Instead, the principal's approach to ESG and sustainability requires that these considerations be embedded in the normal course of business decision-making.

The goal of businesses should be to find profitable solutions to problems. This overarching goal will guide business leaders to focus on long-term value creation, with environmental, social and governance considerations integrated as part of the business decision-making process. This principal's approach by businesses, involving every leader and not just the designated “sustainability officer”, will achieve far greater impact on sustainability than ESG investing.

This article is based in part on a recent SAP INSEAD Masterclass attended by Sustainability executives in Asia.

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