Who's Afraid of ESG?
A Proper Understanding even Milton Friedman would have Endorsed

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In a 1970 essay[1] in the New York Times Magazine, renowned economist and scholar Milton Friedman laid out what the New York Times labeled (30 years to the day later[2]) "arguably the most consequential economic idea of the latter half of the 20th century" and a "manifesto that changed the world". In a nutshell, the Friedman Doctrine holds that the sole social responsibility of a corporation is to maximize the present value of its stream of future profits or, in other words, shareholder value. To assume perceived social responsibilities that conflict with value maximization puts corporate executives at odds with their employers, the shareholders (owners) of a company; they are using other people's money to advance their own private objectives. Further, these actions actually *reduce* social welfare by defeating the market mechanisms (which are subject of course to a legal framework that achieves social ends via the political process) that lead to the optimal allocation of scarce resources to alternative uses. Such an executive, of course, would be entirely blameless for using *his or her own* money to support any preferred social initiative.

The Friedman Doctrine informs us today about the nature of the controversy regarding what has come to be known as "ESG (environmental, social and governance) Investing". In one sense the name is apt and in another it is quite the misnomer that has generated needless controversy in part due to misrepresentations by politicians and pundits.

There are two broad understandings of the meaning of ESG investing. The first which we'll call "Type I", is explained by the Haverford Trust company: "At its core, ESG investing is about influencing positive changes in society by being a 'better' investor"[3] This implies the willingness to forego maximum risk adjusted return in the interest of encouraging societal change, and is not at all inappropriate for a retail investor who regards its charitable giving as a non-pecuniary component of investment return. There are many mutual funds that allow individual investors to balance their desires for profitably with their personal moral principles, be they religious, political, or social.

However, Type I ESG investing is inappropriate for taxpayer-guaranteed public pension portfolios and those to which pensioners are directly at risk and the investment portfolios of publicly owned corporations (e.g. banks, insurance companies and other financial and non-financial entities). Here, the Friedman Doctrine applies directly to investment management.

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[1] *The Social Responsibility of Business is to Increase its Profits,* New York Times Magazine, September 13, 1970

[2] *Milton Friedman's Influential Essay on Business, 50 Years Later* - The New York Times, September 13, 2020

[3] https://www.forbes.com/advisor/investing/esg-investing/

Those exposed to the performance risk of these portfolios comprise diverse populations that hold a diversity of moral values that may guide their own personal investment decisions, but they all expect investment portfolio management from these entities that maximizes expected return for any given level of investment risk undertaken. Anything short of this is a direct analog to the corporate executive at odds with the shareholders (owners) of the company who uses other people's money to advance his own private objectives. The much-publicized backlash against Type I ESG investing by pension funds and publicly owned corporations has been loud and wholly justifiable (if indeed it is occurring); however, not all ESG considerations in investing should be painted with the same broad brush.

Type II "ESG investing" is fully consistent with the Friedman Doctrine, and describes the approach taken by investment managers living up to their fiduciary and shareholder responsibilities. These managers take only ESG, market, credit and liquidity risks that are compensated by commensurate returns and consider possible return enhancements by investing in companies poised to profit by anticipating and facilitating transitions to environmentally friendly technologies. Here, ESG investing is not aimed at influencing or enforcing societal impact (which is left to the sphere of politics) but is aimed solely at achieving portfolios on the efficient risk-return frontier where all targeted expected return scenarios are achieved with lowest possible estimated risk for each. In fact, "ESG investing" is a misnomer – Type II investing simply means acknowledging ESG risks and potential transition returns in decision making just as credit, market and liquidity risks are acknowledged.

Of course, corporations must follow all environmental and labor laws and regulations wherever they operate. Investment managers need to factor in related obligations as well as the potential reputational, operational, and financial risks as they look for profit maximizing ESG configurations and activities within those laws.

Examples of ESG risks that *must* be considered in security selection for achieving the efficient frontier in addition to market, credit and liquidity risks include:

E: the probability and severity of value-destroying earthquakes and fires, droughts, windstorms, and floods, including the likelihood that these probabilities and severities are increasing due to climate change.

S: the probability that corporate executives will wade publicly into divisive social issues that alienate customers and employees resulting in value-destruction through reduced product demand and labor productivity; and related to "E", risks associated with the human conflict, upheavals and dislocations resulting from the environmental factors.

G: insufficient separation between Executive Management and Board of Directors that enables principal-agent problems[4] that put debt and equity holders at risk.

Professor Friedman would surely have recognized Type II investing that manages ESG risk as being entirely consistent with the maximization of shareholder value.

Unfortunately, confusion about the differences between Type I and Type II investing (or ignorance that a difference actually exists) has led to controversy over ESG. Due to this confusion, many states have introduced "anti-ESG" legislation fearing that portfolio returns are being subordinated to "left-wing" or "woke" priorities in conflict with the fiduciary responsibilities of their public pension systems and the responsibilities of corporate agents to their principals. And that fear is reinforced by misleading comments among politicians and pundits. I have examined a number of the largest state and municipal pension systems; each invests with ESG *risk factors* taken into account, and none invests in a manner that conflicts with fiduciary responsibility to maximize risk adjusted return. That said, the following is a sample of comments made by politicians and tabloids aimed at the investments industry about these systems:

"With today's announcement by _______, our state is taking another huge step forward in this fight, as we put the _______ pension fund at the forefront of creating a low-carbon global economy."

"(The fund is) balancing short-term return objectives versus long-term sustainability targets and green investment strategies."

"This divestment of the pension fund is one of the components of the multi-pronged approach that is absolutely critically essential in moving toward more climate-just futures."

"_______ plan tries to balance ESG efforts with its fiduciary duties in 16-month Journey."

Each of these misrepresents the efforts of the CIOs to incorporate ESG *risk factors* into investment decision making. These systems do not "balance" their fiduciary duties with ESG efforts but rather consider ESG risk factors in decision-making; they are not looking to "create" anything other than high risk-adjusted returns; and they do not "divest" (but of course do *disinvest* from particular platforms when the risk/reward balance becomes unfavorable). Their CIOs bristled with frustration when we cited these quotes (which of course we had to do in a risk-focused investment exam); they all reiterated firmly that their

[4] The principal-agent problem arises when there is conflict between the goals of the principal (in this case, the shareholder) and the agent (management). The Friedman Doctrine addresses one example of the principal-agent problem. Another common example of the principal-agent problem is an executive compensation scheme based on short-term earnings results that may incentivize managerial activities that increase current accounting earnings at the expense of the present value of current and future profits.

only concern is managing to an asset allocation consistent with meeting or exceeding the return targets set by their actuaries or by statute with minimal investment risk.

While it is essential that those charged with fiduciary responsibilities and responsibilities to shareholders avoid Type I "ESG investing" it is equally important that investment managers account for ESG risks and potential return enhancements in Type II investing.

Let's not allow a misunderstanding of the very real ESG risks (and in some cases, opportunities) that belong in investment decision-making to throw the Type II ESG baby out with the ESG bathwater.