Who Benefits?
The Real Impact of ESG Investing

Sinclair Davidson and Scott Hargreaves

Executive Summary

The financial sector has made a clarion call for investments in environmental and social sustainability. "Ethical" investing accounts for a significant market share, especially as investors seek to use their investments to support good causes and generate a financial return. As former Governor of the Bank of England, Mark Carney, explains, businesses have moved away from purely profit-drive motives towards generating wealth alongside producing social benefits. Larry Fink, CEO of BlackRock, similarly has called on businesses to take an active leadership role in the green transition and in other social causes.

However, ESG investing is beginning to fall out of favour, not least due to the internal incoherence at the heart of its approach. Concerns are growing that ESG funds do not support the sustainable causes they purport to promote, increase the potential for conflicts of interest, and yield lower financial returns for higher management fees. These concerns give rise to several questions: Are businesses trading the pursuit of profit for the promotion of political causes? What is the role of corporations in the modern economy? Should stakeholder capitalism or shareholder investment have priority? And does ESG actually achieve its stated aims?

Who are the key players?

The top global asset managers hold a combined total of just over $29 trillion in assets under management, in a market with approximately $115.1 trillion in assets under management. In other words, these six firms control one-quarter of all assets under management.

- BlackRock is the largest global asset manager, with $8.5 trillion in assets under management as of 2022, and approximately $9.1 trillion in total assets currently under management.
- Vanguard holds $7.2 trillion in assets under management.
- Fidelity Investments holds nearly $4.5 trillion assets under management.
- State Street has approximately $3.79 trillion assets under management.
- JPMorgan has $3 trillion assets under management.
- Invesco has just over $1.5 trillion assets under management.

Put simply, a significant percentage of the world's assets are highly concentrated in a very small number of hands, who hold significant sway over what is seen as "ethical" investing.

What does ESG promise?

ESG investing promises investors a way to align their investments with their moral and political values, thus creating real-world impact through promoting environmental and social sustainability. The prospect of higher returns and lower risks makes ESG investing an attractive opportunity.

Does ESG investing deliver?

There is a growing body of evidence that suggests ESG does not fulfil its promises and, in several respects, could actively undermine its stated goals. Consider the following areas of concern:

- Lack of standardisation: ESG indexes do not follow a standard set of criteria. Instead, they measure a huge range of qualitative factors according to subjective judgment. For example, some indexes label nuclear energy as "green" and others classify it as a non-renewable source. A lack of transparency, uniformity, and measurability make it difficult for investors to understand what the ratings mean and assess whether their investments accord with their values.

- **Incomplete due diligence:** Several fund managers choose ESG funds where companies voluntarily disclose information on sustainability. Relying on ESG scores, as opposed to investigating companies' environmental and social actions, could create situations where companies have a high ESG score but do not live up to these standards in practice.
- **Masking unethical practices:** Studies have shown that major global indexes have exposure to funds that own shares in companies linked to human rights violations or that engage in "greenwashing" their investments to appear more sustainable than they are in reality.
- **Poor financial performance:** Although passive funds generally outperform active funds, this is not the case for ESG funds. There is now widespread evidence that non-ESG funds outperform ESG funds and charge lower management fees than ESG funds. Put differently, investors in non-ESG funds get more for less. Investors in ESG funds, in contrast, pay a "greenium"—for their ethical impact.
- **Possible conflicts of interest:** Fund managers have a fiduciary duty to act in their clients' best interests. If fund managers have a financial—or political—incentive to promote ESG funds, even where that fund matches a client's investment profile and preferences, how do they avoid apparent or actual conflicts of interest? The size of global asset managers also raise concerns over whether asset managers are capable of acting in their clients' interests despite their shareholders' interests.
- **Concentration of economic power:** The top global asset managers hold a significant concentration of the world's wealth. But who holds them accountable? Similarly, with the rise of passive investment, how can investors be confident that asset managers will invest in the correct social policies when the asset managers themselves are not confident that they can invest in the correct shares?
- **Transfer of democratic accountability:** The current iteration of ESG asks fund managers to assume responsibility for "correcting" democratic governments on "ethical" matters by forming policy through global investment decisions. ESG investing also asks investment funds to play the role of charitable actors, wealth creators, culture shapers, and policymakers all at once, rather than entrust these roles to the appropriate actors and levels of society.

What Next?

Ethical investing is a personal choice. But investors must be able to make informed decisions. Strengthened scrutiny, transparency, methodology, and accountability will help create a system that finds an appropriate balance between shareholders' and stakeholders' interests and empowers companies to contribute to social benefits through the pursuit of profit.

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The Rise and Fall of ESG

"Ethical" investing, or "ESG" (Environmental, Social, and Governance) investing, has become an increasingly popular mechanism for investors to inject corporate responsibility into companies' policies. Moral arguments for corporations to act responsibly are not new—in the late 18th century, Edmund Burke tried to impeach Warren Hastings in part to expose the corruption of the East India Company.[1] But these arguments call into question the role and purpose of corporations and the appropriate limits of stakeholder capitalism. Engaging with the philosophical merits of ESG as a form of stakeholder capitalism is beyond the scope of this paper. Instead, this paper examines the premise that the current iteration of ESG does not stand up to scrutiny, leading to the concentration of wealth and control in the hands of a few top global asset management firms, compromising the commitment to both ethical and financial dividends.

To illustrate the scale of ESG investing, in 2022, ESG funds "accounted for 65 per cent of all net inflows into European ETFs… even as ESG strategies underperformed." As of last year, there were "€249 billion in ESG-aligned ETFs in Europe, representing 18.8 percent of total assets." Yet, data from Morningstar shows that "'sustainable' large-cap equity ETFs in Europe have underperformed their traditional large-cap equity ETF counterparts over the 12 months to the end of December, but also on a three-year and five-year annualised measure." At the same time, concerns of greenwashing led asset managers to downgrade "scores of 'dark green' Article 9 ESG funds holding tens of billions of client money to their lighter green Article 8 counterparts under the EU's sustainability classification."[2]

The financial sector has made a clarion call for investments in environmental and social sustainability. In his 2020 BBC Reith Lecture series, former Governor of the Bank of England, Mark Carney, made the case for a new theory of value that transcends corporations' profit-driven purpose to include social and environmental impact. He explained that companies are now seeking long-term profitability by "pursuing purpose" while also "solving problems for society."[3] In other words, "ESG is a framework that purports to help investors and those claiming stakeholder status understand how well companies are contributing to the realisation of goals over and above profit."[4] This approach historically was not the case. In this argument ESG has emerged as an attempted course correction in an era when public trust in markets and financial institutions has evaporated, especially in the wake of the Global Financial Crisis (2007-2008), leading majority opinion to now question whether the maximisation of profit should be the sole purpose of corporations.[5]

In striving to "find the right balance between purpose and profit,"[6] firms invest in companies with policies tied to anything from reducing greenhouse gas emissions, fighting climate change, improving air quality and energy efficiency, paying employees' a living wage, engaging in fair trade, promoting human rights, and upholding transparency and shareholder rights. There are several mechanisms available to channel ESG investment. For example, the MSCI World Index assigns ESG ratings to companies according to their commitments to these targets, which "[i]nstitutional investors such as pension funds, sovereign wealth funds, endowments and asset managers who have a fiduciary duty to consider significant investment risks commonly use … to assess financial risks in the investment process."[7] Companies with high ESG ratings attract greater investment. According to MSCI, "[c]ompanies with strong ESG profiles may be better positioned for future challenges."[8]

The question now, Carney clarified, "is, for some, will they go further, do they actually give up some profit for broader purpose or broader means?"[9] The financial community has answered this question ardently in the affirmative. In his 2020 letter to investors, Larry Fink, CEO of BlackRock, wrote: "BlackRock does not see itself as a passive observer in the low-carbon transition. We believe we have a significant responsibility – as a provider of index funds, as a fiduciary, and as a member of society – to play a constructive role in the transition."[10] He affirmed the central importance of ESG in his 2021 letter to CEOs, which emphasised that climate change, racial justice, human rights, and wages must be priorities for investment firms.[11] However, this fervour has started to wane. Fink has recently received criticism for retreating from his zealous promotion of ESG. His 2023 letter to investors recognises the risks and opportunities of the energy transition, but it makes no mention of ESG. Instead, Fink stresses: "But as I have said consistently over many years now, it is for governments to make policy and enact legislation, and not for companies, including asset managers, to be the environmental police."[12]

This about-turn brings into focus the tension at the core of ESG investing: what is the role of corporations in the modern economy? Should stakeholder capitalism or shareholder investment have priority? And does ESG actually achieve its stated aims?

At first glance, ESG appears to be a silver bullet. It enables companies to support noble causes and still make a profit and avoids situations where investment decisions condone or cooperate with evil. Reasonable people would largely agree with these aims. But there is an internal incoherence underpinning this approach to investing. Samuel Gregg has questioned "the conceptual integrity of the entire ESG endeavour", drawing attention to ESG's "tendency to blur ethics and sound business practices with the promotion of particular political causes" and the risks of it "corroding understanding of the nature and proper ends of commercial enterprises."[13]

Recent commentary has also highlighted the "internal contradictions" of ESG. Stuart Kirk enumerated some of these in a recent article for the *Financial Times*, where he explained that ESG faces an "existential problem" given that moral norms change due to scientific discoveries or changes in "attitudes, money or politics", the extent and depth of ESG regulations, and reasonable disagreement on "what is good and bad."[14] Writing for *The Telegraph*, Ben Marlow echoed these sentiments argued that ESG engages in "hypocritical do-goodery" not least due to recent revelations that Barclays included a $10 billion revolving credit facility to Shell as part of its overall $150 billion target for social and environmental financing.[15] More sobering was the UK Ministry of Defence's investigation into banks due to concerns that "nearly two thirds of institutional investors have divested from firms involved in security and defence, or are considering doing so."[16] Writing for the *Mail on Sunday*, City Minister Andrew Griffiths and Defence Minister James Cartlidge stated that divesting from defence companies erodes the peace and stability businesses need to operate, undermines national security and democratic freedoms, reduces economic growth and job creation, and limits technological innovation and competitiveness.[17]

Companies are also beginning to question the profitability of ESG investing and are signalling a return to prioritising strong financial returns for shareholders' investments as opposed to the social interests of shareholder capitalism. After reporting annual profits of nearly £23 billion in 2022, British Petroleum ("BP") announced in early 2023 that it would reduce its ESG targets and prioritise oil and gas production in response to market developments and to meet shareholder expectations.[18] A factor in this decision was that "BP's rush to embrace 'socially conscious' investing held back its stock price significantly", as its CEO explained that "the expected profit margin for renewable projects was roughly 6% to 8%, compared with up to 20% from oil and gas investments." [19] Some commentators viewed the consequent

20% jump in BP's shares as "a significant snub to ESG messaging."[20] More recently, Vanguard, one of the largest global asset managers, announced it was withdrawing from the Net Zero Asset Managers initiative (whose members have pledged to reach net zero by 2050).

This decision points to a broader trend that indicates non-ESG funds perform better than ESG funds. A 2022 study conducted by professors at the London School of Economics and Columbia Business School found that "ESG funds underperform non-ESG funds held by the same asset managers [over the same period of time]", yet management fees are higher for ESG funds than for those funds that outperform them.[21] Given that the MSCI ESG Indexes "represent the performance of the most common ESG investment approaches by including, re-weighting or excluding companies by leveraging ESG criteria," examples like these give rise to the question of whether ESG is still fit for purpose.[22]

To answer that question, this paper considers whether ESG is delivering on its promises and who ultimately benefits from this form of investment. It begins with an overview of the key players from asset managers to share indexes to funds and sets out ESG ratings and investment approaches. The paper then interrogates the promises of ESG and whether it delivers on those promises. It turns next to the dark side of ESG, particularly with regards to transparency, accountability, conflicts of interest, and wealth creation. The paper concludes with reflections on whether there is a better way to make moral choices through investments that also increases financial returns for investors.

Key Players and Context

ESG funds represent a significant market share. A 2022 report from PwC anticipates that $33.9 trillion in ESG-related assets will be under management by 2026, which is 84% higher than the $18.4 trillion in ESG funds under asset management in 2021.[23] With regards to passive investment (funds benchmarked against indexes), PwC estimates that as of 2021, $30.7 trillion has been invested in passive management funds, a figure expected to increase to $40.4 trillion by 2025. Put differently, this figure represents just under one-third of the industry's total assets.[24]

To illustrate the size and scale of ESG investing, this section identifies the most prominent asset managers, indexes, and pension funds that hold equities in ESG funds.

Asset Managers

The top global asset managers hold a combined total of just over $29 trillion in assets under management, in a market with approximately $115.1 trillion in assets under management. In other words, these six firms control one-quarter of all assets under management.

- BlackRock is the largest global asset manager, with $8.5 trillion in assets under management as of 2022, and approximately $9.1 trillion in total assets currently under management.[25]
- Vanguard holds $7.2 trillion in assets under management. [26]
- Fidelity Investments holds nearly $4.5 trillion assets under management.[27]
- State Street has approximately $3.79 trillion assets under management.[28]
- JPMorgan has $3 trillion assets under management.[29]

- Invesco has just over $1.5 trillion assets under management.[30]

These asset managers also spend large amounts of money to lobby politicians on ESG investing, especially as scepticism among US policymakers towards ESG investing grows. In 2022, BlackRock spent $2.38 million on federal lobbying, and from that amount has allocated $1.2 million to prominent lobbying firms. Other asset managers spent even more on lobbying, with Fidelity reportedly spending $2.4 million and Invesco disclosing $4.92 million in spending. Vanguard spent $1.82 million on lobbying in 2022, with State Street spending slightly less at $1.76 million, respectively.[31]

Indexes

Passive investors select funds benchmarked against indexes and rely on companies' ESG ratings to make investment decisions. To strengthen their sustainability scores, businesses will sign up to indexes (like the MSCI Emerging Markets Index and FTSE Russell Emerging Index) as well as other initiatives like the Sustainability Accounting Standards Board and the Net Zero Asset Managers (NZAM) initiative. These standards are designed to provide investors with information on sustainability-related risks and climate commitments to improve or align investment decisions with the ethical preferences of their clients.

There are pros and cons to this form of investment. Investors rely on ESG scores and do not need to perform their own due diligence on the funds they select—the indexes provide assurances that the listed companies support environmental and sustainable goals. These funds are cheaper and passive funds typically outperform active funds, although there is growing evidence that "ESG investing does not have any advantage over broad-based investing."[32] On the other hand, the standards against which these companies are measured are not consistent and the indexes do not always assign accurate ESG ratings to listed companies.

These indexes wield tremendous power, and companies face tough consequences for non-compliance. For instance, in a move to tighten its ESG ratings, FTSE Russell (which has approximately $16 trillion in funds benchmarked against its indexes) introduced its new Climate Change Score and "removed 34 groups from its FTSE4 Good All-World benchmark".[33] The "more stringent environmental standards" adhere to "parameters drawn up by the Transition Pathway Initiative, which is backed by 130 investors collectively managing $50 trillion in assets." Previously, "companies have only needed to meet minimum broad environmental, social and governance (ESG) standards to ensure inclusion [on the index]" and the new Climate Change Score marked "the first time a specific climate criteria has been imposed." As one of the company's commented, "'there are a multiplicity of ratings out there. We need to adapt our climate goals to our own strategy, not to every single rating. This whole field of measurement is still developing.'"[34]

MSCI, "which has $13.5 trillion of assets benchmarked against its indices," has also announced plans to apply stricter scrutiny to its EGS ratings for funds, widely anticipated to result in several thousands of funds being downgraded. But there are also inconsistencies in how indexes calculate the ESG risk of derivatives in portfolios, with MSCI's ESG ratings based on "a fund's underlying holdings data" and S&P Dow Jones using indexes, not funds, to determine its ESG ratings.[35]

Companies also face backlash if they opt out of sustainability standards or initiatives, even if there is a clear business case to do so. Vanguard, for example, withdrew from the NZAM initiative over concerns that the initiative's "full-throated commitment to fighting climate change had resulted 'in confusion about the views of individual investment firms.'" It left the initiative in order to "'provide the clarity our investors desire about the role of index funds and about how we think about material risks, including climate-related risks.'"[36]

However, this move further complicates the integrity of indexes' ratings. BlackRock, for instance, relies on NZAM membership as "one of the factors" influencing assessments of companies' commitments to "'boycotting' fossil fuels." Other companies, including JPMorgan Chase, Morgan Stanley, and Bank of America, have also indicated they may leave the initiative over similar concerns that "they could be sued over increasingly stringent decarbonization commitments."[37]

This situation reveals an unintended consequence of the index ratings system: businesses are compelled to sign up for ESG initiatives to receive good ratings on the indexes, even if there is no business case to agree those targets or if it undermines overall profitability.

What does ESG investing promise?

The Promise

ESG investing promises to deliver several benefits to investors. Primarily, by "'doing well by doing good,'" ESG funds "promote the greater good *and* provide superior long-term financial performance."[38] These funds promise at least four benefits: values alignment, real-world impact, higher returns, and reduced risks.[39]

- Values alignment: ESG funds offer investors a way to align their investments with their moral and political values. For example, investors who care about the environment can invest in companies that are working to reduce their carbon footprint.
- Real-world impact: By promoting environmental and social sustainability, ESG funds contribute to real change. For example, ESG companies that invest in renewable energy may be better positioned to create jobs in the clean energy sector.
- Higher returns: Some studies have shown that ESG funds outperform traditional, non-ESG funds over the long term. This performance is likely due to several factors, including the perception—if not the reality—that ESG companies are said to be more resilient to environmental and social risks.
- Reduced risks: ESG companies are often seen as being less risky than traditional companies. Companies with strong ESG practices may be less likely to face regulatory fines, reputational damage, or operational disruptions, which could lead to lower risk and more stable returns.

At face value, it seems that ESG investment practices bring new information to the market. Traditional financial analysis typically focuses on quantifiable, hard financial data such as revenue, profit, debt levels, and the like. ESG data can help investors make more informed decisions by providing additional context about a company's long-term prospects, such as its potential exposure to environmental risks, its labour practices, or the independence of its board of directors. This information highlights additional risks and opportunities that may not be immediately apparent from traditional financial metrics.

The Reality

Despite the belief that responsible investment practices yield both ethical dividends *and* competitive returns, the internal incoherence of ESG is becoming increasingly apparent. Some of these challenges include a lack of standardisation in measuring the performance of ESG funds, overreliance on ESG scores to evaluate environmental and social practices, the promotion of unethical practices, and concerns related to the financial performance of ESG funds. This section considers each of these in turn.

Lack of Standardisation

ESG indexes, including those produced by MSCI, FTSE, and S&P Global, do not adhere to standardised criteria. Different rating agencies use different methodologies to assess ESG performance, and the same company can receive significantly different ratings from different agencies.[40] Recent trends towards "holistic indices" suggest that ESG scores try to reduce funds to "a single metric" – "the goodness standard".[41] This approach raises several problems.

First, these indexes assess so many factors that they are almost too granular to be useful. Secondly, "the incoherence of weighing so many disparate qualitative factors against each other" makes it difficult to objectively assess an ESG score. Put plainly, there is "no objective way to balance an exemplary record on labour relations or gender pay equity against a high carbon footprint."[42] Thirdly, the subjectivity of these assessments leads to different outcomes across indexes. Consider the following examples. S&P's ESG index favours funds that promote renewable energy and strong human rights records, among other things. Yet, S&P characterised nuclear energy as a non-renewable form of energy, even though other actors in the financial sector would classify nuclear energy as a renewable source. Similarly, its ESG index included Apple in its ESG index, despite China, which has a poor human rights track record, being one of Apple's top suppliers. These inconsistent—and subjective—measurements create confusion and contribute to inconsistent ratings across the indexes.[43]

Ratings agencies are often not transparent about the methodologies used to generate ESG scores, a challenge augmented by the subjective weight assigned to various qualitative assessments including corporate reputations. Asset managers often rely on companies' self-reporting on ESG priorities, which can lead to biases or inaccuracies in the data. This lack of transparency, uniformity, and measurability make it difficult for investors to understand what the ratings mean.[44]

Due Diligence

The lack of standardisation is not an isolated issue. It also affects how fund managers select ESG stocks. To illustrate this point, consider the findings of a study conducted by academics at the London School of Economics and the Columbia Business School, which assessed ESG and non-ESG funds managed by the same firms between 2010 and 2018:[45]

- The data revealed that of the funds examined, "ESG funds' portfolio firms have significantly *more* violations of [labour] and environmental laws and pay more in fines for these violations, relative to non-ESG funds issued by the same financial institutions in the same year."

- ESG fund managers also appeared to choose "stocks that voluntarily disclose emissions", suggesting that "ESG funds may be concerned about the existence of firms' disclosures rather than the content of the information being disclosed."

- This approach raises questions of due diligence, as the study's findings imply that fund managers who "rely on ESG scores rather than performing their own due diligence about firms' environmental and social practices" could "lead to investments in firms with poorer levels of stakeholder treatment relative to firms that do not actively incorporate ESG into investment decisions."

- Accordingly, the authors concluded that "…many – if not all – ESG fund managers do explicitly claim to focus on social responsibility for reasons other than financial materiality."

These findings are not dissimilar to other reports on the inherent contradictions of ESG funds. In July 2023, the *Financial Times* ran an article titled, "Companies with good ESG scores pollute as much as low-rated rivals"[46], reporting to research that drew attention to the paradox of how "'ESG ratings have little to no relation to carbon intensity.'" In other words, companies may enjoy high ESG ratings even if they are also high emitters of carbon dioxide.

This problem is, in part, related to the challenges identified in the previous section. Assessing companies according to a litany of "unrelated criteria" makes it less likely for companies "to perform well on all of them."[47] Further compounding these challenges are concerns identified by fund managers related to "incomplete disclosures by companies, particularly regarding environmental data, combined with shifting regulatory requirements" that make it tough to assess funds' ESG ratings.[48]

Unethical Practices

The "S" in ESG refers to the "social" impact of investment, and it includes "human rights, modern slavery, corporate security, diversity, employee relations, supply chain sustainability, consumer relations and personal data protection."[49] Strong ESG scores notionally indicate that funds promote good social causes and would not run afoul of human rights or anti-slavery laws. But a recent study suggests that this is not the case, at least insofar as ESG investment in China is concerned.

A 2022 study by Hong Kong Watch looked at the stocks listed on MSCI's three major global indexes – MSCI Emerging Markets Index, MSCI China Index, and the MSCI All Country ex USA World Index – and analysed the respective indexes' exposure to companies involved with state-sponsored labour transfers in the Uyghur region. The findings of this report are astonishing:[50]

- MSCI China Index: 6 of 12 identified companies acquired Uyghur labourers through state-sponsored labour transfers, and 6 participated in the construction of internment camps or other repressive infrastructure in the Uyghur region.

- MSCI Emerging Markets Index: 7 of 13 identified companies acquired Uyghur labourers through state-sponsored labour transfers and forced labour, while 6 participated in the construction of internment camps or other repressive infrastructure in the Uyghur region.

- MSCI All-Country World ex USA Index: 2 of 4 identified companies acquired Uyghur labourers through state-sponsored labour transfers, while 2 participated in the construction of internment camps or other repressive infrastructure in the Uyghur region.

A subsequent study by Responsible Investor cross-referenced the findings of this report and concluded that "[m]ore than two dozen funds classified as Article 9 [sustainable investments] under the EU [Sustainable Finance Disclosure Regulation] own shares in companies accused of being linked to the persecution of Uyghur Muslims in China." Article 9 funds adhere to "the strictest level of sustainability reporting", and the Responsible Investor study found that "26 separate Article 9 funds [have] holdings in at least one of the companies identified."[51]

The studies divide firms according to two categories: "those that have 'obtained Uyghur labourers through state-sponsored labour transfers', and those that have helped in the construction of repressive infrastructure in Xinjiang." In the former category include companies like Hoshine Silicon, Xinjian

Goldwind Science and Technology, Foxconn Technology, and Lens Technology. Companies in the latter category include China Railway Group and BGI Genomics.[52]

Top global asset managers that have holdings in these companies include BlackRock, Vanguard, Invesco, HSBC, Deutsche Bank, and Macquarie. As well, leading US and Canadian pension funds – including the California State Teachers Retirement System, Canadian Pension Plan, and the Public Sector Pension Investment Board – hold equities in several identified companies, contrary to their investors' position on human rights.[53]

How has this happened? In large part, asset management firms benchmark funds against indexes, taking a passive approach to investing (as opposed to actively, independently assessing in depth both qualitative and quantitative factors of each fund). The complexities of passive investment are discussed in greater detail below.

Financial Performance

Tariq Fancy, former chief investment officer of Sustainable Investing at BlackRock, explained that "[BlackRock's] messaging helped mainstream the concept that pursuing social good was also good for the bottom line. Sadly, that's all it is, a hopeful idea."[54] Some investors may be prepared to accept the trade-off of a lower financial return for the knowledge that their investments promote noble social causes. Setting aside the merits of that compromise, Fancy's comments raise an important question: are "socially responsible" funds more profitable for stakeholders than other funds?

While it was the case that ESG funds outperformed non-ESG funds over the last decade, evidence suggests that this is no longer the case. The authors of a 2023 study on the performance of "green stocks" explain the reasons for this slowdown are twofold.[55] "First, many investors choose to hold a portfolio in line with their values, by allocating more to green assets or divesting their brown holdings," and the "relatively higher demand [for green assets] means green assets command higher prices, thereby implying lower expected future returns." Secondly, "green assets are a climate hedge, performing better than brown [assets] in the face of bad news about climate change," and this hedging ability translates to "higher prices and lower expected returns for green assets relative to brown."[56]

Other studies have similarly concluded that ESG funds, compared to non-ESG funds held by the same asset managers, yield lower returns but charge higher management fees.[57] A study published in the *Journal of Sustainable Finance & Investment* earlier this year also found that "at least two 'stylized facts'" held true between 2015 and 2020: "(1) there is robust evidence for corporate managers that justify investments in sustainability for better corporate financial performance, while (2) returns from ESG investing – averaged across many portfolio management strategies – are indistinguishable from conventional [non-ESG] investing."[58]

The relative importance of ESG in funds' performance is mixed. Some studies suggest ESG is negligible. For instance, one study that examined returns during the COVID-19 pandemic and concluded that "once industry affiliation, market-based measures of risk and accounting-based measures of performance, financial position and intangibles investments have been controlled for, ESG offers no such positive explanatory power for returns."[59] A 2020 study concluded that "best-in-class firms" outperform other funds, regardless of their ESG score, and that all else being equal, there is no significant correlation between performance and ESG ratings for these firms.[60]

That being said, in some situations ESG can provide investors with reassurance to invest "in low-trust countries, and in countries with poorer security regulations and where lower disclosure standards prevail."[61] Where ESG provides better quality information to the market, it can attract greater investment and thus plays an important role in this regard.[62]

The Dark Side of ESG

Notwithstanding the internal incoherencies discussed above, there are other tensions inherent in ESG investing that give rise to concerns. This paper examines three problems with ESG investment strategies: the prioritisation of fund managers' interests over those of investors; the temptation for companies to market themselves as appearing more socially responsible or environmentally friendly than they are in practice; and funds that are not transparent with investors regarding their positioning on ESG. This section discusses each of these concerns in turn.

Asset Managers, Higher Fees, and ESG Funds

Rationales to Promote ESG Funds

If ESG funds do not outperform the market, why would fund managers continue to promote ESG investment products?

A more optimistic explanation is that some investors prefer to invest in ESG funds, even if they do not out-perform the market. For moral or ethical reasons, investors may choose to avoid investing in companies that make alcohol, tobacco, weapons systems, and the like. This approach accords with a long tradition in funds management of offering products that explicitly exclude so-called "sin stocks". That being said, ESG goes beyond these traditional exclusions by offering ESG-themed products and strategies, such as green bonds, social bonds, impact investing, and sustainable funds. Although these products offer investors more options and flexibility to align their investments with their specific ESG preferences, they also pose challenges in terms of defining and verifying the ESG criteria and outcomes the products promote.

A more pessimistic rationale is that investment managers promote ESG funds because it is good for their own business. Arguably, ESG is a box-ticking exercise. Regulatory compliance may require asset managers to consider ESG factors when making investment decisions or disclose why they do not do so. Similarly, marketing an investment product as being "ESG" or "sustainable" can make it more attractive to potential investors, especially those who wish to align their investments with their personal values. This form of branding can help asset management firms attract more clients and increase the number of assets under management.

A more realistic explanation is that it is in the self-interest of fund managers to promote ESG funds. If they receive higher fees for ESG funds compared to non-ESG funds, they arguably have a personal incentive to promote ESG funds even if they do not yield a better financial return for their clients. When the financial incentives or objectives of fund managers do not align with the best interests of their clients, this misalignment can potentially lead to conflicts of interest and violations of fiduciary duties.

Fiduciary Duties of Fund Managers

As fiduciaries, fund managers are legally obliged to act in the best interests of their clients. This duty means they must put their clients' interests ahead of their own and make investment decisions that best serve their clients' investment goals, risk tolerance, and time horizon.

The fee structure for ESG funds creates a conflict of interest—in appearance if not in reality. If asset managers receive higher fees for ESG funds, how can clients know with certainty that they are promoting those funds in the clients' best interest and not in their own self-interest?

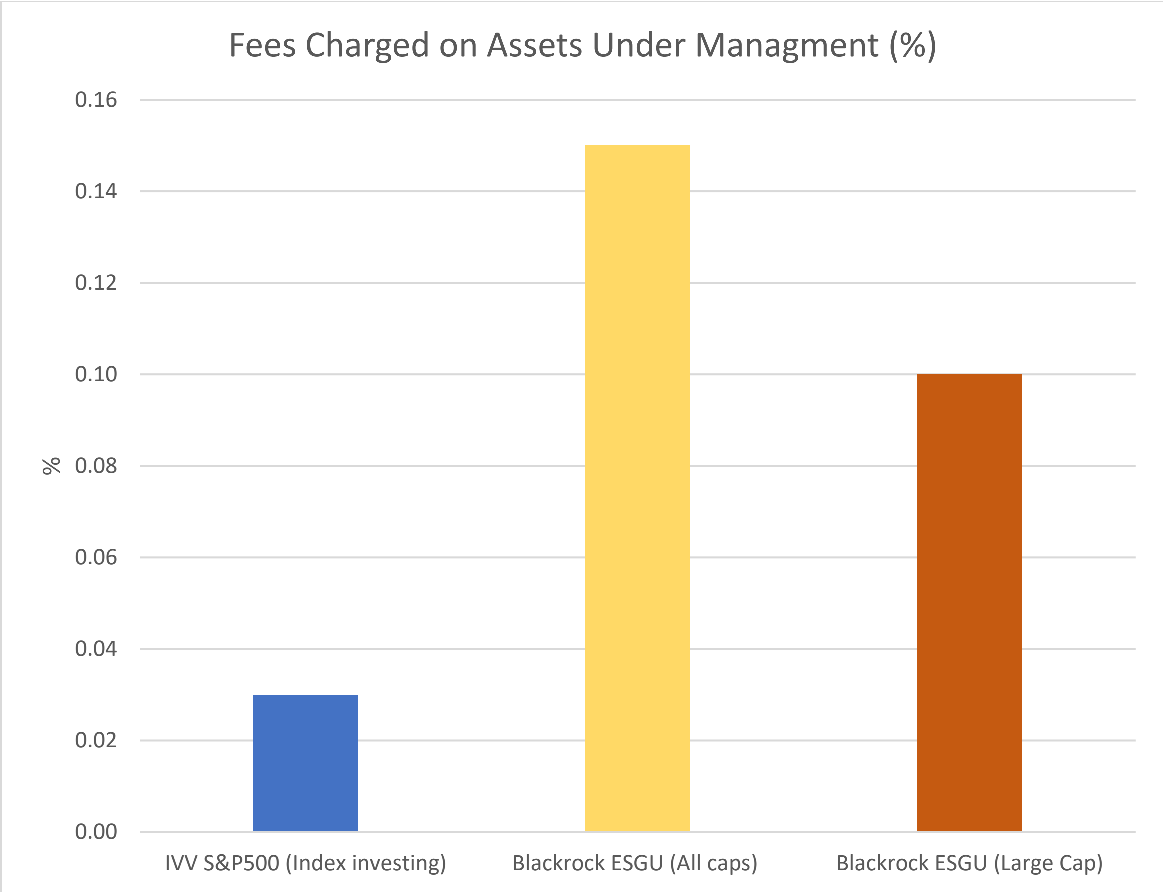
As the Morningstar US Fund Fee Study reported in 2020, "Investors in sustainable funds are paying a 'greenium' relative to investors in conventional funds. This is evidenced by these funds' higher asset-weighted average expense ratio, which stood at 0.61% at the end of 2020 versus 0.41% for their traditional peers."[63]

Similarly, Casey Smith, President of Wiser Wealth Management, has asked the question of whether ESG funds are about promoting good causes or increasing fund managers' wealth:[64]

> "ESGU [All Cap ESG Fund] also costs 5X more. IVV [S&P500] has an expense ratio of 0.03% compared to ESGU's 0.15% and USXF's [Large Cap ESG ETF] 0.10%. In all cases, ESG funds cost more than the core indexes. By driving more investors to ESG, BlackRock increases its revenue as well. For example, if ESGU's investors bought IVV instead, BlackRock would lose $26 million in revenue. So, are ESG investment strategies really about their underlining meaning or are they about increasing the fund providers' revenue?"

Consider the fees illustrated in Figure 1 below. In this scenario, fund managers who recommend ESG funds to their clients in order to receive higher management fees would violate their fiduciary duties. Those duties require fund managers to act in their clients' best interests, and the motivation to offer ESG funds should rest in the funds' expected returns or alignment with the client's values. A failure to disclose any potential conflicts of interest would breach fund managers' fiduciary duties.

Figure 1. Fees Charged on Assets Under Management



The risk of these ethical challenges is more acute given that non-ESG funds outperform ESG funds. How then do fund managers guard against a potential conflict of interest? Even if an ESG fund matches a client's profile and preferences (i.e., their investment objectives, risk tolerance, time horizon, or values), a conflict of interest, apparent or otherwise, could arise simply because the fund manager stands to gain a higher fee from the ESG fund.

Fund managers may not act for their financial gain alone. In more severe cases, a fund manager could be influenced by their own political or ideological beliefs to favour ESG investments, regardless of whether those investments align with a client's financial objectives. If these biases influence investment decisions without the client's knowledge or consent, a breach of fiduciary duty could arise.

Greenwashing

What is Greenwashing?

Regulators are growing increasingly concerned about "a 'clear increase' in financial institutions overstating their climate credentials" and their commitment to social responsibility.[65] This practice is commonly referred to as "greenwashing".

Greenwashing misleads consumers by persuading them to invest in products that appear to be more sustainable than they are in practice.[66] Misleading consumers can constitute fraud, resulting in criminal sanctions. It also damages companies' reputations when they are exposed for greenwashing, which can lead to backlash from consumers, investors, and regulators and jeopardise their financial performance.[67] Greenwashing can create distrust among consumers and undermine the efforts of companies genuinely trying to promote sustainable practices.[68]

Global Efforts to Combat Greenwashing

Earlier this year, "[a]n explosion in the number of ETFs that invest according to environmental, social and governance principles [fuelled] concern among regulators that fund managers are 'greenwashing'."[69] In the last two years, "the number of ETFs carrying an ESG label more than doubled … reaching almost 1,300 at the end of 2022."

The European Banking Authority recently identified practices of "banks and investors promoting their support for initiatives such as clean energy while failing to say they also financed projects linked to fossil fuels, deforestation and human rights abuses." EU regulators pointed to the following examples:

- "One bank portrayed its investment in an airport as 'environmentally sustainable'".
- "Another described its financing of a company building an oil sands pipeline in the face of opposition from indigenous people as 'sustainability linked'."
- "Customers had also been misled about the carbon footprint of individual portfolios."[70]

The European Securities and Markets Authority also found evidence of benchmark providers, asset managers, and investment advisers engaging in "misleading" conduct, including: "'Cherry-picking, omission, ambiguity, empty claims (including exaggeration), misleading use of ESG terminology such as naming and irrelevance."[71] In response to these reports, European parliament is endeavouring to create disincentives for this behaviour, although various measures have been met with opposition.

Greenwashing concerns are not limited to EU Article 9 funds alone. Earlier this year in the United Kingdom, the Financial Conduct Authority ("FCA") "issued a blunt warning to index providers that they were fuelling greenwashing after identifying 'widespread failings' in ESG-related disclosures."[72] The FCA rated "the overall quality of ESG-related disclosures made by index providers" as "'poor'" and called for formal regulation of ESG ratings providers along with renewed determination to "take enforcement action" with financial penalties and other measures.[73]

Key findings from the FCA's letter to chief executives of index providers include:

- "One of our observations was that the subjective nature of ESG factors and how ESG data and ratings are incorporated into benchmark methodologies could increase the risk of poor disclosures."
- "The limited information given by index providers about ESG metrics and a lack of clarity over how these are applied in the calculation of sustainable investment benchmarks could be contributing to greenwashing" was also cause for concern.
- The "little material difference between the constituents of ESG indexes and similar non-ESG benchmarks" heightened these concerns.
- Index providers also came under fire "for failing to implement their own ESG methodologies correctly", including instances of "index providers using outdated ESG data and ratings as well as failures to properly apply exclusion criteria to the constituents of ESG benchmarks."[74]

The Australian Securities and Investments Commission ("ASIC") has also intervened in several cases where financial products or managed funds were not "true to label"—that is, the names of the products or funds included sustainability-related terms that were inconsistent with the funds' investments, or the investment process described. ASIC has also issued infringement notices, secured corrective disclosure outcomes, and commenced civil penalty proceedings against some firms that engaged in greenwashing.[75]

The United States has also taken action, with the US Securities Exchange Commission's 2021 announcement of the creation of a Climate and ESG Task Force, which will focus on identifying material gaps or misstatements in issuers' disclosure of climate risks under existing regulation. To provide some context as to the extent of the potential for greenwashing, Clarity AI, a sustainability technology platform, found that only 4% of "sustainability" funds met the regulatory eligibility criteria for such funds in the EU, UK, and US.[76]

The Many Forms of Greenwashing

In 2007, TerraChoice Marketing—a Canadian environmental marketing company—developed the seven sins of greenwashing tool:[77]

- Sin of the hidden trade-off: An investment fund could promote its ESG credentials based on a single criterion, such as low carbon emissions, while overlooking other significant factors. For example, a company included in the portfolio might have low emissions but could also have poor labour practices or inadequate governance structures.

- Sin of no proof: This happens when an ESG investment product makes an environmental claim that is not backed up by reliable evidence or third-party certification. For example, an ESG fund may claim to exclude fossil fuel companies from its portfolio but fail to provide a clear definition or criteria for what constitutes a fossil fuel company.

- Sin of vagueness: This involves using vague or ambiguous terms that can be interpreted in different ways by different consumers. For example, an ESG fund may use terms like "green", "sustainable", or "responsible" without explaining what they mean or how they measure them. The term "ESG" itself can sometimes be used vaguely, with different fund managers interpreting it in different ways. Without clear definitions and standards, it can be hard for investors to know what they are really getting when they invest in an "ESG" fund.

- Sin of worshiping false labels: Some funds may use self-created ESG labels or ratings that give the impression of third-party verification, but that are not actually based on rigorous, independent assessment.

- Sin of irrelevance: This entails making an environmental claim that is true but not relevant or helpful for consumers seeking environmentally preferable products. For example, an ESG fund may boast that it does not invest in companies that use chlorofluorocarbons, even though chlorofluorocarbons have been banned under the Montreal Protocol since 1987.

- Sin of lesser of two evils: This sin could occur if an ESG fund invests in companies or sectors that are considered "best in class" within their industry, but the industry itself is fraught with ESG issues. For example, a fund might invest in the "greenest" oil company, despite the widely held view that the oil industry has substantial (negative) environmental impacts.

- Sin of fibbing: This is a straightforward falsehood. A fund might claim it incorporates ESG factors into all investment decisions, but it does not, or it does so in such a minimal way that the claim is misleading.

Greensmuggling

What is Greensmuggling?

Vivek Ramaswamy, an American entrepreneur now running for the Republican US presidential nomination and co-founder of Strive Asset Management, is a critic of ESG investment, stakeholder capitalism, and "woke capitalism".[78] He has coined the phrase, "greensmuggling". In his latest book *Capitalist Punishment*, Ramaswamy argues that a lack of transparency—investors saying one thing (conventional funds) but delivering another product (ESG funds)—is the biggest problem:[79]

> "But greenwashing isn't the biggest ESG scam. Dedicated ESG funds represent a relatively small minority of total funds in the asset management industry. The real problem is the inverse: greensmuggling. That occurs when non-ESG funds smuggle ESG policies into their investment practices. Again, investors believe that they are getting one thing (standard investments that are just supposed to make money), when in fact they are getting another (objectives that include combating climate change and societal injustices)."

According to Ramaswamy, concentrated asset management funds, for example BlackRock, Vanguard, and State Street, have an increasingly influential role in the global economy due to the vast amounts of assets they manage. He suggests that these fund managers use their economic power, which arises from their concentrated ownership, to drive personal ideological agendas, such as implementing ESG-type policies across their portfolio companies.

The central argument here is that the financial industry, once considered a neutral player focused solely on maximising shareholder returns, could be unduly influenced by the personal ideologies of a small group of powerful individuals. When these fund managers push for ESG policies, they are not just making investment decisions but also are shaping corporate behaviour and, in turn, influencing social and environmental outcomes.

Conflicts of Interest, Real World Impacts, and Cronyism

If true, this situation has the potential to create several problems and conflicts of interest:

- Unelected Influence: Asset managers are not elected politicians and do not represent the public, yet their decisions can have wide-ranging impacts on society and the environment. This raises questions about democratic accountability and transparency.

- Investor Interests: Fund managers have a fiduciary duty to act in the best interests of their investors, typically interpreted as maximising investment returns subject to investment risk. If they prioritise their personal ideologies over financial performance, they neglect, and arguably breach, this duty.

- Diversity of Opinion: The ideological agendas of a few large fund managers may not reflect the diversity of opinion among all investors. Smaller investors, who might not agree with these ESG policies, have little influence over the funds' strategies.

- Greenwashing: As discussed in the previous section, financial institutions may overstate their commitment to the environment and social responsibility.

- Market Concentration: The growing concentration of asset ownership in the hands of a few large funds can reduce competition in the financial industry, potentially leading to less innovation and higher fees for investors.

- Corporate Governance: If a few powerful asset managers can significantly influence corporate policies, this concentration of power could undermine the role of other stakeholders, such as employees, customers, and communities, in corporate governance.

These conflicts of interest are not trivial. They have real-world impacts on investors and the market in general, some of which are canvassed here.

- Informed Consent: When a fund's strategy covertly incorporates ESG factors, investors may unknowingly support causes or companies with which they might not agree. The absence of informed consent is a breach of their right to make informed decisions about where their money is going.

- Transparency and Trust: If an investment fund claims to focus purely on financial returns but secretly incorporates ESG factors, it can lead to a breakdown of trust with clients. Investors need transparency to make informed decisions. Greensmuggling undermines this transparency, potentially leading to a loss of investor trust in the asset management industry.

- Misaligned Expectations: Investors typically choose non-ESG funds with the expectation of maximising returns, without any non-financial objectives. Greensmuggling can lead to a mismatch between investor expectations and actual fund performance, especially if ESG factors negatively impact returns.

- Market Distortion: Covertly incorporating ESG policies can distort market mechanisms. If ESG factors indirectly influence market prices without being explicitly accounted for, it can lead to mispriced assets and inefficient allocation of capital.

But there are two other pressing problems associated with greensmuggling: political capture and cronyism.

(i) Political Capture

First, greensmuggling could lead to political capture. Large investment funds often wield significant influence over the companies in which they invest. If these funds use this influence to promote ESG policies, they could essentially be shaping corporate policies according to their own preferences and values, rather than in the broader interests of their investors or the public. This influence can extend beyond individual companies to entire industries and even regulatory bodies.

Practically speaking, if fund managers use their influence to shape regulations in favour of their ESG goals, they could effectively capture the political process. The market share controlled by the top global asset management firms and the pressure companies face to subscribe to ESG disclosure regimes and indexes create the appearance of political capture.

(ii) Cronyism

Secondly, there are concerns greensmuggling could result in cronyism given its opportunities for favouritism and unethical conduct. For example, it is possible for fund managers to use ESG criteria to justify investments in companies with which they have personal ties, or to exclude companies with which they have personal conflicts. This selective favouritism could create an uneven playing field where certain companies are favoured because of their connections to influential fund managers and not because of their financial performance or true commitment to sustainability.

Is ESG Fit for Purpose?

The investment industry is rife with conflicts of interest, apparent or otherwise, and an arguably improper concentration of control between the shareholders of asset management firms and their dominance of investment indexes. In such a climate, one questions whether ESG remains fit for purpose.

The Rise of the Managerial Class

As is evident from this paper's discussion on the key players in ESG investing, the top global asset management firms control a significant amount of wealth and passively invest funds benchmarked against indexes. The close relationship between firms, funds, and indexes creates concerns over the rise of the managerial class, which leads to several challenges.

The managerial class are a group of professional administrators who, despite owning only a small portion of a firm's shares, if any, have control over the firm's operations.[80] Commentators explain that historically shareholders, who legally have ownership over companies, had been separated from those that control the companies, such as managers and directors who themselves had very low levels of shareholding within the companies that they controlled.[81] This relationship raised accountability issues, as managers and directors could pursue their own interests at the expense of the shareholders. In the case of the managerial class, this misalignment of interests creates several problems.

- First, managers might prioritise short-term gains to meet quarterly targets or improve short-term financial metrics, potentially at the expense of the firm's long-term success. This approach could lead to underinvestment in important areas like research and development, workforce training, or infrastructure.

- Managers may also be less risk adverse than shareholders. If managers receive compensation according to the firm's performance, they may be incentivised to take excessive—or fewer—risks compared to shareholders' preferences, leading to disastrous outcomes.

- Without proper oversight, managers could award themselves excessive compensation packages. As shareholders bear these costs, this compensation represents a direct wealth transfer from shareholders to managers.

- Managers could also pursue strategies that increase the size of the corporation (e.g., through mergers and acquisitions), not because these strategies are in the shareholders' best interests, but because they increase the managers' power, prestige, or profits.

- Similarly, managers could act in their self-interest to protect their own jobs, even if those financial decisions are not in the best interests of shareholders. For instance, they could resist takeovers that would benefit shareholders or create a corporate structure that makes it difficult for shareholders to replace the management team.

Despite these concerns, the separation of ownership and control model has several benefits. It provides an efficient way to manage large corporations. For instance, modern firms are so large that no one single owner could provide all the financing necessary to fund their operations. Even if sufficiently wealthy individuals did exist, there is no reason to believe that they would have the skills or even interests to manage those organisations. The modern corporation allows for specialisation—those individuals who have the skills, inclination, and interest in managing large corporations can do so, even if they do not have the wealth to do so. The separation of ownership and control results in a more efficient allocation of human and financial capital across the economy. Capital markets, financial regulatory systems, product markets, shareholder resolutions, and internal controls lend to the efficiency of this model.

The Rise of Passive Investment

Passive funds consistently outperform active funds. Investment management firm Morningstar explains, "Overall, active funds' long-term success rates are low. In fact, over the past 10 years, active funds' success rates were less than 23% across two thirds of the surveyed categories. The majority of active funds both survived and outperformed their average passive peer in just three of 42 equity categories."[82] As Morningstar explains, "Compared to active funds, passive funds are usually significantly cheaper, making them difficult to beat over the long-term."[83]

Why does this matter?

Passive funds dominate ESG investing. Investors trust the top global asset management firms to invest their funds in companies benchmarked against ESG indexes, like MSCI or FTSE Russell. Although passive funds generally outperform active funds, they do not necessarily outperform non-ESG funds, nor do they always promote socially responsible policies. In part, these discrepancies are due to the different ways in which these funds are managed.

Active funds attract a higher degree of scrutiny from asset managers. Active asset management is an investment strategy where fund managers try to outperform a specific benchmark by selecting securities they expect to perform well, based on various analytical research, forecasts, and their own judgment and experience. They may also attempt to time the market – buying when they expect the market to rise and selling when they expect it to fall.[84]

In contrast, passive funds, as the name implies, attempt to mimic the performance of a market index, without trying to beat the market. Passive funds, also known as index funds, offer investors broad market exposure at low cost, without the need for active management.

The rise of passive investing has been dramatic. The low cost, simplicity, and research supporting market efficiency have driven more and more investors to choose passive strategies over more active strategies. As a result, passive investment firms have grown significantly in size. Large asset management firms like BlackRock, Vanguard, and State Street—often referred to as the 'Big Three'—collectively manage trillions of dollars, much of which is invested in passive funds.[85]

This shift towards passive management has had profound implications for the investment management industry, as well as for corporate governance given the voting power these large asset managers now

wield. Despite concerns about potential concentration of power and agency issues, passive investing continues to gain popularity, making it an important part of the investment landscape today.
As this trend continues, however, concerns have arisen around the governance implications of concentrated ownership by these large, passive asset managers. With their vast holdings, these asset managers wield substantial voting power in many public companies.[86] Yet, due to their passive strategy, these managers may lack both the incentive and the resources to effectively monitor and engage with the companies in their portfolios.[87]

This situation brings to the fore an important aspect of agency theory and the separation of ownership and control. The clients of these asset managers are the principals, and the asset managers themselves are the agents. The clients entrust their capital to asset managers with the expectation that the managers will act in their best interest. However, this relationship can create a conflict of interest if the asset managers prioritise their own preferences or interests over those of their clients.[88]

In the context of ESG investing, the preference for passive investment raises questions of accountability (both for asset managers and the ESG ratings of the funds themselves) and profitability (even though passive funds outperform active funds, they do not necessarily outperform non-ESG funds). Is this form of ESG investing actually doing good for investors and for the world?

Transparency and Accountability: Quis Custodiet Ipsos Custodes?

With many temptations for asset managers to act in their own self-interest, the question arises: Who is guarding the guardians?

Profit and Competition in a Market Economy

In a market economy, people are motivated by profit and disciplined by competition. Leading economists have conceptualised profit as resulting from entrepreneurs' success or failure in foreseeing future consumer demand and adjusting their production tactics accordingly. When entrepreneurs successfully anticipate consumer needs and provide the desired goods or services in the most cost-effective and high-quality way, they are rewarded with profit. On the other hand, entrepreneurs who either squander scarce resources or manufacture goods that are not sought after by consumers suffer losses.

Profits also function as a feedback mechanism. This information helps entrepreneurs to identify and rectify mistakes and streamline their processes to achieve greater efficiency.

Competition further amplifies this discipline. In a competitive market, businesses constantly strive to outperform one another to win consumer patronage. They must continually improve their products or services, find ways to reduce costs, and respond to changes in consumer preferences to remain competitive and attract profits. Companies that fail to compete effectively risk losing market share and revenue, and in extreme cases, may go out of business.

A successful business model in a market economy aligns businesses' incentives with the needs and desires of their consumers. This alignment is critical because the ultimate goal of any business is to create value for its customers, which in turn leads to profits and sustainability for the business. From the business's perspective, the primary incentive is to generate profit. A business achieves this aim by efficiently providing goods or services that are in demand and for which consumers are willing to pay.

By identifying and responding to consumer needs and preferences, businesses can increase sales, enhance customer loyalty, and expand their market share.

On the consumer side, the motivation is to get the highest value—quality, utility, satisfaction—for the price paid. When businesses are successful in delivering this value, consumers are more likely to purchase goods and services from these businesses and become repeat customers. This mutual incentive structure creates a positive feedback loop. Businesses strive to improve their offerings and meet consumer needs effectively, while consumers reward these efforts by purchasing goods and services, thus contributing to the profitability of the business.

In theory, the principles of aligning incentives and consumer interests apply equally to the fund management sector. In this context, the fund managers are the businesses, and the investors are the consumers. A successful fund management company aims to generate strong returns for its clients—the investors. For investors, their desire is to increase their wealth. Investors seek fund managers who can deliver strong, consistent returns and protect their investments from excessive risk. Thus, the interests of fund managers and investors are naturally aligned: both benefit from the profitable and prudent management of the fund's assets.

There is, however, a problem that arises in the theoretical story that we have told in this section.

Client Interests vs. Shareholders' Interests

One would expect that fund managers' primary incentive is to increase the value of the assets they manage on behalf of their clients (the consumers). In doing so, they earn higher fees and also attract more clients to the fund, thus increasing their overall profits. Fund managers earn their profits not by maximising the returns their clients earn, but by maximising the assets they have under management.

Vivek Ramaswamy[89] explains that fund managers make a profit regardless of whether "they make money or they lose money":

> "Mutual fund complexes like BlackRock make money based on the totality of assets that they manage, not based on the actual investment performance of those assets. If you've ever invested in a mutual fund, you've probably noticed that they quote a fee for their product—often something like 1 percent. Know that they're referring to the fee that they charge on the money you hand over to them, not on the actual gains that they generate. In fact, mutual funds like BlackRock profit just the same whether they make money or they lose money. Just like during the pre-2008 housing bubble, the people who sold financial products stood to gain whether the underlying investment strategy performed well or not."

Global asset management firms are companies with their own shareholders. Fund managers owe duties to their shareholders and to their clients. But it is not necessarily true that their shareholders' interests will match with their clients' interests. In that case, who holds fund managers accountable to act in their clients' best interests?

Several conflicts of interest become immediately apparent:

- Lack of Performance Incentive: Since asset managers fees are based on assets under management, not on performance, fund managers may have less incentive to strive for the highest possible returns. Put simply, fund managers get paid regardless of whether the fund makes or loses money.

- Risk-Taking Behaviour: As fees are not tied to performance, fund managers might take on excessive risk to increase the number of assets under management. If those risky investments do not pay off, investors ultimately bear the loss while fund managers' profits could still increase.

- Focus on Asset Gathering: Asset management firms may prioritise attracting new assets to increase the total number of assets under management, rather than focus on improving the performance of their existing assets. Without proper management, funds could become too large and unwieldy to manage effectively, leading to diminishing returns.

- Potential Conflicts of Interest: Incentives for firms to increase the number of assets under management could lead to sub-optimal investment decisions for investors if companies promote funds to increase their profits, rather than those that are the best fit for an investor.

- Over-hyping: Fund managers might capitalise on the buzz surrounding certain investment trends or "hot" sectors, creating new funds that cater to these fads, like ESG investing. Trendy areas of the market garner significant interest, which could lead to new investments and higher fees for fund managers. A focus on short-term investment gains may lead to worse outcomes longer term and asset bubbles that eventually burst and damage investor returns.

In the context of ESG investing, these challenges are acute. Asset management firms have an incentive to invest clients' funds in ESG funds, given the prospect of higher management fees even if the funds' performance is worse than non-ESG funds. ESG investing is thus rife with potential conflicts of interest given the apparent mismatch between the interests of asset managers, their shareholders, and their clients.

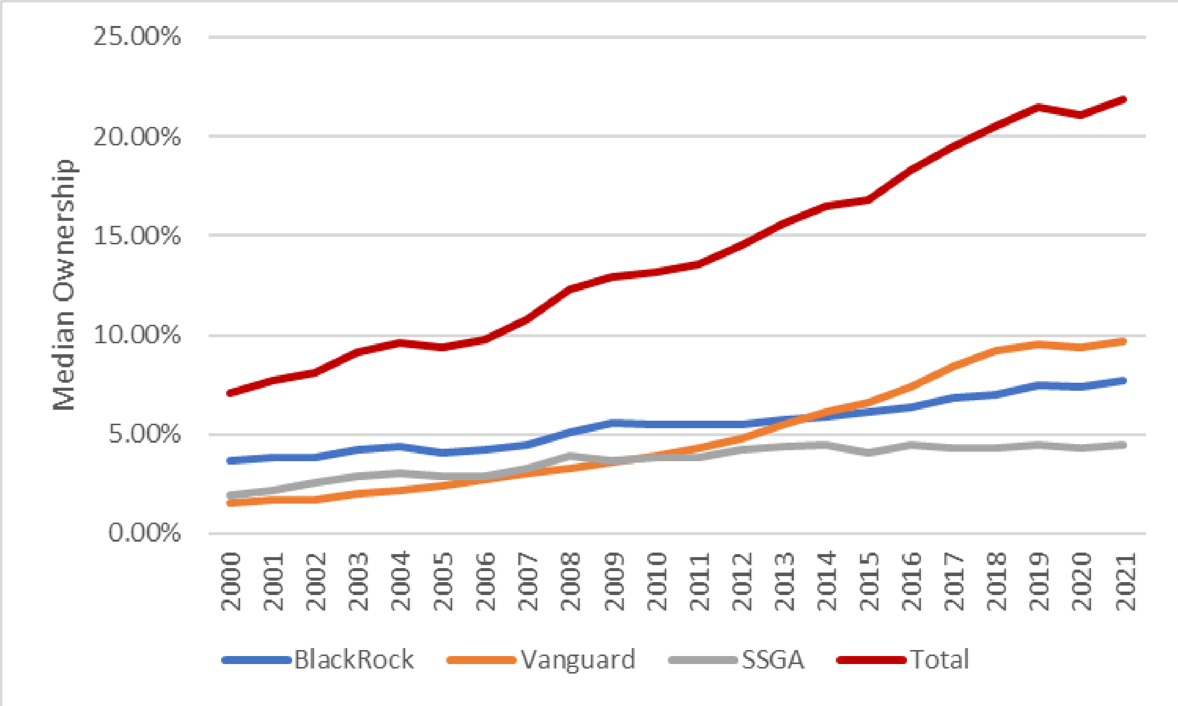
A Climate of Concentration not Competition

The rise of passive index tracking has given rise to two distinct forms of concentration. In the first instance, levels of ownership of the underlying companies have increased over time, resulting in fewer shareholders holding a larger portion of power. The second problem is that ownership of the index funds themselves has become concentrated in the hands of a few top global asset management firms. Benjamin Braun[90] has described this state of affairs as "Asset Manager Capitalism".

Increased Shareholder Control

Figure 2 below shows the median ownership of S&P500 companies over the period between 2000 and 2021. [91]

Figure 2: Median ownership of S&P500 companies by BlackRock, State Street Global Advisors, and Vanguard



By 2021 just three shareholders held 22% of the stock of S&P500 companies in the United States. This is a very different reality to the standard view that the stock of large corporations is held by millions of individual shareholders. The first problem here is known as common ownership.

Many of the firms within the S&P500 are competitors with each other in the product market. Some may be complements—firms that may be suppliers or customers of other firms in the S&P500. Why is this a problem?

The basic assumption in economics is that each firm maximises its own value in the interest of its shareholders. But a shareholder who owns a diversified portfolio that includes competitors and collaborators may not wish individual firms to maximise their profits. Instead, they may wish these firms to maximise their joint profits. To the extent that this form of profit maximisation occurs, it represents a wealth transfer from less diversified shareholders to the common shareholders. Worse, the common shareholding may result in a decline in competition in the product market.

Einer Elhauge explains the problem with joint profit maximisation as follows:[92]

> "But the standard economic model of market competition assumes that when a firm takes away sales by undercutting its rivals' prices, the firms' owners gain the profits from those sales but lose no profit on the sales taken away from their rivals. When the owners of a firm also own the firm's rivals the calculus is entirely different. This is easiest to see when the owners of a firm are identical to the owners of that firm's rival. In that case, when a firm undercuts its rival's price to take away a sale, the movement of the sale to the firm from the rival simply moves their owners' money from one pocket to another; the net effect of the price cut for those owners is that the prices charged by both firms are lower, thus lowering those owners' profits across both firms."

To the extent that joint profit maximisation, as opposed to individual profit maximisation, occurs, it reduces competition in the product market and introduces less discipline in financial markets.

Consumers and shareholders lose out on a strong return on investment. Moreover, this approach makes it easier for firms and select shareholders to pursue their personal interests at the expense of consumers and non-dominant shareholders.

Concentration of Control over Index Funds

Three of the top global asset management firms have overlapping shareholder control with each other's firms. As reported in *The Wall Street Journal* "Vanguard is the largest owner of BlackRock and State Street, in each case followed by BlackRock. Taken together, the Big Three directly own about 19% of BlackRock and 22% of State Street."[93] But their cumulative control is even higher:

> "Start with Vanguard, the privately held company of the group. Though 100% of Vanguard's equity is held by its own managed funds, its investors hardly control them. The company's directors are also the trustees of its funds, tasked with appointing its managers. Those managers are the only 'owners' with votes on the membership of Vanguard's board. It's difficult to imagine a more circular arrangement.
>
> But the rest of the Big Three come close. Vanguard is the largest owner of BlackRock and State Street, in each case followed by BlackRock. Taken together, the Big Three directly own about 19% of BlackRock and 22% of State Street. The companies also own controlling shares of many of the other institutional stockholders holding the Big Three's shares. After including those holdings, the Big Three cumulatively control—if indirectly—no less than about 32% of BlackRock's equity and 42% of State Street's."

Not only do these three firms control a cumulative total of over $20 trillion in assets between them, but also this revolving door of shareholder control is unconscionable. Put plainly, three shareholders who are insulated from market discipline have controlling shareholder stakes in the largest and most influential firms in the world.

Proxy Advisors and the Delegation of Oversight

Several commentators view proxy advisers with scepticism or hostility. Their concern stems from the influence proxy advisors exercise over the direction of corporations, primarily because they advise institutional fund managers to vote according to ESG performance, even though those ratings may be reached without due diligence and not based in actual performance or reasonable expectations of a profit-making enterprise.

It is ironic that proxy advisers arose only because fund managers were, in the first place, enabled to vote on behalf of the shareholders whose assets they hold in trust.

It may well be true that institutional investors "vote the bulk of the world's equity capital", but they cannot be said to "own" that equity in an economic sense. Instead, institutional investors impose their own preferences on their clients. Proxy advisers lobby the government to create rules more favourable for proxies to vote on behalf of shareholders. Consider the example of Robert Monks lobbying to change proxy voting rules for his company's benefit:[94]

> "Ironically, it was a Reagan-era regulatory change that empowered the likes of BlackRock, granting fund managers outsized influence over corporate governance. In the 1980s, a failed Republican Senate candidate named Robert Monks became

> administrator of the Office of Pension and Welfare Benefit Programs at the Department of Labor. Monks worked to change proxy-voting rules to allow fund managers, instead of the underlying beneficial owners, to vote the shares they held on behalf of investors. Notably, Monks then left the government to found Institutional Shareholder Services, or ISS, one of the leading proxy advisers making recommendations on how institutional managers should vote their shares."

While Monks may not have acted for nefarious motives, the "revolving door" between his role in government, the changes he made to proxy voting rules, and the company he subsequently created that directly benefitted from his policy change, point to conflicts of interest and perverse incentives prevalent in the institutional investment industry.

The Corporate Governance Matrix

How then might the investment industry mitigate conflicts of interest and the concentration of wealth among the top global asset management firms? As a starting point, this paper argues that companies can pursue an active corporate governance structure to mitigate the challenges associated with passive investment.

Figure 3 below shows a matrix juxtaposing asset management style with corporate governance style. In simple terms, this is what the matrix shows:

- Each style (asset management and corporate governance) can either be active or passive.
- Active investment management involves active buying, selling, and portfolio adjustment based on market research and predictions, while passive investment management involves long-term investing in a diversified mix of assets, typically through index funds, with minimal buying and selling based on short-term market fluctuations.
- Market realities show that many asset managers now pursue passive asset management strategies.
- Active corporate governance involves rigorous oversight and strategic decision-making by the board and shareholders to guide a company's operations and performance.
- In contrast, passive corporate governance is characterised by a hands-off approach where shareholders offer limited input, often leading to a dominance of decision-making by the board and/or management.

Figure 3: Corporate Governance / Asset Management Matrix

		Asset Management	
		Active	Passive
Corporate Governance	Active	Idealised B&M	
	Passive	Wall Street Walk	Strong Insiders Weak Outsiders

Historically, asset managers pursued an active asset management strategy while also following passive corporate governance practices. This combination of strategies is known as the "Wall Street Walk". In that scenario, instead of engaging with a company's management to improve corporate governance issues, asset managers chose to sell their shares (i.e., "walk away") when dissatisfied with a company's performance or governance. Index funds, however, do not have the ability to divest their shares when dissatisfied—by definition, they must hold the index.

In an ideal world, corporate governance would be active and the owners of the firm play an active role in decision-making. This is how Berle and Means had envisaged corporate governance would operate.

Historically, corporate governance became passive due to the separation of ownership and control of businesses. Passive corporate governance has influenced the modern approach, which favours strong insiders and weak outsiders.

Active Corporate Governance

That being said, in view of the considerable challenges identified in ESG investing, there is a strong argument for firms to pursue active corporate governance as an antidote to an overwhelming preference for passive investment strategies. An active approach could lead to the following outcomes:

- Efficiency and Cost Savings: Lower management fees and lower transaction costs can result in higher overall returns for investors.

- Market Returns: Passive investors can expect to receive the market rate of return by tracking a market index. If the overall market or sector performs well, the passive investor will share in those gains.

- Effective Decision-Making: Active corporate governance can ensure the company's strategic objectives align with shareholders' interests. It can also monitor management performance, potentially leading to better financial results.

- Transparency and Accountability: Active corporate governance could lead to enhanced transparency and accountability, helping to build investor trust and potentially boost the firm's reputation and valuation.

Challenges with the Status Quo

Vivek Ramaswamy is unconvinced that active corporative governance strategies will succeed. He queries why society accepts "no one can reliably pick the right stocks" and yet "the Big Three seem to have absolute faith that they can pick the right social policies."[95] In other words, why do asset managers say they cannot make prudent investment choices (their area of expertise) but can opine on pressing social issues (outside their area of expertise)? He explains this phenomenon in more detail:[96]

> "Most asset managers believe that they have no ability to make wise choices within their area of expertise but exceptional insight outside it. They think that no one can beat the financial market but beating the political one is easy. Predicting the future performance of a stock? Impossible; foolish even to try. Predicting the future financial impact of boardroom diversity quotas or the state of the planet thirty years from now, along with environmental regulations twenty years from now? Easy. They've read a couple of good articles on the subject. They watch the news—when they have time."

Shareholders versus Stakeholders

There are, at least, two problems with adopting a broader approach to corporate governance (stakeholder capitalism) rather than a narrow approach (shareholder capitalism). First, it conflates the roles of corporate governance and political governance. Secondly, it is an instance of "nirvana economics", which is not grounded in "real world" assumptions.

Political Governance

ESG investment practices favour stakeholder capitalism over shareholder capitalism, which erodes companies' conventional corporate governance structures. Instead, these practices replace the traditional understanding of corporate governance with political governance. It turns companies into political actors. But this practice creates practical challenges as these policies ask companies to perform a function to which they are not suited. Unlike political institutions, which seek to ensure democratic representation, rule of law, and liberty, corporations are responsible to their shareholders and serve an economic function, as opposed to a political one.

Put simply, *The Wall Street Journal* captured the anti-democratic nature of ESG with the following quote: "The Big Three use their vast economic clout to push a social and political agenda that many Americans don't support and never voted for. It's a usurpation of their political rights."[97]

There is an inherent tension between these two forms of governance: should shareholders' or stakeholders' interests take priority? As Roland Benabou and the 2014 economics Nobel laureate, Jean Tirole, explain:[98]

> "Textbook economics has thus long embraced the shareholder-value approach, which posits that firms should be controlled by profit-maximizing shareholders while other stakeholders are protected by contracts and regulation. Stakeholders' insulation from

> managerial decisions operates through fixed nominal claims (wages and severance pay, fixed debt repayment combined with priority and collateral, etc.) and exit options associated with general training, flexible labour markets and short-term debt maturities. … In a nutshell, following Pigou (1920), the state, and not citizens or firms, is in charge of correcting market failures and income or wealth inequality."

There are several reasons to avoid conflating the two modes of governance:

- Lack of Expertise: Corporations and governments have different areas of expertise. Corporate leaders are often not well-equipped to make political decisions, and politicians may lack the necessary understanding of the complex dynamics involved in running a business.

- Conflicts of Interest: Corporations primarily aim to maximise shareholder wealth, which can sometimes conflict with the public interest, leading to issues related to fairness, equity, and sustainability.

- Governance Inefficiency: Different governance mechanisms are designed to address different needs. Applying the wrong approach can lead to inefficiencies, misaligned incentives, and ineffective decision-making.

- Democracy and Accountability Issues: Unlike political governance, corporate governance typically is not subject to democratic control. As such, corporations wielding political power without the corresponding democratic accountability is profoundly problematic. Vivek Ramaswamy argues that this situation usurps democracy.

The anti-democratic nature of ESG has also been noted in The Wall Street Journal:

> "The Big Three use their vast economic clout to push a social and political agenda that many Americans don't support and never voted for. It's a usurpation of their political rights."

There is another argument, however, that we should consider. It may well be that ESG investment is a private sector response to public failure. The standard economic argument is that governments intervene when markets fail. But it is well-known that governments fail too. There is a plausible argument to be made that ESG investment then is a corrective measure for government failure. ESG investing could constitute the private provision of otherwise public goods or outcomes that should be provided via political governance but are better provided through corporate governance.

This argument has been made by US politicians—as reported in *The Wall Street Journal*:[99]

> "Proponents of ESG—environmental, social and governance—investing are posing as champions of the free market. Utah Attorney General Sean Reyes and I testified earlier this month before the House Oversight Committee regarding our continuing investigations into several global financial alliances that aim to impose ESG policies on American businesses and consumers in defiance of our free-market economy.
>
> Minutes into the hearing, Rep. Jamie Raskin (D., Md.) claimed that my colleague sand I were 'assaulting the free market' and attempting to 'stop the market from responding to the climate crisis.' Rep. Katie Porter (D., Calif.) continued the gaslighting, noting that 'capitalism delivers freedom,' which 'happens when markets let people choose what they want.'"

The author of that article, Steve Marshall, the attorney general of Alabama, is sceptical of the argument. Nonetheless, it is an argument that could have validity and should not be summarily rejected. It is plausible that ESG investing is a form of privatisation, where the state is supplanted by the market.

It is fair to say that government has failed to adequately address many social and economic problems in modern society. And it is reasonable for private sector entrepreneurs to attempt to address those very issues—private charities have existed for centuries. Similarly, there is no reason why for-profit organisations should not attempt to earn a profit by providing what might otherwise be public goods and services.

The private sector may have an important role to play in this regard. Competition and profit motives drive the private sector, making it easier for companies to deliver services more efficiently and innovatively than the public sector. The private provision of goods could result in better quality or more cost-effective solutions. The private sector can help to fill gaps where government services are insufficient, slow, or non-existent. For-profit organizations often have access to resources, expertise, and networks that can be harnessed to address societal challenges.

Figure 4 shows a matrix that sets out a juxtaposition of private and public failure to help frame our arguments.

Figure 4: Private Failure / Public Failure Matrix

		Public Failure	
		Yes	No
Private Failure	Yes	'Failed State'	Idealised Pigouvian World
	No	ESG?	Idealised Society

The Nirvana Fallacy

Many policymakers seeking to propose change in the world begin with the assumption that neither the private sector nor the public sector fail. In other words, their starting point is the "nirvana fallacy" where they create policies according to "the best of all worlds" as opposed to "the real world". This approach leads to idealised, rather than pragmatic, solutions to pressing problems of the day.[100]

The argument that ESG investing is a private solution to public failure may hold water. That being said, there are many questions that require answers.

First, can ESG investment be a genuine substitute for government intervention? Governments are elected and accountable to citizens. By contrast, private entities are accountable primarily to their shareholders. Their decisions may not reflect the will of the public, and citizens have limited means to influence these decisions. This shift of power from public entities to private ones can undermine democratic control over critical societal functions.

Secondly, the interests of the few may dominate the interests of the many. To the extent that a separation of ownership and control has occurred, or that private entities are captured by insiders, corporate policies and behaviour may reflect the priorities and values of a relatively small group of investors and corporate executives. These priorities may not align with those of broader society, including workers, consumers, and communities affected by corporate activities. This concentration of influence can lead to the imposition of elite opinions on societal issues. These elite opinions may diverge significantly from public opinion. Vivek Ramaswamy, for example, argues that ESG imposes many values that the electorate would never agree to at the ballot box.[101]

Thirdly, how can ESG investors solve societal and economic problems that the government cannot solve? Some suggest that corporate social responsibility is a form of "decentralised correction of externality and inequality". Yet, ESG investment is not decentralised. It is a form of planning imposed by concentrated shareholding that resembles government planning. Both government and private planning in this instance is likely to apply a "one-size-fits-all" approach and is very unlikely to incorporate local information into decision-making. Precisely the same factors that bedevil public intervention is likely to bedevil private intervention.

The difference between ESG investing and social entrepreneurship is this: An organisation specifically established to address a specific social or economic problem will incorporate local knowledge into its decision-making. This type of organisation does not need to specifically subscribe to ESG priorities identified by asset managers. It is already working to promote socially responsible causes.

Where Next?

This paper has identified several challenges with ESG investing. ESG ratings are based on subjective, not objective, criteria and often rest on inaccurate or unaudited data. ESG funds do not necessarily deliver better financial returns and they are more expensive, with management fees approximately 40% higher than non-ESG funds. These incongruences have spurred backlash from the investment community, with widespread concerns of greenwashing and Morningstar's decision to remove "the ESG tag from more than 1,200 ESG funds managing over $1trillion in assets because the funds did not 'integrate [ESG factors] in a determinative way in their investment selection.'"[102]

Ethical investing is a personal choice. But the performance of ESG funds carries financial implications. Companies have considered changing their listing from the London Stock Exchange to New York's because the United States offers a more attractive investment environment. As Gary Nagle, chief executive of Glencore, recently remarked, "In Europe, investors seem a little bit more focused on ESG, and it seems to be the ESG desk that makes more decisions – and returns are sometimes put second or third in the list. That's a concern for us." In contrast, "'American investors … seem to take a more pragmatic approach towards [ESG investing], where they want the yield."[103]

In an environment where investors question the financial performance of ESG funds, difficult questions need to be asked. What is it that these funds achieve? What is their objective? Is it appropriate for the top global asset management firms to control such a large portion of wealth and retain such a large percentage of control in each other's firms? Are ESG funds actually promoting the socially responsible causes they purport to endorse? Should firms be more transparent with investors about the trade-offs between financial backing for their ethical values and lower financial returns?

It is clear from the challenges identified in this paper that ESG is not fit for purpose. Concerns related to apparent or actual conflicts of interest or breaches of fiduciary duties demonstrate the need for urgent action. Greater parliamentary scrutiny and regulatory oversight are necessary to resolve the internal incoherence in ESG investing.

Recent analysis in the *Financial Times* calls for "tougher scrutiny, regulation and reform of the raters' own practices," explaining that ratings agencies should not be allowed to "offer consulting services to the companies they rate on how to improve their scores" to maintain "impartiality and trust."[104] Standardised ESG disclosure metrics and clear methodology on how agencies measure companies' ESG ratings would also introduce greater consistency across the industry. Similarly, an accountability mechanism whereby companies can raise, and address, concerns with their ESG ratings will improve regulatory oversight of ratings agencies and ensure investors have access to accurate information. Policymakers must also consider the implications of the concentrated economic control held by a handful of global asset managers, and whether such concentrations of economic power are desirable.

More work needs to be done to find the appropriate balance between shareholders' and stakeholders' interests. If corporations are to abandon their socially mandated roles of selling goods and services to willing customers while earning a profit for their shareholders, then a strong case needs to be made for that change. It is true that some individuals such as Mark Carney and Larry Fink have attempted to make that case, it is also clear the implementation of their views has not been as successful as they may have hoped. At the same time, if we agree that corporations play an important role in generating wealth as a way of contributing to the social good then the pursuit of profit is entirely consistent with the promotion of social benefits.[105]

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