Ethics & Alpha: Can Investing Responsibly Enhance Returns?

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"There is one, and only one, social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud," Nobel Prize-winning economist Milton Friedman.[1]

Friedman, perhaps the twentieth century's most celebrated free-market economist, described the idea that businesses had a responsibility to wider society as a "fundamentally subversive doctrine".

His seminal article for The New York Times Magazine, published in September 1970, sparked a furious debate as to whether firms can increase their value by incorporating environmental, social and governance (ESG) considerations into their business operations. While that argument continues to rage nearly half a century later, there is a growing body of evidence to suggest they can.

Empirical evidence

In recent years researchers from both academia and the asset management industry, drawing on an ever-expanding universe of data, have conducted numerous studies to establish whether such a relationship exists.

According to researchers at the University of Hamburg and Deutsche Asset and Wealth Management, a positive relationship between ESG ratings and corporate performance was found in close to half of the 1816 academic studies published since 1970, with a negative correlation being found just ten per cent of the time.[2] For instance, a July 2013 Harvard Business School study found that over an 18-year period, a sample of ninety "high-sustainability" companies "dramatically outperformed" ninety low-sustainability firms in terms of both stock market and accounting measures.[3]

Logical explanations

There are logical explanations as to why high, or improving, ESG ratings might boost investment returns.

Firstly, assets underpinned by high ESG ratings are likely to be less risky. For instance, while in the short term, firms may in some instances be able to get away with exploiting their customers or workforce, or degrading the environment, common sense suggests they will eventually be damaged by such behaviour.

Secondly, there is plenty of evidence to suggest highly-rated firms have a lower cost of capital. A number of studies have found good environmental performance correlates with a lower cost of debt and stronger credit ratings (Graham and Maher[4] ; Bauer and Hann[5]; and Schneider[6]), and one found the same for good employee relations (Bauer et. al.[7]).

However, even if there are strong grounds for believing there is a relationship between ESG rankings and corporate performance, it has not always been clear investors have been able to profit from it in their portfolios.

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ESG Integration does work

The rationale for doing so ultimately boils down to the extent to which you believe in the efficient market hypothesis – the idea asset prices fully reflect all available information and it is impossible to 'beat the market' consistently on a risk-adjusted basis.

In recent years investors have moved away from applying screens, of either the negative or positive variety, towards integrating ESG considerations into mainstream investment processes and areas such as impact investing.

Unfortunately – and perhaps one of main reasons why people still question whether ESG can add value, –it is difficult to accurately quantify the value of embedding ESG considerations into the investment process. Since it is just one of multiple investment considerations disentangling its effect on fund performance from other factors is impossible to do in a purely objective way.

Nonetheless, there is overwhelming evidence ESG data can give investors valuable insight into how well a business is run, where its material risks lie and how sustainable its business model and practices really are. As a result, there is no logical reason why fund managers who have not already done so would not wish to broaden their investment process by integrating material non-financial data.

Engage or divest?

Incorporating ESG criteria into the investment process can improve investment returns in other ways. Since the evidence suggests companies can create value by improving their ESG scores, it makes sense to engage with them to help improve their approach. For example, investors may wish to encourage an oil company to improve its safety record to lessen the danger of oil spillages, or to be more transparent in assessing the risks it faces due to climate change. Such improvements are likely to be rewarded by the market, even if not immediately.

Having said that, there is a decision to be made in terms of how much time and money should sensibly be devoted to engaging with companies, not least because there is likely to be a 'free-rider' problem with other investors potentially benefitting from those efforts. Collaborating with other investors often makes sense.

The trend is clear

That the debate sparked by Friedman continues to rage nearly 50 years later is partly because his comments have frequently been taken out of context. In a forgotten part of the oft-quoted article he also said the responsibility of a corporate executive is to "make as much money as possible while conforming to their basic rules of the society; both those embodied in law and those embodied in ethical custom".

However you define it and subsequently measure its impact, it is becoming extremely difficult to argue against incorporating some level of ESG analysis into the investment process. While investors need to be wary of overpaying for assets based on ESG criteria alone, there is every reason to believe investing responsibly, far from leading to returns being sacrificed, will pay off.

FOOTNOTES

1 The Social Responsibility of Business is to Increase Its Profits, The New York Times Magazine, September 13, 1970
2 Friede G, Busch T & Bassen A (2015): ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment
3 Eccles R, Ioannou I, & Serafeim G (2011): The Impact of Corporate Sustainability on Organizational Process and Performance, Working Paper Harvard Business School
4 Graham A & Maher J (2006). Environmental Liabilities, Bond Ratings and Bond Yields, in: Freedman, M., Jaggi, B. (eds.), Environmental Accounting: Commitment or Propaganda, Advances in Environmental Accounting & Management, Vol. 3, Elsevier Ltd. pp. 111-142.
5 Bauer, R & Hann, D (2010). Corporate Environmental Management and Credit Risk, Maastricht University, European Centre for Corporate Engagement
6 Schneider, T (2010). Is environmental performance a determinant of bond pricing? Evidence from the U.S. pulp and paper and chemical industries. Working Paper: University of Alberta.
7 Bauer, R, Derwall, J & Hann, D (2010). Employee relations and Credit Risk. Working Paper Maastricht University and Tilburg University.

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