

The End of ESG

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and ECGI

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Abstract

ESG is both extremely important and nothing special. It's extremely important because it's critical to long-term value, and thus any practitioner or academic should take it seriously, not just those with "ESG" in their job title or list of research interests. Thus, ESG doesn't need a specialized term, as that implies it's niche. It's nothing special since it's no better or worse than other intangible assets that drive long-term value and create positive externalities for wider society, such as management quality, corporate culture, and innovative capability. The following implications follow: 1. Companies shouldn't be praised more for improving their ESG performance than these other intangibles; investor engagement on ESG factors shouldn't be put on a pedestal compared to engagement on other value drivers. We want great companies, not just companies that are great at ESG. 2. Investors who greenwash are correctly being held to account. But so should other investors who fail to walk the talk, such as actively-managed funds that closet index or systematically underperform. Clients of non-ESG funds deserve the same protection as clients of ESG funds. 3. Practitioners shouldn't rush to do something special for ESG factors that they wouldn't for other drivers of value, such as demand that every company tie executive pay to them, force a firm to report them even if not relevant for its particular business, or reduce complex intangibles to simple quantitative metrics. 4. Many of the controversies surrounding ESG become moot when we view it as a set of long-term value factors. It's no surprise that ESG ratings aren't perfectly correlated, because it's legitimate to have different views on the quality of a company's intangibles. We don't need to get into angry fights between ESG believers and deniers, nor politicize the issues, because reasonable people can disagree on how relevant a characteristic is for a company's long-term success.

Keywords: ESG, CSR, responsible business, sustainable investing, intangible assets, externalities

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The End of ESG¹

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1. Introduction

Now is the peak of ESG. It's front and center in the minds of executives, investors, regulators, business students, and even the public. Major corporations are appointing Chief Sustainability Officers to the C-suite, justifying strategic decisions based on their ESG impact, and tying executive pay to ESG metrics. By the end of 2021, 4,375 investors managing \$121 trillion had signed the Principles for Responsible Investment ("PRI"), dwarfing the 63 investors overseeing \$6.5 trillion who helped found the PRI in 2006. Regulators are establishing taxonomies of which corporate activities may be labelled "sustainable", and tiering funds by their ESG incorporation. Business schools are rushing to introduce ESG courses, establish ESG centers, and reinvent faculty as ESG experts. Newspapers are publishing dedicated ESG newsletters, and customers are increasingly basing their purchasing decisions on a company's ESG impact.

With this context, it seems crazy to title an article "The End of ESG". But this title intends not to signal ESG's death, but ESG's evolution from a niche subfield into a mainstream practice. The biggest driver of this ascent is the recognition that ESG factors are critical to a company's long-term value. But then *all* executives and investors should take them seriously, not just those with "sustainability" in their job title. Considering long-term factors when valuing a company isn't ESG investing; it's investing. Indeed, there's not really such a thing as ESG investing, only ESG analysis.

¹ This article is based on my plenary talk at the Accountability in a Sustainable World conference, hosted by the Notre Dame Center for Accounting Research and Education. I thank Tom Gosling for helpful comments.
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The value relevance of ESG was how I got into the topic in the first place. In 2007, I went on the academic job market² with a theory paper on how blockholders (large shareholders) help enhance a company's long-term value (Edmans, 2009). My model showed that blockholders don't just assess a company by its quarterly earnings; instead, they do a deep dive into its intangible assets, such as its corporate culture, customer loyalty, and innovative capability. Doing so is costly and time-consuming, but their large stakes make it worthwhile. In turn, if a company knows that its anchor shareholders will assess it based on long-term value rather than short-term earnings, this frees it to focus on the former and not fret so much about the latter.

Importantly, the shareholders in my paper were just that – shareholders. They weren't ESG investors; they weren't analyzing a company's long-term value because they were forced to by regulation or pressured to by PRI commitments or client mandates. They just wanted to beat the market, and you can only do so with information that's not already in the price. Quarterly earnings, dividends, and cash flows are all freely available, but it's long-term factors that are hidden treasure. When seminar audiences asked me to give examples of investors that my model exemplified, I'd reply Warren Buffett, Bill Miller, and Peter Lynch. None of these are ESG investors; they're simply long-term-oriented investors.

But there was one question I didn't yet have a good answer to. They asked me why blockholders were needed at all – why companies can't just disclose the value of their intangible assets, like they do with quarterly earnings. I replied that intangibles were difficult to report credibly – there are few verifiable measures of items such as corporate culture. And even if there were, investors may still not

² The academic job market takes place in the final year of your PhD. You have a "job market paper" which you send to universities when applying for jobs. While universities will assess your full portfolio, particular attention is paid to your job market paper. Candidates who make it to the final stage are invited to visit the university and present their job market paper at a seminar, where the faculty probe you on it.

take them into account – it’s hard to know how to change cell C23 upon learning that a firm actively encourages dissenting viewpoints.

Yet I only had common sense to buttress my responses; back then, there was no evidence either way. So when the job market was over, I started a new paper on this topic. I took the “100 Best Companies to Work For in America” and found that they significantly outperformed their peers over a 28-year period, even when controlling for a long list of firm characteristics, their industry, and risk. The Best Companies list is public information, and highly visible. If markets were efficient, the Best Companies’ stocks would jump as soon as the list came out, preventing future outperformance. The superior returns imply that the market failed to fully incorporate employee satisfaction.

I initially published the paper in a finance journal (Edmans, 2011); since human capital is also a management topic, a management journal invited me to publish a management-oriented version (Edmans, 2012). Neither article mentioned ESG even once. I didn’t study employee satisfaction because it’s an ESG factor, but because it’s a value-relevant factor; my goal was to show that the stock market overlooks important value drivers. The finance paper is titled “Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices” – I viewed employee satisfaction as an intangible asset, but nothing more special than that. Serendipitously, Lloyd Kurtz, who chaired the Moskowitz Prize for Socially Responsible Investing (“SRI”), learned of my paper and kindly invited me to submit it to the competition. I’d never thought of my research as an SRI paper, but did some research after Lloyd’s email and found that many SRI investors indeed used worker welfare as a key criterion. I added some implications for SRI into the paper, but doing so opened a mini Pandora’s box. If the paper was about SRI, why study employee satisfaction and not other SRI screens such as Catholic values and animal rights? I stressed that human capital theories provide strong reasons for why employee satisfaction might be value-relevant, but the theoretical justification wasn’t so clear for those other factors. A convincing rationale is particularly important to rebut concerns of

data mining – there are dozens of SRI factors that you could try correlating with returns; if one turns up significant, you can publish a paper on only that result and hide the ones that don't work.³

If ESG is a set of value-relevant factors, then it's both extremely important and nothing special. ESG is extremely important because *any* practitioner should care about the drivers of long-term value, particularly (for practitioners who are investors) ones that are mispriced by the stock market. Indeed, the title of this article is inspired by Thaler's (1999) "The End of Behavioral Finance", which predicted that behavioral finance would become mainstream – to understand asset prices, it would become widely accepted that you need to study not only cash flows and discount rates, but also investor behavior. The same is true for ESG. Critics of capitalism argue that finance textbooks focus on short-term profit and need to be radically rewritten to incorporate ESG. As the new co-author adding ESG into a long-standing finance textbook (Brealey, Myers, Allen, and Edmans, 2022), I'd love to claim I'm radically reforming business education. But Finance 101 has always stressed how a company's worth is the present value of *all* its cash flows, including those in the very distant future, and must take into account any factor that affects future cash flows. A company's relationships with its employees, customers, communities, suppliers, and the environment are highly value-relevant; there's nothing particularly cultish, liberal, or – dare I say it – "woke" in considering them.

But this article aims to go beyond just applying Thaler's analogy to ESG. And that's where the second point comes in – that ESG is "nothing special". This isn't meant to be disparaging, but to highlight how ESG is no better or worse than other factors that drive long-term value. This matters for several reasons. First, ESG shouldn't be put on a pedestal compared to other value drivers. Companies and investors are falling over themselves to demonstrate their commitment to ESG, with

³ Similarly, the management-oriented article (Edmans, 2012) contains the term Corporate Social Responsibility ("CSR"), the company-level equivalent of the investor-level term SRI. However, the paper never started out as a CSR paper, but one on human capital that ended up having implications for CSR. The title of Edmans (2012) is "The Link Between Job Satisfaction and Firm Value, With Implications For Corporate Social Responsibility."

company performance on ESG metrics given a special halo, and investors praised even more for engaging on ESG issues than productivity, capital allocation, and strategy. In some cases, such as Danone and the very many ESG funds that underperform, this may lead to ESG being prioritized at the expense of long-term value. Second, practitioners shouldn't rush to do something special for ESG factors that they wouldn't for other drivers of value, such as demand that every company tie executive pay to them, or reduce complex intangibles to simple quantitative metrics. Third, many of the controversies surrounding ESG become moot when we view it as a set of long-term value factors. It's no surprise that ESG ratings aren't perfectly correlated, because it's legitimate to have different views on the quality of a company's intangibles. We don't need to get into angry fights between ESG believers and deniers, because reasonable people can disagree on how relevant a characteristic is for a company's long-term success. It makes no sense to politicize ESG issues, when we'd never politicize other drivers of both shareholder and stakeholder value, such as innovation and resilience, to anything like the same degree. On the flipside, if ESG is nothing special, then some practices we're starting to implement for ESG could be rolled out to other areas of finance. Regulators are cracking down on ESG funds that are greenwashing – and they should similarly scrutinize other investors who aren't doing what they say, such as actively-managed funds that are closet indexers.

2. ESG Metrics

Investors, regulators, and other stakeholders are increasingly demanding that companies report their performance along various ESG metrics. Many are calling for a common set that all firms are supposed to disclose, as well as standards to ensure they're all measured in the same way.

This seems a no-brainer. You need metrics to hold companies to account for walking the walk, else they'll just talk the talk. And just like income statements and balance sheets, they should be

comparable so that investors can see how firms stack up to their peers. If ESG drives long-term value, then investors need ESG metrics to be able to estimate long-term value.

But if ESG drives long-term value, then it's no more special than any other intangible assets that do so. And it's particularly non-special since we've known for at least 30 years that the value of a company depends on more than just financial factors. Kaplan and Norton (1992) introduced the "balanced scorecard" which "complements the financial measures with operational measures on customer satisfaction, internal processes, and the organization's innovation and improvement activities – operational measures that are the drivers of future financial performance." Importantly, Kaplan and Norton stressed the importance of reporting measures not because they're part of a framework or a box to be ticked, but because they "are the drivers of future financial performance." Indeed, the title of their article is "The Balanced Scorecard – Measures That Drive Performance."

ESG has helped advance the balanced scorecard from Kaplan and Norton's time. Nowadays, the value of a company depends not only on its financial and operational performance, but also its stakeholder relationships. But viewing metrics through a long-term value lens rather than an ESG lens shifts our thinking in two ways. First, it widens our perspective, because many value drivers don't fall under the narrow umbrella of ESG. Companies should tune out the noise created by reporting frameworks and stakeholder demands and instead ask – what are the attributes that we ourselves want to monitor, because they're "measures that drive performance"? In other words, what are the Key Performance Indicators ("KPIs"), or leading indicators, that help us assess whether our company is on track? These KPIs will certainly include ESG metrics, such as carbon emissions for an energy company, but they'll also include other dimensions such as customer net promoter scores or new patent generation. This perspective moves ESG from a compliance exercise – a set of boxes to be ticked – to a value creation tool.

The most important broadening is that most ESG metrics capture “do no harm” – the amount of damage a company inflicts upon society, such as water usage, particulate production and worker injuries. That’s certainly important, but long-term value is much more about whether a company “actively does good”; in Edmans (2020) I refer to the latter as growing the pie, and the former as splitting the pie fairly. The measures that track how value creation will be specific to a company’s strategy. Unilever gauges the number of citizens it reaches through its hygiene campaigns, Olam measures the number of smallholder farmers who participate in its sustainable farming programs, and MYBank reports the number of small and micro enterprises that it lends to who’d never obtained a bank loan before.

A common set of ESG metrics doesn’t stop companies from going further and reporting additional bespoke factors. But common measures will likely get most focus, since everyone reports them – that’s why some investors fixate on quarterly earnings, even though companies have been reporting non-financial dimensions for decades. Common measures are also easy to compare as they don’t require expertise. Even if I don’t watch a single game in the English Premier League, I can still see which players score the most goals, even though they’re only one dimension of what you’d look for from a footballer. Similarly, an investor who knows nothing about the drivers of long-term value can still notice that 8 tons of emissions are higher than 5. Indeed, some of the biggest calls for common metrics are from people late to the ESG bandwagon, because reducing an art to a number comparison exercise allows everyone to join the party.

Replacing the ESG lens with the long-term value lens also focuses our perspective, as it suggests that companies should report ESG factors *only if* they “drive performance” – a leading indicator is one that leads to future outcomes.⁴ The first shift in thinking stressed that driving performance is a

⁴ These need not be financial outcomes, but other outcomes (such as patents) that matter for long-term company performance.

sufficient condition to report a KPI; it doesn't matter if it's an "ESG" metric or not. This second shift highlights that it's also a *necessary* condition. This focus is important, because there are literally hundreds of ESG metrics that companies could report. Not only would this divert a company's attention from actually creating value to reporting on creating value, it would ironically reduce transparency to investors and stakeholders as they don't know where to look.

2.1 ESG-Linked Pay

Many companies are going beyond simply reporting ESG metrics to linking pay to them. A PwC (2022) study found that 92% of large US companies and 72% of large UK firms are using ESG metrics in their incentive plans. Some investors, on both sides of the Atlantic, argue that all firms should tie executive pay, at least in part, to ESG. Regulators are contemplating requiring such a link.

Such ties make sense under the ESG lens. Companies obtain a public relations boost from linking pay to ESG, as it suggests they care so much about ESG that they pay for it. Investors who loudly call for every company to incorporate ESG metrics in bonuses are seen as ESG pioneers. But under the long-term value lens, it's far from clear cut. The balanced scorecard stressed the importance of paying close attention to non-financial metrics, but Kaplan and Norton (1992) never advocated putting them into compensation contracts. Doing so is unnecessary – if ESG metrics are indeed relevant for long-term value, then tying pay to long-term value is sufficient to encourage executives to bolster them, as found by Flammer and Bansal (2017). More than being unnecessary, they could backfire by prompting CEOs to focus only on the ESG dimensions in the contract, and not the myriad of other value drivers. The Best Companies survey didn't just focus on employee turnover, wages, and number of weeks of parental leave, but credibility, respect, fairness, pride, and camaraderie. Since only quantitative metrics can be put into a contract, ESG-linked pay may cause executives to focus on them at the extent of the qualitative.

For most drivers of long-term value, such as patents, net promoter score, and customer attrition, companies will report them – and scrutinize them very carefully, not just looking at whether they’ve gone up or down but understanding why. However, they’ll stop short of linking pay to them. This should generally be the approach for ESG metrics (in Edmans (2021) I consider exceptions).

2.2 *The Other Motive for ESG*

But there’s an elephant in the room. I explained that the main reason for the rise in ESG is its relevance to long-term value. Yet that’s not the only reason – we care about ESG because of the *externalities* it imposes on society. A 2013 Trucost report estimated the environmental costs created by business at \$4.7 trillion per year, and this figure has likely soared since then. Beyond the environment, business workplace practices can lead to burnout, physical injuries, and even deaths; whom companies hire and promote affects social inequality and inclusion. By definition, externalities don’t affect a company’s profits, even in the long run. Thus, ESG advocates argue that we should require companies to disclose externalities, so they can be held accountable for reducing them; tying CEO pay to externalities will further incentivize such a reduction.

But intangible assets also have substantial externalities: Haskel and Westlake’s (2017) book on intangibles highlights “spillovers” and “synergies” as two of their defining features. An innovative new product creates a huge amount of value over and above what customers pay for it (known as “consumer surplus”), competitors build on it to launch their own versions, and suppliers earn “producer surplus” from selling inputs for more than their cost. Training employees increases their human capital, and many of the benefits won’t be captured by the firm providing the training: they may leave for a competitor, relocate for family reasons, or be more likely to find another job if their current employer shuts down – attenuating the large social costs suffered when a major local employer

closes (e.g. Goldstein, 2017). Turning to a negative externality, a sluggish executive team can impose huge costs on society – Kodak went bankrupt after missing the digital revolution; it had been worth \$31 billion to its shareholders at its peak and employed 150,000 people at one point.

Externalities are a market failure, and best dealt with through government intervention to correct this failure. For example, governments provide tax credits for R&D and training, or undertake externality-producing activities themselves, such as funding universities to conduct research and teaching. Investors don't campaign for firms to spend 2% of their revenues on R&D. Indeed, many ESG factors– at least the quantitative ones that receive most focus – are easier to regulate than intangible assets. Governments can tax carbon emissions, impose minimum wages, and introduce diversity quotas. It's the government that's best placed to address these externalities, since it's democratically elected by a country's citizens, whereas investors disproportionately represent the elites. Thus, the latter may underweight the impact of decarbonization on rank-and-file jobs in the fossil-fuel industry. In contrast, governments can't regulate corporate culture or management initiative, so investors may have a particular role to play in monitoring them.

Now governments fail, and companies could legitimately argue that they should pursue ESG – even it doesn't improve long-term value – due to its positive externalities. But it needs to have a clear mandate from investors to do so, as such pursuit is at the expense of shareholder returns; if so, such actions shouldn't be confined to ESG but to extend to other externality-creating investments. Shareholders may be happy to give such a mandate – pension funds might rationally sacrifice a few basis points of financial return to reduce a company's carbon emissions, because pensioners care not only about their income in retirement but the state of the planet. There is a trade-off, but the trade-off is more than worth it. However, if ESG is pursued for its externalities, companies and investors should be very clear that it may be at the expense of value. We've discussed how the defining feature of ESG is not its link to long-term returns, nor its positive externalities, both of which are shared with

intangible assets. If, instead, the defining feature of ESG is the fact that its externalities are sometimes at the expense of long-term value, it might not be put on such a pedestal.

3. ESG Funds

Money is pouring into ESG funds. In 2020, \$17.1 trillion (\$1 in every \$3 under professional management) was invested in ESG strategies in the US – that’s 42% higher than in 2018, and 25 times as high as in 1995 – with similar growth around the world. Hartzmark and Sussman (2019) find causal evidence that investors flood into ESG funds with higher Morningstar globe ratings.

One reason for their popularity is the belief that ESG investing systematically outperforms. The UK’s largest retail broker emailed all its clients claiming that “study after study that shown that businesses with positive ESG (environmental, social and governance) characteristics have outperformed their lower ranking peers”. The evidence is far more ambiguous than claimed (see the survey of Matos (2020)), but even if it were true, academic research has documented a huge number of other investment strategies that outperform (see, e.g., McLean and Pontiff (2016)).

Of course, long-term financial returns are not the only motive to invest in ESG funds. Another is to change company behavior – improve its ESG, thus creating more positive externalities. Impact can be achieved through two channels: exit and voice (see the surveys of Edmans (2014) and Edmans and Holderness (2017)). Exit involves divesting from an ESG laggard, driving down its stock price. *Ex post*, this increases its cost of capital and hinders its expansion; *ex ante*, the company might improve its ESG performance to avoid being sold (Edmans, Levit, and Schneemeier, 2022). However, this channel works for *all* measures of performance, not just ESG ones. Investing in innovative companies with great management teams and strong cultures helps them create more positive externalities, as well as encouraging enterprises to be “best-in-class” in the first place. Voice involves engaging with a company through voting, private meetings and – if necessary – public activism, to cut its carbon

footprint or improve its employee diversity. Such actions can indeed create value for both shareholders and society, but so can engagement on other topics. Cutting costs by eliminating duplication improves investor returns, reduces resource usage, and increases a company's resilience, but shareholders obtain far less credit for it than ESG engagement. We want great companies, not just companies that are great at ESG.

Regulators, the media, and investors are cracking down on ESG funds for not being ESG enough – for holding stocks in brown industries, and for sometimes voting against ESG proposals. But blanket divestment is often not the most effective way to improve corporate ESG behavior (Edmans, Levit, and Schneemeier, 2022) and some ESG proposals may be overly prescriptive or micromanage the company (Norges Bank Investment Management, 2020). Even setting aside these concerns, funds should absolutely be held to account for doing what they say. Yet it's not clear why investors in non-ESG funds deserve any less protection. Any thematic fund claims to follow a strategy. Does the Jupiter Global Financial Innovation hold only companies that are truly financially innovative? Does the Capital Group New World fund only invest in the most frontier economies? Should a value fund be punished for owning growth stocks? And it's not just thematic funds that make pledges – *any* actively-managed fund claims to beat the market. But a fund that underperforms the market 5 years in a row, costing its investors thousands of dollars in retirement savings, is unlikely to be as publicly shamed as an asset manager who opposes a high-profile ESG proposal. Funds that consistently underperform, actively managed funds that are closet indexers, and thematic funds that persistently deviate from their theme, should be scrutinized as much as their ESG counterparts.

4. ESG Controversies

4.1 ESG Ratings

Viewing ESG as a set of intangible assets also helps defuse many of the controversies surrounding it. One is the significant disagreement between ESG rating agencies (Berg, Kölbel, and Rigobon, 2022). Critics interpret this as evidence that rating agencies are failing – why can't they agree about a company's ESG, like since S&P, Moody's, and Fitch do about creditworthiness? But an ESG rating isn't fact; it's opinion. Reasonable people can disagree about the long-term value potential of a company's ESG – which factors are relevant (will companies suffer financially from producing electromagnetic radiation?), how to assess them (how inclusive is a company's corporate culture?), and the relative weight to put on each.

Credit ratings aren't a good analogy as there's no ambiguity on what they're trying to measure – whether a company will repay its debt. There might be different views on how to assess it, but the object of the assessment is clear. For ESG, it's not even clear which factors should be measured to begin with. The better analogy is to equity research reports, which also try to measure long-term value.⁵ No-one would argue that stock analysts can't do their job because Goldman Sachs says "Buy" and Morgan Stanley recommends "Sell". Indeed, another word for disagreement is "diversity", ironically something ESG advocates should embrace rather than lament. A diversity of opinion is far more informative than if everyone said the same thing. The main complaints are from ESG-by-numbers investors who want a single unambiguous ESG rating they can use for portfolio selection. But a mainstream investor would never automatically buy just because Goldman Sachs says so; she'd read the reports of different brokers, use her expertise to evaluate whose arguments are most convincing, and supplement them with her own analysis.

⁵ The two main differences are that equity research studies the long-term value of a company from all sources, not just ESG sources, and also compares the estimated value to the current price to make an investment recommendation.

4.2 ESG Classifications

Prior to Russia's invasion of Ukraine, many investors considered defense companies as "non-ESG". Afterwards, many did a hushed-up U-turn, rewriting their investment policies to redefine defense as ESG. A *Financial Times* article, "Are Defence Stocks Now ESG?", describes this binary thinking.

But, viewed through the long-term value lens, it makes no sense to classify stocks as ESG or non-ESG. Some companies might have more value-creation potential than others, but it's a continuum, not a black-and-white classification. Moreover, thinking of ESG as intangible assets reduces the temptation to see it in such a binary way. The value of any asset must be compared to its price. Yet many ESG advocates would give three cheers to environmentally-friendly, diverse companies that donate generously to charity without any regard for its price, which can lead to ESG bubbles (as we've seen with electric cars). The less binary we make our classifications, the less inflexible they'll be, and the less back-tracking we'll need to make if the world changes.

4.3 The Politicization of ESG

Finally, viewing ESG as a set of long-term value drivers will hopefully defuse the worrying politicization of ESG. ESG critics label its advocates as the woke Left; devotees accuse anyone who even questions the value-relevance of ESG as being a Republican corrupted by political donations to protect vested interests. Reasonable people can disagree about how relevant a factor is for both financial and social returns. Yet views on ESG often move beyond opinion to ideology.

A senior ESG practitioner who teaches at a top university messaged me "Hiya Alex. You want to fight?! Me and Aswath Damodaran about to get in boxing match about his ESG takedown piece. Please consider co-writing a counterpoint op-ed with me?" But my initial instinct was not to fight; if someone dubbed the "Dean of Valuation" has a differing view on the relevance of ESG for valuation,

I'd like to learn from it. A Managing Director at a large investment bank wrote to me: "See *The Economist* Special report on ESG this w/e – why do you think these papers give anti-ESG rhetoric oxygen? ... They fan flames of the deniers." Yet those who recognize that ESG has cons as well as pros aren't necessarily driven by rhetoric; instead, they're able to see both sides of an issue. Most people aren't "believers" or "deniers" – language which focuses on ideology – but academics or practitioners who've developed their own view through a combination of evidence and experience.

It's unprofessional for ESG critics to label its supporters as "woke", or portray them as hippies with no clue about business – in contrast, understanding ESG is critical to understand the value of a business. Some pat themselves on the back for crushing the woke crowd, when they should view their contribution as providing a different perspective on what creates long-term value. But respondents don't need to stoop to their level. One practitioner, whom I'll name X, labelled concerns as "just complete BS" that spread "nonsense around ESG". A professor whom I greatly respect and whose writings I've learned a lot from called sceptics "Taliban" and "Flat Earthers". An otherwise excellent article was titled "A Tutorial On ESG Investing In The Oil And Gas Industry For Mr. Pence And His Friends." In addition to unintentionally slighting the target audience, suggesting they needed a tutorial but others don't, it politicized the issue, implying that true Republicans should be anti-ESG, thus reducing its effectiveness. Research by the Yale Cultural Cognition Project (e.g. Kahan (2015)) finds that the more you associate an issue with an identity (such as climate change with political affiliation), the less persuasive your arguments, as people base their view on their identity than any evidence you might bring to bear. A practitioner wrote "Thank heavens for this excellent piece from X, who tells it like it is: "I don't know about you, but when I see the likes of Ted Cruz, Marco Rubio, Greg Abbott, Mike Pence, and Elon Musk railing against "ESG", I know ESG must be doing something right." But "telling it like it is" involves using arguments based on facts, data, and evidence, not telling other

people off. The criterion for the success of ESG is whether it creates long-term value for shareholders and society, not whether it riles Republicans.

Unfortunately, many ESG supporters herald as heroes those who display the most extreme outrage rather than use the most convincing evidence. If you view ESG as a political fight, you cheer the people who fight most aggressively. If you view ESG as understanding what drives long-term value, you celebrate the people who contribute most to your understanding, by helping you see both sides of an issue. Another top-tier academic wrote an article which ended with “Which side are you on? We hope you will not only side with us in the critical debate but also get involved”. But ESG is not a “debate” on which you have to take a “side”; it’s a subject, just like business is a subject – people’s stance on a subject should evolve with the evidence rather than being anchored on a side. It’s surprising that some academics contribute to this polarization since they appreciate the value of scientific enquiry and the importance of listening to different viewpoints.

One justification of a streetfighter approach is that ESG issues are so important to society that we need to get them right. But topics such as unemployment, free trade, and government spending also have huge impacts on both people and planet; academics have punched hard, but not below the belt. Fields such as environmental economics, health economics, and economics of children have been around for decades, and advanced through reasoned debate rather than hyperbole and point-scoring. It’s precisely the importance of ESG that we need to use the best evidence to guide us, which involves listening to other viewpoints – and doing so with the intent to understand, not the intent to reply. Doing so isn’t betraying our ideals; as is commonly attributed to Aristotle, “it is the mark of an educated mind to be able to entertain a thought without accepting it.” Even if 90% of what skeptics say is wrong, in our eyes, 10% might be right, and that 10% means we come away more informed than we were beforehand. But if ESG is a political issue, we see any counterargument as a threat to our identity, just like a different perspective on abortion or gun control. Both sides can do better.

5. Implications for Research

Finally, viewing ESG through a long-term value lens has several implications for academic research. Most generally, it means that sweeping questions such as “Does ESG work?” are unlikely to be fruitful. No scholar would write a paper entitled “Does investment pay off?”, because it depends on what you’re investing in; similarly, the value-relevance of ESG depends on the type of ESG. Instead, the long-term value lens suggests four directions that research could move in.

The first is to be more granular. ESG is an umbrella term, capturing many potentially contradictory factors. E and S is primarily about stakeholders, whereas G often ensures that that management act in the interest of shareholders (rather than themselves). Closing down a polluting plant is good for the environment, but bad for employees (an S factor). In my 2011 and 2012 papers, I had to explain why I was studying employee satisfaction and *not* other ESG factors – because there’s a strong theoretical motivation for its link to long-term returns. Similarly, future research could focus on the ESG dimensions most relevant for the research question being studied.

The second is to be less monotonic. Many papers use an ESG variable assuming that more is always better – higher ESG scores, more frequent votes for ESG proposals, or tying pay to more ESG metrics. However, companies can overinvest in ESG, and investors might overly micro-manage it.

The third is to be less binary. As explained earlier, most ESG issues are valuation factors, not exclusion issues. The evidence for the value of board diversity is mixed or negative (Fried, 2021), but even if it were unambiguous, this wouldn’t be a reason for researchers to put non-diverse boards into a separate category (or regulators to prohibit them). Diversity would then be a valuation issue – a company with a non-diverse board might suffer a 10% valuation discount, but it might still be a good investment if the price were sufficiently attractive, or offset by the company’s other characteristics.

The fourth is to be less quantitative. This, in turn, can lead to research in two directions. One is to gather qualitative ESG assessments, such as the Best Companies to Work For survey. The other is to

still use numerical data, but to pay attention to quality rather than just quantity. Using an example on intangible assets rather than ESG, Cohen, Diether, and Malloy (2013) measure the quality of innovation based on the payoffs from past R&D expenditures. This quality-based measure significantly predicts future stock returns, while the mere quantity of R&D spending does not.

6. Conclusions

ESG is both extremely important and nothing special. It's extremely important since it affects a company's long-term shareholder value, and thus is relevant to all investors and executives, not just those with ESG in their job title. It also affects a company's impact on wider society. This is relevant for any practitioner who has objectives beyond simply financial returns, as well as for ensuring that capitalism works for all and safeguarding the public's trust in business.

But ESG is also nothing special. It shouldn't be put on a pedestal compared to other intangible assets that affect both shareholder and stakeholder value, such as management quality, corporate culture, and innovative capability. Like other intangibles, ESG mustn't be reduced to a set of numbers, and companies needn't be forced to report on matters that aren't value-relevant. Funds that use ESG factors to guide stock selection and engagement shouldn't be lauded over those who study other drivers of value, and investors in the latter deserve the same protection. We can embrace differences of opinion about a company's ESG performance just as we do about its management quality, strategic direction, or human capital management. And, perhaps most importantly, ESG needn't be politicized. Instead, reasonable people can disagree with – and indeed learn from – each other about the factors that create value for both shareholders and society. Aggression and hyperbole are signs of weakness, not strength. As Karl Popper noted, “Whenever a theory appears to you as the only possible one, take this as a sign that you have neither understood the theory nor the problem which it was intended to solve.”

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