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Concerns About and Criticisms of ESG

Exploring the validity of the prevailing arguments against the use of ESG strategies in the capital markets

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- The concerns and criticisms frequently discussed with respect to ESG fit into five different categories of sentiment: that ESG is subjective, that it requires sacrificing returns, that it is redundant, that it distracts from the most important issues, and that it is virtue signaling.

- While some of these sentiments are well-founded concerns, others are partially based on misinformation, and many are taken to a degree of absolutism that strips away their validity. By dissecting which aspects of the sentiments are grounded in fact and which are not, important nuance is added back into conversations about ESG.

Introduction

Our annual Sustainable Investment Survey offers unique and unfiltered insights into the opinions of private market participants on the topics of environmental, social & governance (ESG) strategies and Impact investing. For our 2022 survey, we received a record number of open-ended responses, many of which were supportive of ESG and Impact investing and many of which surfaced concerns about and criticisms of sustainable investing. This report will focus on the latter group, as the number of markedly anti-sustainable-investing responses has increased considerably over the past few years. Our 2020 survey had one such response, our 2021 survey had five, and our 2022 survey had approximately 50. Most of these responses fit into five different categories of sentiment:

- ESG is subjective, and ESG performance is difficult to substantiate through measurement and comparison.
- ESG requires sacrificing returns and constitutes a breach of fiduciary duty.
- ESG is redundant because it is already part of best practice.
- ESG as a whole distracts from the highest-priority issues and areas of potential Impact.
- ESG is mostly virtue signaling and rarely involves follow-through on the actions stated or implied by ESG practitioners.

In this analyst note, we explore which of these views are founded in fact, which are founded in misinformation, and which are a mix of both, with the intent of offering clarity around why the disconnect between the advocates and opponents of ESG is so wide. One common thread among the open-ended anti-ESG responses was that they often contained a degree of valid concern or criticism, but it was taken to an extreme that pushed it beyond the bounds of accuracy. The politicization of ESG and the polarization surrounding it have been increasing in recent years, and the amount of productive discourse has decreased as absolutism on both ends of the ESG-support spectrum cuts away important nuance from the conversation. Here, we aim to bring that nuance back into discussions about ESG.

Sentiment 1: ESG is subjective, and ESG performance is difficult to substantiate through measurement and comparison.

"ESG is increasingly difficult to measure and frequently involves greenwashing. We appreciate companies pursuing environmental objectives but find the S and G components are too subjective and not accurately reported." —LP, North America[1]

Well-founded concern: It is true that there is subjectivity involved in ESG strategies. In the same way that one might receive different diagnoses from different doctors and then select one of several potential treatment plans to work toward a desired health outcome, ESG practitioners have diverse beliefs around materiality, which risks are acceptable, and how one should execute on risk mitigation. Thus, the use of an ESG strategy can result in very different outcomes depending on the practitioner and portfolio, as explored in our analyst note ESG, Impact, and Greenwashing in PE and VC. There is good and bad to this subjectivity: the good lies in the ability of any private market participant to theoretically find an approach to ESG that is palatable and customizable to them, and the bad lies in misaligned expectations and difficulty distinguishing between the ESG approaches of fund or asset managers and benchmarking them against one another.

For example, one manager's ESG strategy might necessitate investing in only carbon-neutral businesses, while another's might involve acquiring companies in "dirty" industries such as oil, coal, and gas and making ESG improvements to them where possible. If both asset managers have funds they describe as ESG aligned, an LP might expect the use of one strategy and find that it has invested in a fund that uses the other. This kind of dissonance between what one party expects from another's ESG strategy has resulted in greenwashing accusations, feeding into negative perceptions of ESG. Thus, it is necessary for GPs, LPs, and portfolio companies to all proactively communicate about what their approach to ESG entails, what its purpose and goals are, and how it will be implemented.

It is also true that ESG performance is difficult to substantiate concisely, aggregate effectively, and compare accurately. The data collection process for portfolio companies is burdensome, especially given the quantity of metrics GPs request from companies, some of which they may not be familiar with. With so many different metrics gathered from different sources, such as from a company's utilities providers, human resources software solutions, in-house legal counsel, and information technology function, miscalculation and misreporting are possible. More ESG data collection and aggregation solutions have entered the market in recent years, with a multitude of platforms claiming to facilitate the process, but GPs are still finding it challenging with so many frameworks and standards of measurement to align to.

1: While our Sustainable Investment Survey responses are anonymous, respondents self-identify as GP, LP, Both, or Other and share their organization's primary base of operations. As such, we are able to identify the respondent type and geography for open-ended answers.

Aggregation comes with its own catch-22. Information about ESG performance cannot be simplified and aggregated without losing important context and details about why metrics are what they are. Yet LPs do not have the bandwidth to analyze long, complex ESG reports for every portfolio company their GPs invest in, so it is necessary to aggregate ESG performance information, even if this obscures the complete picture of performance. As an example of how simplifying and aggregating ESG performance information can result in an unfavorable view of performance, if a portfolio company with strong diversity, equity & inclusion (DEI) practices completes multiple acquisitions, its overall diversity stats may become weaker, as it is acquiring companies over which it has not yet had any influence. Without that context, it may seem that the portfolio company's DEI performance has suffered, and this is the information that an LP would likely receive in an aggregated format. Regardless of whether one believes that the portfolio company should have acquired only diverse companies, which would have prevented the diversity stats from becoming less favorable, the story behind the data influences its meaning.

Whether or not a GP chooses to analyze ESG risks and opportunities and how they are addressed among potential portfolio companies, they still exist. Material risks left unmitigated are likely to negatively impact a business.

Comparison also presents challenges. A portfolio of software-as-a-service companies or early-stage tech ventures is bound to have a smaller carbon footprint than one comprising consumer goods manufacturers or utilities providers. Yet those goods and utilities may bring value to society and yield strong returns, and avoiding investing in them does not prevent them from producing emissions. If, instead, a comparison is made between the percent change in a company or portfolio's emissions year to year, another problem arises: A portfolio of rapidly scaling companies will experience scaling carbon emissions. Adjustments could be made based on a portfolio's revenue, yet this creates other complications, and so on. In essence, no comparison is perfect, and aggregated comparisons mask extenuating circumstances. Of course, ignoring ESG performance because it is subjective and difficult to substantiate does not resolve these issues. Whether or not a GP chooses to analyze ESG risks and opportunities and how they are addressed among potential portfolio companies, they still exist. Material risks left unmitigated are likely to negatively impact a business.

There is hope for resolution—or at least reduction—of this concern. If recent years are any indicator, the future holds continued convergence toward one, or even just a few, ESG taxonomies and standards of ESG performance measurement, allowing for more accurate communication and comparison. In addition, technological solutions to help address challenges around gathering data will continue to grow more standardized and effective. While perfect comparison will remain infeasible and the aggregation catch-22 will persist, the value derived from measuring and benchmarking performance is likely to outweigh the harm associated with its deficiencies. As convergence occurs and the investment community gains access to more and better tools that facilitate the reporting process, substantiation will become less burdensome and greenwashing less common.

Sentiment 2: ESG requires sacrificing returns and constitutes a breach of fiduciary duty.

"I have no desire to betray my fiduciary responsibility and sacrifice returns for the sake of promoting leftist political ideology." —LP, North America

Partially based on misinformation: ESG does not require investors to sacrifice returns for the sake of creating positive social or environmental outcomes, a practice sometimes referred to as "accepting concessionary returns." In fact, many consider ESG to facilitate the opposite by limiting downside risk. The association of ESG with concessionary returns likely arose in part because of the conflation of ESG and Impact investing. This is because some—but not all—Impact investors knowingly accept concessionary returns in order to achieve social or environmental goals. In contrast, investors using an ESG-aligned framework may not achieve market returns but tend not to do so intentionally.

Thus, while there may be some approaches to ESG that would constitute a breach of fiduciary duty, in many parts of the world, the contrary is thought to be true: that failing to consider ESG risks and opportunities would more likely result in a breach of fiduciary duty.

Still, there are many different philosophies of ESG, and as such, implementation can look very different depending on the asset manager. The argument that ESG involves concessionary concerns can also be tied to the idea of an asset manager refusing to invest in or disproportionately investing in certain industries or business models. Yet there are many asset managers that do not forgo investment in high-ESG-risk industries or business models or prefer "clean" ones but still aim to mitigate risks where possible. Thus, while there may be some approaches to ESG that would constitute a breach of fiduciary duty, in many parts of the world, the contrary is thought to be true: that failing to consider ESG risks and opportunities would more likely result in a breach of fiduciary duty.

Historically, research on how ESG strategies and performance relate to returns has been heavily skewed toward the public markets.[2, 3] A meta-study from New York University's Stern Center for Sustainable Business that reviewed more than 1,000 research papers from 2015 through 2020 did find there was a "positive relationship between ESG and financial performance for 58% of the 'corporate' studies focused on operational metrics such as ROE, ROA, or stock price with 13% showing neutral impact, 21% mixed results [...] and only 8% showing a negative relationship. For investment studies typically focused on risk-adjusted attributes such as alpha or the Sharpe ratio on a portfolio of stocks, 59% showed similar or better performance relative to conventional investment approaches while only 14% found negative results."[4]

2: "ESG Factors and Equity Returns—A Review of Recent Industry Research," Principles for Responsible Investment, Toby Belsom and Laura Lake, June 17, 2021.
3: "Positive ESG Performance Improves Returns Globally, Research Shows," Reuters, Cole Horton and Simon Jessop, July 28, 2022.
4: "ESG and Financial Performance," New York University, Tensie Whelan, et al., February 10, 2021.

Compelling as the results of NYU's meta-study may be, more research is needed on private market portfolios, which function very differently from public market portfolios and listed companies. Furthermore, given the variety of approaches to ESG, it would be valuable to categorize strategies and evaluate how each strategy influences fund performance. For example, do funds that strictly invest in companies already performing well with respect to ESG fare better or worse than those that invest in companies that could benefit from ESG risk mitigation and make those improvements during the holding period? It also bears asking which industries benefit most from ESG-related improvements. Do ESG strategies equally improve returns across funds investing in healthcare, technology, real estate, and manufacturing? Questions abound.

Until those studies can be conducted, market participants must make decisions based on the information at hand, including studies on publicly traded funds and corporations. In addition, it is worth noting that, in many cases, the logic of ESG does seem to hold based on cost-benefit analysis. If an employee is badly injured and manufacturing operations must be halted, or a food product must be recalled because it is causing illness among consumers, this harms the bottom line. Some of the potential impacts of these risks and the costs of mitigating them can be easily quantified, if desirable. For example, the Occupational Safety and Health Administration has a tool that can help estimate the cost of employee injuries, and there are models to calculate how much a food product recall could cost.[5, 6] Comparing the potential costs of unmitigated material risks to the costs of mitigating them can present a compelling case for some ESG improvements in the absence of other, more comprehensive research.

From a legal standpoint, according to a 2020 Stanford Law Review article that assessed the law and economics of ESG investing by a trustee of a pension, charity, or personal trust, ESG investing is permissible for such a trustee subject to American trust fiduciary law if it meets two necessary conditions: 1) "the trustee reasonably concludes that the ESG investment program will benefit the beneficiary directly by improving risk-adjusted return," and 2) "the trustee's exclusive motive for adopting the ESG investment program is to obtain this direct benefit."[7] At the corporate level, according to a memo from premier law firm Wachtell, Lipton, Rosen & Katz, "Considering the interests of not only shareholders, but also all who are critical to the success of the company, is essential to ensuring long-term sustainability, and is consistent with the board's fiduciary obligation to inform itself of and consider all relevant information […] It is imperative that companies oversee and address ESG and sustainability-related risks as such risks can damage and disrupt a corporation's strategies, business positioning, operations, and relations with stakeholders."[8]

5: "OSHA's Safety Pays Program," United States Department of Labor, n.d., accessed February 27, 2023.
6: "Recall: The Food Industry's Biggest Threat to Profitability," Food Safety Magazine, Tyco Integrated Security, October 11, 2012.
7: "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee," Stanford Law Review, Max M. Schanzenbach and Robert H. Sitkoff, February 2020.
8: "Understanding the Role of ESG and Stakeholder Governance," Wachtell, Lipton, Rosen & Katz, November 28, 2022.

Distilling this information, there is some consensus that awareness, consideration, and mitigation of material ESG risks is compatible with fiduciary duty.

Distilling this information, there is some consensus that awareness, consideration, and mitigation of material ESG risks is compatible with fiduciary duty. The materiality element is essential, drawing the line between risks that should be addressed and those that should not, but that is also where the line begins to blur, as different ESG practitioners will have different assessments of the materiality of particular risks. What is clear, however, is that making ESG-related improvements that will not benefit a company or portfolio nor prevent harm to it would likely constitute a violation of fiduciary duty. As such, overinvestment in sustainable industries, complete avoidance of high-ESG-risk industries, and unnecessary spending on ESG programs at the company level increase the risk of a fiduciary duty breach. Yet rejection of ESG entirely is not a solution, as failing to assess and address material ESG risks can also result in a breach of fiduciary duty. Thus, market participants must walk this line carefully and be prepared to justify their ESG-related decision-making.

Finally, with respect to the idea that ESG is promotion of leftist ideology, it is true that ESG has become highly politicized in recent years, and in the US, the political right has adopted more anti-ESG positions. However, ESG risks themselves are not inherently political. Consider, for example, employee health and safety risks and data privacy and security risks. It would be difficult to plot the prevention of a breach of consumer data on the political spectrum. While other topics, such as DEI, may seem more tied to leftist values, the risks themselves are not. Whether or not one believes in affirmative action or the value of diversity, a series of heavily publicized discrimination and harassment lawsuits would be not only expensive but also bad for business.

Sentiment 3: ESG is redundant because it is already part of best practice.

"ESG is dogma—it goes without saying that all organizations must have continuous improvement initiatives in all aspects of the business."
—LP, North America

Partially based on misinformation: Many aspects of ESG do seem like common sense. In some ways, ESG appears to be a new framework for assessing alignment to old ideals: following the law, treating your employees fairly, not damaging the land on which your business operates, not harming the consumers of your product or service, and preparing for when things go wrong. Yet ESG is more than that. Not only is it a granular and sophisticated framework for analyzing risks that are related to these ideals, but it is also flexible enough to identify and assess new risks as they arise. For example, with the advent of artificial intelligence & machine learning, additional risks around the ethics of these technologies and how they impact stakeholders have made their way into ESG analysis. While the concept of business ethics has existed for decades, ESG frameworks help adapt this older ideal to modern business practices.

ESG frameworks help increase awareness of the minutiae of the risks, helping ensure that the right questions are asked of the management team.

Furthermore, practically speaking, a company's management team does not know what they do not know, and each ESG issue area has great depth. This is the reason that many companies hire experts, such as chief information security officers for data privacy and security, employee engagement managers for employee recruitment and retention, and chief supply chain officers for supply chain social and environmental compliance. ESG frameworks help increase awareness of the minutiae of the risks, helping ensure that the right questions are asked of the management team. Even if a management team is aware of these issues, it is time-consuming for the team to stay up to date on the regulatory developments and changes to best practice that are relevant to all of the issue areas on top of all of the other responsibilities the team holds. Because of this, use of a framework for surfacing and assessing risks—familiar and unfamiliar—and their mitigation is valuable.

Some ESG strategies also extend beyond risks and evaluate opportunities pertaining to ESG issues. These opportunities often fall outside of what would typically be considered under continuous improvement initiatives. For example, when considering climate change transition risks, a rental car company may become aware of an opportunity to incorporate electric vehicles into its fleet and charge a premium for the environmentally friendly option. As another example, a cosmetic brand assessing product stewardship may identify an opportunity to pursue a greater share of the market by increasing the range of skin-toned shades it offers, simultaneously bolstering the brand's perception as inclusive. The use of an ESG lens increases cognizance of opportunities like these so that potential business benefits can be calculated to determine which are worth pursuing.

While ideally businesses would adhere to best practices and mitigate ESG risks unprompted and on their own, history has shown that not all management teams do so. This may be due to either intentional or inadvertent noncompliance. As such, ESG programs utilizing performance assessments and recommendations around ESG improvements are not redundant—they are necessary to ensure awareness and management of myriad risks and opportunities. GPs tend to find it helpful to use ESG due diligence to assess the extent to which a company is engaging in "common sense" ESG practices. Similarly, a GP's use of an ESG framework signifies its awareness of these issues, which can provide an LP more confidence in the portfolio's overall risk profile. ESG is becoming part of best practice, but this does not mean that a formal ESG program is unnecessary—rather, the opposite is true.

Sentiment 4: ESG as a whole distracts from the highest-priority issues and areas of potential Impact.

“We have our own focus on Impact and will not get entangled into the political morass that ESG factors represent.” —GP, North America

Well-founded concern: While ESG and Impact investing are different components of sustainable investing, they are frequently discussed together and confused with one another. This sentiment touches on two problems sustainable investors have been confronted with as ESG has become more popular. First, ESG programs do not always allocate the most resources to the risks and opportunities that are most impactful to society. This is because ESG is predominantly concerned with how ESG factors influence company performance. Second, as ESG and Impact have been conflated, Impact has become politicized and ESG has detracted attention from Impact. Investors seeking socially and environmentally impactful investments have turned to ESG despite the fact that Impact, more than ESG, optimizes for benefit to society.

Regarding the first issue, ESG does create space for investors to pick and choose which risks they mitigate and which they accept, and in this way, it does allow them to address some risks and not others while still asserting that they are making sustainability-related improvements. This problem is a difficult one to resolve because the priority of various ESG issues may differ depending on the person. One investor may hold that diversity and inclusion is the most pressing issue to address, while another may believe that mitigating climate change’s effects is the task with the most immediate importance. It is unlikely that the markets will ever reach a consensus on how to prioritize various ESG issues, so there will always be some market participants dissatisfied with how risks are or are not being addressed.

While one GP’s ESG program may allow for improvements outside of the most pressing ESG issue of another GP, this allows for more improvements to be made overall. If all funds using an ESG strategy were forced to ensure all portfolio companies transitioned to net-zero-carbon businesses, there would likely be a larger decrease in funds using ESG strategies than an increase in funds transitioning all of their portfolio companies to net-zero-carbon businesses. GPs that previously would have made other ESG improvements would be deterred. While this is an exaggerated example, the incentive of being able to attract capital from LPs committing to ESG funds does influence the behavior of GPs, as became clear with the waves of asset managers jumping on the ESG bandwagon in recent years. If this incentive were canceled out because it created a greater burden around one particular ESG issue, this would likely reduce the overall use of ESG strategies and thus the improvements they involve.

Every company faces ESG risks and opportunities, some of which it can benefit from addressing while simultaneously decreasing negative or creating positive externalities for society. However, not every company crosses the threshold into creating sufficient positive impact to be called an Impact investment.

Just as not all ESG practitioners greenwash, not all ESG practitioners baselessly virtue signal, and to the extent that virtue signaling is hollow, it is already widely recognized as problematic.

As for the second issue, the conflation of ESG and Impact has proven harmful to both categories of sustainable investing, making it important to use clear and precise language when discussing these topics. As previously noted, it has contributed to the misconception that ESG inherently involves concessionary returns, and it has made Impact more highly politicized. The intent of ESG and the intent of Impact are frequently very different, with ESG generally used to improve an investment's risk profile and performance and Impact generally employed to create positive outcomes for the world while simultaneously seeking returns for the company. Every company faces ESG risks and opportunities, some of which it can benefit from addressing while simultaneously decreasing negative or creating positive externalities for society. However, not every company crosses the threshold into creating sufficient positive impact to be called an Impact investment. As such, Impact can and does exist without ESG and vice versa, but incentivizing both creates space for the most benefit to society, through intentional Impact and positive externalities.

Sentiment 5: ESG is mostly virtue signaling and rarely involves follow-through on the actions stated or implied by ESG practitioners.

"Despite all the 'virtue signaling,' at the end of the day, investors just want top-quartile returns. Period." —LP, North America

Partially based on misinformation: ESG, in some respects, could be considered to involve virtue signaling. On one hand, baseless virtue signaling and greenwashing are one and the same, and both are heavily criticized by market participants. Just as not all ESG practitioners greenwash, not all ESG practitioners baselessly virtue signal, and to the extent that virtue signaling is hollow, it is already widely recognized as problematic. Regulatory bodies have also become increasingly aware of the need for rules around the substantiation of sustainability-related claims of financial products. Geographies such as the European Union (EU) and UK are moving more quickly on this front, with the EU's Sustainable Finance Action Plan and the UK's Sustainability Disclosure Requirements, and the US's Securities and Exchange Commission is looking to follow suit. As these regulations evolve, repercussions for baseless virtue signaling and greenwashing will deter those behaviors.

However, when virtue signaling is not baseless—which is to say, when it involves follow-through on the stated or implied actions—it is not necessarily harmful. As discussed throughout this note, ESG frequently involves tangible actions to mitigate risks and, at a minimum, ensure awareness and consideration of them. Stakeholders, especially consumers and employees, do increasingly care about the sustainability of the businesses with which they come into contact. When done accurately, communicating about sustainability-related practices is positive and can help support customer and employee relations. Plus, as highlighted earlier in this note, ESG can improve investment returns, so information about the use of an ESG program is relevant to investors as well as other stakeholders.

Conclusion

As ESG has proliferated and discussion of it has intensified, it has become more difficult to distinguish between well-founded concerns and critiques based partially on misinformation. There are valid concerns about ESG's subjectivity, the difficulty of substantiating its performance, and its distraction from issues that could be considered the highest priority. Among those partially grounded in misinformation are the sentiments that ESG requires sacrificing returns and is inherently a breach of fiduciary duty, is redundant, and is baseless virtue signaling. By pulling apart the facts and fiction of the discourse around ESG, we help redirect the conversation to the issues that must be addressed for ESG to bring the most value to the markets and to stakeholders.