



THE UNIVERSITY OF CHICAGO

HARRIS SCHOOL  
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## ESG: Right Thesis, Wrong Data

**An outmoded ESG data regime hasn't kept pace with the needs of investors, companies, and rating agencies. It's time for ESG data that measures financial and societal impact, not just risk.**

By Jason Saul<sup>1</sup> and Phyllis Kurlander Costanza<sup>2</sup>

ESG has been called “socialist” by Milton Friedman,<sup>3</sup> a “scam” by Elon Musk,<sup>4</sup> a “mirage” by Bloomberg,<sup>5</sup> and an “unholy mess” by the Economist.<sup>6</sup> Friedman argued that corporations sacrifice their bottom lines when they focus on purely *extrinsic* social responsibilities. That may be true.

But what Friedman and other critics fail to realize is that not all social and environmental impacts are purely *extrinsic* to business. When corporations focus on societal impacts that are *intrinsic* to their business, ESG can be a powerful predictor of financial return.

The controversy around ESG stems *not* from a flawed investment thesis but rather from flawed data. What ESG investors want is data that measures the impact of ESG factors on corporate financial performance. Instead, what investors have today is a list of perfunctory ESG statistics regarding management policies, operating principles, and adherence to codes of conduct.

Why the disconnect?

Today's ESG reporting frameworks (let's call “ESG 1.0”) were conceived in the mid-1990s by activist organizations like RobecoSAM, KLD, AccountAbility, and GRI. These frameworks were designed to disclose evidence of bad corporate behavior (e.g., damaging the environment, inhumane employee treatment, mishandling personal data). ESG 1.0 data covers issues like child labor, human rights violations, anti-bribery and corruption policies, waste disposal, and board diversity.

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<sup>3</sup> <https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html>

<sup>4</sup> <https://www.barrons.com/articles/elon-musk-tesla-esg-51653336436>

<sup>5</sup> <https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/>

<sup>6</sup> <https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions>

As a result, most ESG data focuses on compliance with codes of conduct and ethical guidelines. The ESG “inputs” are administrative data points or checklists that align with socially responsible standards, policies, and codes of conduct. Rating agencies typically derive an “ESG score” from these data, aggregating a company's results on different dimensions of ethics compliance and sustainability disclosures.

ESG 1.0 data was never designed to help investors and equity analysts improve financial returns or evaluate societal impact. Since it was intended to help watchdogs assess whether companies were doing bad things, trying to advance sustainable investing with ESG 1.0 data is like trying to bake bread with stale yeast. As HBR puts it:

“Many ESG measures already very effectively capture inputs, but they presume causality—that adding women to top management teams, say, will produce better outcomes. But measures that capture *inputs* (such as the numbers of women on those teams) don’t capture *outcomes* (such as decision-making that reflects diverse perspectives) and *impacts* (such as the social value created by such decisions).”<sup>7</sup>

In other words, where ESG 1.0 falls short is its focus on “input” data instead of “impact” data. The controversy arises when investors try to stretch ESG 1.0 input data to evaluate whether ESG strategies have a material *impact* on the business or society.

### **Immaterial Materiality**

For the past 20 years, the ESG data industry was built on a concept called *materiality*, which is a fancy way of saying “what really matters.” Materiality governs the scope and content of how ESG data is collected and ratings are constructed. Yet it has become somewhat of an existential crisis for ESG, resulting in a conceptual tug-of-war between two different versions of materiality: what matters to auditors and what matters to investors.

Auditors are more risk-oriented and think of materiality in terms of regulatory compliance, legal exposure, employee conditions, executive compensation, anti-bribery and corruption, ethical violations, and the like. On the other hand, investors are typically more impact-oriented and care about risk and *positive* value creation data. The SEC defines investor materiality: as “a substantial likelihood that [key facts] would have been viewed by the reasonable investor as having significantly altered the 'total mix of information made available.”<sup>8</sup> In other words, what is “material” is what investors say matters to them.

Yet over those 20 years, ESG investors have been evolving their view of “what really matters.” While some investors view ESG materiality primarily in terms of *risk*, most are now focused on *impact*—both financial and societal impact. As a result, the total mix of information that investors demand must evolve too.

Financial returns are still paramount for most investors. But what ESG has taught us is that “non-financial” factors are increasingly driving financial performance. In fact, according to Ocean Tomo research, intangible

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<sup>7</sup> <https://hbr.org/2021/01/esg-impact-is-hard-to-measure-but-its-not-impossible>. Jennifer Howard-Grenville

<sup>8</sup> *S.C. Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976); see *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (as the Supreme Court has noted, determinations of materiality require “delicate assessments of the inferences a 'reasonable shareholder would draw from a given set of facts and the significance of those inferences to him....” *TSC Industries*, 426 U.S. at 450)

factors now account for 90% of the market value of S&P 500 companies (up from 17% in 1975).<sup>9</sup> And a big part of that type of intangible value these days derives from ESG strategies such as:

- sustainable innovation
- employee productivity
- social equity
- corporate partnerships
- license to operate
- supply chain productivity
- competitive advantage
- customer-brand purpose connection
- economic stability
- financial inclusion
- and the list goes on...

McKinsey researchers found five key linkages between ESG and corporate value creation

- top-line growth (i.e., attracting customers with more sustainable products)
- cost-reductions (lower energy consumption)
- regulatory & legal interventions (great strategic freedom and subsidies)
- productivity uplift (attract better talent and boost employee motivation)
- investment & asset optimization (better capital allocation for long-term ROI)<sup>10</sup>

The problem is that today's ESG data wasn't designed to measure impact or value creation—even though consumers, employees, and investors demand it.

When asked directly "what matters" about ESG, 83% of consumers and 90% of employees would even take a pay cut to work at companies with aligned social and environmental values.<sup>11</sup> Having worked at UBS AG for over a decade, Phyllis saw firsthand over a hundred ultra-high net worth individuals with assets of tens of billions of dollars, moving their wealth to financial institutions that can help them make a positive impact on the world—contributing substantially to the bottom line.

All of this has nothing to do with socialism, political agendas, or "woke" thinking. It involves data that directly and quantifiably impact a company's bottom line—it's simply modern finance.

According to Andrew Ang of Blackrock: "ESG data that do meet [certain] criteria can be incorporated in signals alongside more traditional financial data ... The frontier of factor research is to incorporate ESG data into the factor definitions themselves."<sup>12</sup> For example, Ang points out that green patents are "patents filed under fields corresponding to U.N. Sustainable Development goals." If a company can deliver clean water or renewable energy, these goals are not only for society but also represent attractive commercial opportunities. We can incorporate green intangible value (falling into "E" of ESG) alongside more traditional value

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<sup>9</sup> Intangible Asset Market Value Study - Ocean Tomo: <https://www.oceantomo.com/intangible-asset-market-value-study/>

<sup>10</sup> <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value>

<sup>11</sup> <https://www.weforum.org/agenda/2022/05/attracting-and-developing-talent-to-techs-highest-calling/>

<sup>12</sup> <https://www.blackrock.com/us/individual/investment-ideas/what-is-factor-investing/factor-commentary/andrews-angle/esg-in-factors>

measures (like earnings yields or cashflow-to-enterprise value) to construct an ESG-friendly portfolio capturing the value factor."<sup>13</sup>

## ESG 2.0: From Materiality to “Intrinsicity”

There may be a better standard than materiality to govern ESG data.

In 2011, Dartmouth professor Kusum Ailawadi tested “intrinsic” and “extrinsic” ESG value propositions with a sample of retail grocery store customers. Ailawadi defined *extrinsic* ESG benefits as “related to broader social good but not related to the customer's direct exchange with the firm (such as environmental friendliness or community support).” In contrast, Ailawadi defined *intrinsic* ESG benefits as those that “pertain to the customer’s direct exchange with the firm (such as fair treatment of employees and locally-sourced products).”<sup>14</sup>

Not surprisingly, the researchers found that the largest segment of customers (60%) financially rewarded retailers for *intrinsic* ESG benefits, while *extrinsic* ESG benefits decreased their likelihood of shopping at that store.

That's because consumers perceived *extrinsic* ESG benefits as taking up company resources that could otherwise improve customer value. In other words, customers respond positively when ESG is directly tied to their commercial experience (i.e., the store employees serving them or the locally sourced products they purchase). Whereas their response is negative when the ESG is not directly relevant to their shopping experience (i.e., general environmental friendliness or charitable support by the retailer).

Many investors feel the same way about ESG. A reasonable investor would expect corporate ESG activities with strong *intrinsic* value to benefit the company financially. In contrast, companies that score high on *extrinsic* ESG ratings may not perform as well. And research backs this up.

A study by Mozaffar Khan, George Serafeim, and Aaron Yoon found that companies with strong ratings on strategically “material” (i.e., *intrinsic*) sustainability issues significantly outperform firms with poor ratings on these topics. Unsurprisingly, they found that “environmental issues tend to be more material for the nonrenewable resources and transportation sectors, governance and product-related issues tend to be more material for the financial sector, and social issues tend to be more material for the healthcare, services, and the technology and communications sectors.”<sup>15</sup>

The evidence is clear: companies that do well at disclosing *extrinsic* ESG risks (meaning score higher on today’s ESG 1.0 ratings) don’t perform better financially. This does *not* necessarily prove that ESG is a flawed investment strategy. It proves that ESG 1.0 data is not correlated with financial performance. Indeed, it's a tough argument to make that “not having child labor in your factories” is a good predictor of whether your company will outperform the market. If, instead, companies were able to report data on their *intrinsic* ESG

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<sup>13</sup> <https://www.blackrock.com/us/individual/investment-ideas/what-is-factor-investing/factor-commentary/andrews-angle/esg-in-factors>

<sup>14</sup> “Does Retailer CSR Enhance Behavioral Loyalty: A Case for Benefit Segmentation” by Kusum Ailawadi et al.

<sup>15</sup> [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2575912](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912)

impacts, this might be more relevant to investors and more fulfilling to the promise of ESG as an investment thesis.

The trouble is measuring “intrinsic value” isn't easy.

### **How do we get to ESG 2.0?**

The future of ESG depends on producing a new generation of ESG 2.0 data that reliably measures the link between societal impacts and corporate *intrinsic* value.

So, what will it take to realize an ESG 2.0 data regime?

We need three key innovations.

#### **1. Adopt a standardized taxonomy of societal impacts.**

ESG 1.0 has lots of data taxonomies—primarily using “inputs” or administrative data. In ESG 2.0, what matters are outcomes—changes in status, condition, or behavior for employees, customers, and the community. Companies need to report their contributions to these outcomes—social determinants of health, racial equity, financial inclusion, education, housing, improved water access, etc. While these may seem hard to define and measure, many concepts we never thought were quantifiable are now widely accepted as measurable.

We can do the same on the social side. Granted, there are far more outcomes to standardize, but as we have done it for issues like health care, measuring the Quality Adjusted Life Years, we can do that across all social outcomes, and indeed we have.

A standardized taxonomy of societal impacts will enable all companies to tag and report their ESG activities by outcomes, which investors can use to determine the overall societal impact of a firm and the intrinsic value of those impacts. One example is one of the Impact Genome Project—a publicly funded initiative to standardize the coding for all the world's social outcomes.<sup>16</sup>

#### **2. Establish an ESG 2.0 “intrinsicity” map.**

Today's ESG 1.0 data agencies like the Sustainability Accounting Standards Board (SASB) and S&P ratings use “materiality maps” to evaluate the relative importance of ESG data to companies. [See S&P example below].<sup>17</sup> Unfortunately, these materiality maps are almost exclusively focused on *extrinsic* value (i.e., according to S&P, the most financially material ESG impacts are “climate transition risk” and “waste transparency”).

To get to ESG 2.0, we need *intrinsic value maps* that identify the environmental, social, and governance *impacts* that significantly contribute to corporate value creation. As McKinsey noted above, intrinsic value is defined

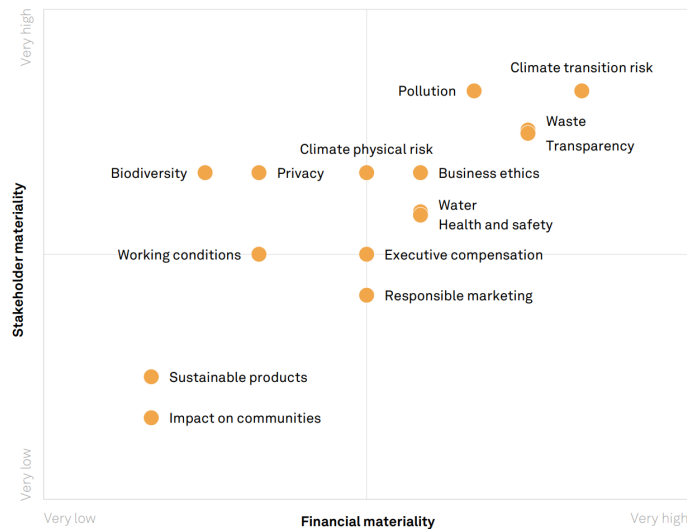
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<sup>16</sup> [www.impactgenome.org](http://www.impactgenome.org) [Note: one of the authors, Jason Saul, is the co-founder of this initiative]

<sup>17</sup> [https://www.spglobal.com/\\_assets/documents/ratings/research/101560738.pdf](https://www.spglobal.com/_assets/documents/ratings/research/101560738.pdf)

as ESG strategies that contribute to value creation in one of five ways: top-line growth, cost reductions; regulatory and legal interventions; productivity uplift; and investment and asset optimization.<sup>18</sup> An intrinsic value map would chart the range of social and environmental impacts against those five value-creating outcomes.

Chart 2  
Example Of An ESG Materiality Map For The ABC Sector



### 3. Extend Measurement, Reporting, and Verification (MRV) to "S."

Currently, the only reliable (i.e., third-party verified) data in the ESG 1.0 world is in the “E” column. For example, there is broad acceptance of how to measure carbon removal. And there is an infrastructure for the “E” or environmental world where environmental impacts are standardized, reported, and verified by carbon registries (e.g., Verra and the Gold Standard). And even that could use some better standardization and data integrity.

In the ESG 2.0 world, intrinsic value for firms is only created if impacts are verifiably achieved. Simply donating money, operating “feel good” programs, and producing glossy “SDG” reports can't prove to investors that outcomes were achieved. Without verifying societal impacts, investors can't bank on any potential intrinsic value that would flow from those activities. ESG 2.0 requires the level of rigor used for “E” to be extended to cover impacts in “S.”<sup>19</sup>

ESG investment analysts and rating agencies can then assess the materiality and strategic value of each company's impact data (going far beyond the binary approach of ESG 1.0 materiality). Instead of asking if a company has a particular policy, we should be asking:

- Are the impacts extrinsic or intrinsic?
- How significant are the impacts on corporate performance?

<sup>18</sup> <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value>

<sup>19</sup> See [Fixing The “S” in ESG](#), published in SSIR.

- How credible are the claims?
- How do they compare to competitors?

This may seem like a pipedream, but we are closer than you might think. ESG 2.0 is just around the corner.

There are many exciting “ESG 2.0” developments, including the G-7’s Impact Task Force Report on Impact Accounting,<sup>20</sup> The Impact Genome Project<sup>21</sup>, the World Wellbeing Movement, Harvard Business School’s Impact-Weighted Accounts initiative,<sup>22</sup> and its affiliated International Foundation for Valuing Impacts,<sup>23</sup> to name a few.

The power of ESG as a force for making a measurable positive impact on society while improving a corporation's value is inevitable. But without the right data, the virtue of this movement is being called into question. The right call to action for ESG advocates is not to fight the criticism with indignancy but to embrace it and evolve with more credible and compelling data.

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<sup>20</sup> <https://www.impactprinciples.org/sites/default/files/2022-01/Workstream-A-report.pdf>

<sup>21</sup> [www.impactgenome.org](http://www.impactgenome.org)

<sup>22</sup> <https://www.hbs.edu/impact-weighted-accounts/Pages/default.aspx>

<sup>23</sup> <https://www.hbs.edu/news/releases/Pages/IFVI-IAWI.aspx>