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ESG: Right Thesis, Wrong Data

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Abstract
In this article, we argue that there is a need to move away from the outdated ESG regime that focuses on external risks for a corporation to one that addresses intrinsic issues that can have positive commercial and societal impacts. The current ESG inputs reflect administrative data points or checklists that align with socially responsible standards, policies, and codes of conduct. However, when corporations focus on societal impacts that are *intrinsic* to their business, ESG can be a powerful predictor of financial return. 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. To get there, three key innovations are needed, including: (1) adoption of a standardized taxonomy of societal impacts, (2) establishment of an ESG 2.0 “intrinsicality” map; and (3) extension of Measurement, Reporting, and Verification (MRV) to "S."

Introduction
ESG has been called "socialist" by Milton Friedman,[1] a "scam" by Elon Musk,[2] a "mirage" by Bloomberg,[3] and an "unholy mess" by the Economist.[4] 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.

ESG 1.0
Today's ESG reporting frameworks (let's call it "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.

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)."[5]

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

[1] https://nyti.ms/2I0pRDe
[2] https://bit.ly/3f72BZe
[3] https://bloom.bg/3dBLTkn
[4] https://econ.st/3fbGhOb
[5] https://bit.ly/3C260li

as having significantly altered the 'total mix of information made available."[6] In other words, what is "material" is what investors say matters to them.

Yet over those 20 years, ESG investors have been evolving their views 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 factors now account for 90% of the market value of S&P 500 companies (up from 17% in 1975).[7] 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, etc.

McKinsey researchers identified five key linkages between ESG and corporate value creation:

- **Top-line growth**: attracting customers with more sustainable products.
- **Cost-reductions**: lower energy consumption.
- **Regulatory and legal interventions**: great strategic freedom and subsidies.
- **Productivity uplift**: attract better talent and boost employee motivation)
- **Investment and asset optimization**: better capital allocation for long-term return on investment ROI[8]

All of this really has nothing to do with socialism, political agendas, or "woke" thinking. It has to do with data that directly and quantifiably impact a company's bottom line. Much of the controversy around ESG can be boiled down to the problems inherent with the ESG 1.0 data regime: it doesn't measure impact (either on society or the bottom line) and it's too distal, or long-term oriented. The ESG movement is handicapped by its data. Another way to interpret the criticism from those that argue that ESG is "too political" or "activist" is that ESG 1.0 data is falling short of making a true business case for environmental, social and governance impacts. And they're not entirely wrong.

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."[9] 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 measures (like earnings yields or cashflow-to-enterprise value) to construct an ESG-friendly portfolio capturing the value factor."[10]

ESG 2.0: from materiality to "intrinsicality"

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

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[6] 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)

[7] https://bit.ly/2I5xZog

[8] https://mck.co/3LyB3rO

[9] https://bit.ly/3DGxz4z

[10] https://bit.ly/3LxN7JM

support).” In contrast, intrinsic ESG benefits were defined as those that “pertain to the customer’s direct exchange with the firm (such as fair treatment of employees and locally-sourced products).”[11]

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 is 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 that have poor ratings. 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.”[12]

The evidence is clear: companies that do well at disclosing extrinsic ESG risks (meaning score higher on today’s ESG 1.0 ratings) do not 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 is 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 impacts, this might be more relevant to investors and more fulfilling to the promise of ESG as an investment thesis.

The trouble is that measuring “intrinsic value” is not 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? To get there, the field needs three key innovations:

Step 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

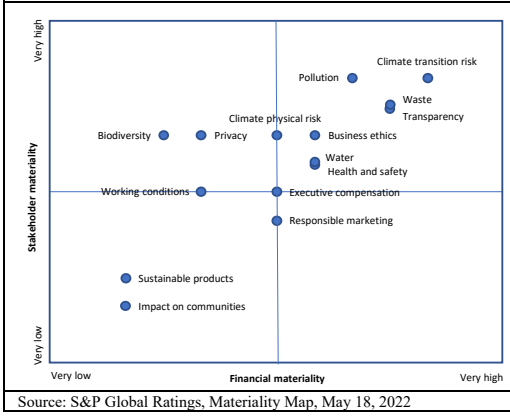
[11] https://bit.ly/3dz6HsI
[12] https://bit.ly/3C0o2nV

impacts. One example is the Impact Genome Project - a publicly funded initiative to standardize the coding for all of the world's social outcomes.[13]

Step 2: Establish an ESG 2.0 "intrinsicality" 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 Figure 1).[14] 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 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.[15] An intrinsic value map would chart the range of social and environmental impacts against those five value-creating outcomes.

Figure 1: Example of an ESG materiality map for the ABC sector



Source: S&P Global Ratings, Materiality Map, May 18, 2022

Step 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 cannot prove to investors that outcomes were achieved. Without verifying societal impacts, investors cannot 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".[16]

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). In addition to ESG 1.0 data, investment analysis need data that informs these questions:

- Are the company's ESG impacts extrinsic or intrinsic?
- How significantly do the ESG impacts contribute to corporate performance?
- How credible are the ESG impact claims?
- How does this companies ESG impact compare to their competitors?

ESG 2.0 may seem futuristic, but we are closer than you think. ESG 2.0 is happening now.

One of the big advances in the field of impact is in the area of impact data standardization and verification. The Impact Genome Project has created a global coding standard for 132 common societal outcomes. The Impact Genome also serves as the world's first impact registry. Companies, nonprofits, and government agencies can report their impacts to the Impact Genome using a standardized taxonomy and have their impact claims independently verified, priced, and benchmarked.

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[13] www.impactgenome.org [Note: one of the authors, Jason Saul, is the co-founder of this initiative]
[14] https://www.spglobal.com/_assets/documents/ratings/research/101560738.pdf
[15] https://mck.co/3SkQm9R
[16] See "Fixing The "S" in ESG," published in SSIR - https://bit.ly/3qTN6ql

Analysts, assurance firms, investors, and other stakeholders can review these impacts and factor them into decision-making and investment models to explore positive commercial benefits.

This is only just the beginning.

There are many other exciting ESG 2.0 developments afoot, including the G-7's Impact Task Force Report on Impact Accounting,[17] the World Wellbeing Movement, Harvard Business School's Impact-Weighted Accounts initiative,[18] and its affiliated International Foundation for Valuing Impacts,[19] 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.

[17] https://bit.ly/3dt5q6F
[18] https://bit.ly/3DNzLHA
[19] https://bit.ly/3UtbbSg