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Washington is divided on the subject of 'woke investing.' So are states.

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Do-good investing has become an increasingly polarizing issue in Washington and on the 2024 campaign trail. The same clash has been playing out in statehouses for years.

On one side are the Democratic strongholds of California and Maine which are seeking to force government divestment from fossil fuel companies.

On the other side are states like Texas that have enacted laws to prohibit public money managers from considering environmental, social, and corporate governance (ESG) principles — or even giving business to private asset managers that do.

An initial wave of research about these experiments offers warnings to both sides of the ESG debate, showing a disconnect between political rhetoric and what government intervention actually looks like in action.

Some studies concluded these policies would cost taxpayers, make it more difficult to maximize returns and achieve stated political goals. In some states, public pension managers even essentially revolted and rolled back some of the mandates, citing their fiduciary duties.

The lesson from the states, at least for Devin Hartman of the energy-focused R Street Institute, is "that the role of government is not really to be pro- or anti-ESG."

During a recent panel appearance, he added that "we need to have a much more like discerning conversation about the forms of ESG and the proper role of government."

But it remains to be seen if that more nuanced conversation is in the offing. The political temperature around ESG is likely to only increase nationally in the months ahead. Wednesday, GOP lawmakers in Washington are kicking off 'ESG month' with the first of a slew of hearings that will see Republicans assail the investing trend.

Meanwhile, contenders on the GOP presidential campaign trail from Ron DeSantis to Vivek Ramaswamy are making attacks on 'woke investing' a key part of their 2024 message as they try to find a way to challenge front-runner Donald Trump.

The state of ESG in Texas, Florida, and Indiana

Republican-run states like Texas and Florida have enacted anti-ESG laws in the name of maximizing shareholder returns. But those efforts have come with an array of hidden costs.

In 2021, Texas passed a wide-ranging law that included a ban on local governments doing business with banks that have ESG policies around issues like fossil fuels and firearms.

A follow-up study from Wharton business school found that the new rules haven't changed bank behavior but instead had the effect of cutting off these cities from the nation's largest underwriters like JPMorgan Chase (JPM) and Goldman Sachs (GS).

The consequence, the researchers found, is less competition and higher borrowing costs with Texas cities paying over $300 million in additional interest on bonds in just the first eight months of the law.

Texas Gov. Greg Abbott deliver his State of the State speech in 2021. (Bob Daemmrich/Pool Photo via AP)

Early studies have also emerged around a more recent bill signed into law in Florida by Gov. Ron DeSantis that bars state officials from investing public money to promote ESG goals. There is a similar fear there that the effort there could also cost taxpayers millions.

And when Indiana lawmakers were considering a similar law, a state analysis found the proposal could cut a whopping $6.7 billion from the state's public pension system.

Why? Because a ban on working with investment managers that consider ESG and provisions may have effectively cut the state off from private equity. Lawmakers ended up rejecting the bill.

The state of ESG in Maine and California

Meanwhile, efforts on the other side of the political divide also haven't gone smoothly.

In 2021, Maine became the first US state to require divestment from fossil fuels with a law that required Maine's Public Employees Retirement System to sell about $1.3 billion of fossil fuel exposure by 2026.

But the response from the manager of the state's $17 billion pension system was essentially to revolt. The asset managers said the new law conflicted with their fiduciary responsibility, and they invoked a clause in the new law that is likely to at least slow the divestment efforts.

They said they need to keep as least some fossil fuel positions as part of their overall investing mix to stay "in accordance with sound investment criteria."

In 2021, Gov. Janet Mills signed a law that made Maine the first state in the US to order state officials to sell fossil fuel assets. (Ben McCanna/Portland Press Herald via Getty Images)

Similarly in California, the state Senate passed a bill to divest from fossil fuel companies by 2031. But the state's $457 billion California Public Employees' Retirement System announced its opposition, arguing the bill could "create a ripple effect on our ability to produce the investment returns needed to fulfill our members' retirement promises."

In addition, the fund's board members also said that divestment would not materially help efforts to fight climate change with the money simply being re-routed.

'A nice narrative'

The fights around government policy coincide with a heated debate over ESG returns more broadly. One study from sustainability data firm ESG Book found ESG funds outperforming competitors over a five-year span but some attributed that to hype sending extra money in these sectors and driving up short-term returns.

Other research over a longer term finds little measurable effects.

In recent history, sustainable indexes outperformed the market in the first quarter of 2023, according to Morningstar, fueled by outsized returns in the ESG-friendly tech sector. But that came after 2022 when ESG fared more poorly as fossil fuel stocks surged following the invasion of Ukraine.

What remains unclear is how the lessons from the state level will be reflected in the national conversation or on the campaign trail in the months ahead as lawmakers push for increased intervention from Washington.

On Capitol Hill this week, the House Financial Services Committee is scheduled to convene four hearings in three days and consider at least 18 bills around ESG issues. The Republican leaders want to address ESG practices around things like housing, insurance, and the proxy shareholder voting process.

During this week’s panel discussion, Jennifer Schulp of the Cato Institute predicted that the political heat around ESG wasn’t going anywhere, noting it "makes for a nice narrative."

She expressed hope that many lawmakers both in the states and in Washington are beginning to take lessons from recent ESG experiences and operating with more nuance, noting "we've seen better questions being asked even if they don't often make the headlines."