Does the market care about ethical investment? It depends

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Washington regulators and corporate America are rushing to adopt new corporate environmental, social and governance (ESG) policies. Enthusiasts claim that these policies are both good business and good for the world. Whether the latter is true is a matter of opinion. Whether ESG policies are good for a company's bottom line, however, has been the subject of several hundred peer-reviewed studies over the past four decades. And the answer is: It depends.

Corporate ESG actions can be voluntary or involuntary, and this distinction is important in understanding the true impact of ESG on company value. But new government mandates to pursue ESG goals are likely to prove costly to American shareholders and workers.

Voluntary ESG actions, such as operational and human resource investments that many U.S. corporations made during spring 2020 in response to the COVID-19 pandemic, are observationally equivalent to what we would expect to find if managers were focused on just maximizing long-term shareholder value. For example, 69 percent of the 100 largest U.S. corporations voluntarily made drastic changes to their employee work schedules to safeguard employee health, and 64 percent of these companies voluntarily made significant changes to accommodate customer concerns about health safety and logistical convenience. These examples highlight an important point — in a competitive labor market, managers (voluntarily) have to compensate their workers fairly and treat them well if they wish to hire and retain them. Similarly, in a competitive product market, managers (voluntarily) have to be responsive to customer concerns.

Meta-analysis of financial studies indicates that the overall relationship between adopting ESG practices and firm performance is either zero (statistically insignificant) or marginally positive. Moreover, the economic magnitude of any effect is rather small, compared to, say, when a corporation becomes the target of a tender offer. Even this small effect becomes ever smaller when researchers include basic controls like industry and size of the company.

More interesting, these studies indicate that *prior* positive financial performance does predict the adoption of ESG policies (such as, recruiting diverse executives and board members, making large charitable donations), but a firm's adoption of ESG policies does not produce similar positive *future* financial performance. This suggests that profitable companies can afford to engage in ESG activities that do not increase shareholder value; however, just engaging in ESG activities without changes in corporate business operations do not enhance financial performance.

When ESG activity is driven not by the company, but by government mandate, however, the impact on firm value is mostly negative. For example, a recent paper finds negative stock market reaction to the European Union's mandates to increase non financial disclosure related to ESG activities. Another recent paper documents negative market response to the California Senate bill that mandated board gender diversity quotas for companies headquartered in California. This negative response to board diversity quotas has also been documented for Norwegian companies when Norway passed a law requiring that 40 percent of board members be women. In a different continent and on a different version of ESG requirements, companies in India experienced a negative stock market reaction to their government passing a law that 2 percent of corporate income be spent on ESG initiatives.

Why does it matter if pursuing ESG goals is voluntary or required? One explanation is that much voluntary ESG behavior is largely symbolic, such as the widespread practice of "greenwashing" — misleading corporate communications that aim to form overly positive beliefs among stakeholders about a company's environmental practices. These slick practices are facilitated by the notoriously vague and inconsistent metrics used by ESG rating firms that make it possible for companies to pick the most favorable rating agency as their judge. Involuntary mandates, by contrast, typically are more objective and harder to evade, thus the costs on shareholders and workers tend to bite harder.

Contrary to the claims of its supporters, therefore, there is little evidence that adoption of ESG policies provide much, if any, benefit for shareholders. On the other hand, promoting trendy ESG goals may be an effective way for CEOs of profitable companies to leverage shareholders' money and the corporation's public profile to enhance their personal reputation and garner fawning news headlines. Equally important, publicizing their focus on non-shareholder ESG priorities allows managers to escape responsibility for the company's financial performance.

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