ESG AND THE PROXY PROCESS:

What Does the Research Say?

INSTITUTE FOR
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EXECUTIVE SUMMARY

As public pensions continue facing calls to divest from various stocks, the role of environment, social, and governance (ESG) investing needs to be examined. The Institute for Pension Fund Integrity continues to argue that ESG investing for public pension funds has merit when it is a financial decision and when the ESG strategy adds value to the fund. Yet with the increasing role that politically motivated investing plays, there are concerns that ESG investing leads to reduced returns, ultimately hurting public pension plan members. Does research back up this claim?

It absolutely does, especially when looking at exclusions or divestments of certain stocks. Evidence shows that ESG funds fall short of traditional fund performance, prioritizing ethical, social, or even political concerns ahead of optimizing returns for investors. This real-life experience is reinforced by theoretical and academic study that argues compellingly that limiting investment options and increasing frictional costs restrains performance.

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Policymakers and pensioners should pay attention to this evidence. They should also carefully scrutinize the role that proxy advisory firms are now playing in the ESG investment ecosystem, especially in light of the Securities and Exchange Commission’s review of the proxy process. This issue brief describes the convergence of ESG and the proxy process to provide insights for parties following these issues.

- **Years of Experience Show ESG Funds Fall Short**. One popular exchange-traded fund that follows the ESG model, the iShares MSCI KLD 400 Social ETF, has trailed conventional investment funds over recent three-, five- and ten-year periods. The S&P beat this ESG fund in seven of the past ten calendar years. A November 2016 paper from the Center for Retirement Research showed similar results, with both Vanguard large-cap and mid-cap funds beating equivalent ESG funds.
- **Frictional Costs and Values Screens Limit Fund Performance**. ESG investing necessarily requires more frictional costs (research, trading costs, etc.) than straight index investing. In addition, modern investing theory shows that limiting the investment universe on a non-financial basis, using values screens to exclude stocks, creates a less efficient and higher risk portfolio.
- **Exclusions and Divestments Are Particularly Harmful to Returns**. A number of academic studies show that exclusions used to limit investments for values-based purposes can be a drag on performance. Divestments are particularly dangerous for investors, with real-life examples revealing the scale of this danger. In California, divestment of CalPERS from tobacco stocks cost the fund $3 billion. A potential divestment by the San Francisco Employees Retirement System from energy stocks could have cost that fund as much as $23.1 million.

- **The Role of Proxy Advisors in the ESG Ecosystem Deserves Scrutiny**. There is strong research indicating the power of proxy advisory firms to influence fund decisions on proxy votes, including decisions related to ESG investments. However, there is very little research on whether these ESG policies, as advocated by these proxy advisor firms, enhance shareholder returns. This deserves further scrutiny if investors are to be protected, particularly as the leading two firms, Institutional Shareholder Services (ISS) and Glass Lewis, have adopted the strategy of environmental activists in an attempt to shape the policies of global businesses.
- **Pensioners Deserve Protection**. Certain ESG policies, exclusions, and divestments are almost certain routes to lower returns for pension funds. Policymakers should take the steps necessary to ensure that ESG considerations, whether pushed by proxy firms or others, don't unfairly threaten the retirement funds of American workers.

KLD 400 VS. S&P 500

One of the problems in determining the performance of ESG stocks is defining the criteria. What is a "socially responsible" or "ESG" (environmental, social, and governance) company?

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The oldest ESG index is the MSCI KLD 400, founded in 1990 as the Domini Social Index. The KLD includes large- and small-cap stocks that have what MSCI calls "strong sustainability profiles."[1] These are necessarily subjective qualities and require sophisticated firm-based judgments. The KLD 400 also avoids "companies incompatible with values screens." Specifically, the KLD excludes companies whose business involves gambling, civilian firearms, military weapons, nuclear power, adult entertainment, and genetically modified organisms. But other ESG screens exclude different categories.

> "... over the 10 years ending in August 2016, the Vanguard large-cap funds returned an annual average of 7.5% vs. 6.9% for the ESG funds"

A popular exchange-traded fund (ETF) based on the KLD 400 index, called the iShares MSCI KLD 400 Social ETF, has trailed the top ETF that is based on the benchmark Standard & Poor's 500 Index (called "Spiders," or SPDR S&P 500 ETF) over the three-, five- and ten-year periods ending on Jan. 25, 2019.[2]

Over the five-year period, for example, the ESG fund returned an annual average of 11.22% while the S&P returned 12.01% -- a significant difference over time. The S&P beat the ESG fund in seven of the past nine calendar years.

These results are compatible with the results of a November 2016 paper from the Center for Retirement Research at Boston College by Alicia Munnell, the center's director, and Anqi Chen.[3] The researchers compared investment returns for over 200 ESG-screened mutual funds from members of the Forum for Sustainable and Responsible Investments with returns from comparable Vanguard mutual funds. They found that over the 10 years ending in August 2016, the Vanguard large-cap funds returned an annual average of 7.5% vs. 6.9% for the ESG funds; Vanguard mid-caps beat equivalent ESG funds by 7.7% to 7%.

1 https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6
2 https://www.morningstar.com/etfs/arcx/dsi/quote.html
3 http://crr.bc.edu/wp-content/uploads/2016/11/slp_53.pdf

WHY THE UNDERPERFORMANCE OF ESG FUNDS?

One reason for the poorer performance of ESG funds is that ESG investing necessarily requires more frictional costs (simply for the research involved in assembling the portfolio or for trading costs if new categories are divested) than straight index investing. But the main reason is more basic.

It stands to reason that an investor who is picking stocks from a limited pool of choices will be outperformed by one who is picking stocks from a broader pool.

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If, for example, a fund manager is prohibited from investing in energy stocks or tobacco or defense stocks, she will necessarily miss opportunities for profit if some (perhaps only a few) of those stocks are deemed exceptional investments.

In a paper published by Morningstar in 2016, Jon Hale, the firm's Head of Sustainability Research, explained that “Modern Portfolio Theory [MPT] suggests that limiting the investment universe, especially when it is done on a purely nonfinancial basis, forces an investor into a less-efficient portfolio that will have lower risk-adjusted performance than a more efficient portfolio selected from the broader universe.”[4]

Actually, this is not merely a “suggestion” of MPT. It is the crux of it – and the reason that broad index funds have become so popular.

In fact, investing solely in categories of stocks that are excluded from the broader universe can be profitable. Hale writes that “studies focused on the effects of exclusionary screens, particularly sin stocks, also draw negative conclusions. Hong and Kacperczyk find that sin stocks have higher expected returns than otherwise comparable stocks and suggest the reason is they are neglected by norm-constrained investors.[5] Trinks and Scholtens also found that investing in stocks often excluded by responsible investors in many cases results in additional risk-adjusted returns.”[6]

ACADEMIC LITERATURE ON ESG INVESTING RETURNS

In one way, the academic literature on ESG investing returns is mixed. One widely cited study in the Journal of Portfolio Management by Timothy Adler and Mark Kritzman is described this way:

The authors estimate the cost of practicing socially responsible investing.[7] Using these results, investors may determine whether imposing restrictions on the available investment universe is the most cost-efficient method for promoting the particular social ideal. The authors design and execute a Monte Carlo simulation to compare the performance of a skillful investor in an unrestricted investment universe with the performance of the same investor in a restricted investment universe. They repeat this for a variety of skill levels and investment universes and find that the cost of socially responsible investing is substantial for even moderately skilled investors.

But the ESG community takes strong issue with Adler and Kritzman – and other studies that show socially responsible stock underperforming. And there is some support for the ESG advocates view. A meta-analysis by Christophe Revelli and Jean-Laurent Viviani, published in 2015, examined 85 studies and 190 experiments and concluded that “the consideration of corporate social responsibility in stock market portfolios is neither a weakness nor a strength compared with conventional investments.”[8]

How can we reconcile this analysis with both theory and practice?

4 https://video.morningstar.com/ca/170717_SustainableInvesting.pdf
5 http://pages.stern.nyu.edu/~sternfin/mkacperc/public_html/sin.pdf
6 https://link.springer.com/article/10.1007/s10551-015-2684-3
7 https://jpm.iijournals.com/content/35/1/52
8 https://onlinelibrary.wiley.com/doi/abs/10.1111/beer.12076

EXCLUSIONS VS. INCLUSIONS

Hale of Morningstar, in a detailed 13-page analysis, comes up with what he calls a "more robust explanation" for the performance of socially responsible funds. He argues that picking stocks based on the strength of the ESG characteristics of a business produces slightly higher returns (on the order of 0.16%, according to one study) but that "exclusions that are used to limit investments solely for values-based and nonmaterial reasons can be a drag on performance."

> "...exclusions that are used to limit investments solely for values-based and nonmaterial reasons can be a drag on performance."

Or, as CNBC's Constance Gustke wrote in an article about Hale's research: "In other words, it's better to identify reasons to invest in a stock than harp on reasons to avoid owning one."[9]

The Adler-Kritzman study focused on portfolios that excluded "sin" categories, but the Revelli-Viviani analysis looked at portfolios that were both exclusionary and selected individual stocks that met ESG criteria. Still, the fact that stock pickers who stress ESG (which is defined in different ways by different fund managers) may beat the broader market over short periods is meaningless. What is significant is that if you exclude whole categories, you will – in theory and practice – get lower returns.

DIVESTMENTS AS RETURN-KILLERS

The effects of individual exclusions can be devastating. For example, the board of the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the country, made a decision to divest tobacco stocks from its portfolio. An analysis in 2015 found that the divestment cost the fund $3 billion, and later calculations by Wilshire Associates show the "amount of foregone performance has continued to grow."[10] Despite the losses, the CalPERS board rejected the advice of its staff in 2016 to reinstate tobacco stocks.[11]

In 2017, the board of the San Francisco Employees Retirement System (SFERS) asked NEPC, an investment consulting firm, to analyze the effects of banning the energy stocks of the so-called Underground 200.[12] NEPC advised against divestment. "Widely accepted financial theory...predicts lower risk-adjusted returns from a restricted portfolio," NEPC wrote, citing Modern Portfolio Theory, just as Hale did.[13] The firm projected a shortfall on the SFERS equity portfolio of $5.8 million to $23.1 million.

The NEPC analysis cited eight academic studies that show that "investment decisions to sell and permanently exclude portions of an investment universe have not been not accretive to investors."

9 https://www.cnbc.com/2017/06/16/how-to-win-in-socially-responsible-investing-dont-exclude-bad-stocks.html
10 https://www.calpers.ca.gov/docs/board-agendas/201612/invest/item05b-00.pdf
11 https://www.rstreet.org/2016/12/20/calpers-considers-then-rejects-efforts-to-end-tobacco-divestment-2/
12 https://gofossilfree.org/top-200/
13 https://mysfers.org/wp-content/uploads/012418-special-board-meeting-Attachment-B-NEPC-Commentary.pdf

PROXY ADVISORS AND THE ESG ECOSYSTEM

Proxy advisory (PA) firms play a critical role in the ESG ecosystem. In 2003, the Securities and Exchange Commission (SEC), with benign intentions, promulgated a regulation that had unintended and adverse consequences.[14] It unwittingly established two firms as the principal arbiters of corporate governance in America. The firms, Institutional Shareholder Services (ISS) and Glass Lewis, account for 97 percent of the market for PA services.

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The regulation began as a simple requirement that funds provide transparency on potential conflicts of interest. But because of subsequent staff interventions, it was interpreted to mean that funds must effectively vote on all proxy issues, with the added feature of an almost blanket exemption from liability for proxy advisers that provide fund managers with recommendations on how to vote.[15]

As a result, PA firms wield enormous power. The late Lynn Stout of Cornell, a scholar of corporate governance and finance, wrote “When institutional investors follow ISS [proxy recommendations] en masse, directors of public corporations can expect to see 20%, 30%, even 50% of their company’s shares being voted not as the directors recommend, but as ISS recommends.”[16] In a submission to the SEC that cited Stout in 2009, Tamara Belinfanti of New York Law School added that Stout argues that institutional shareholders’ “reliance on ISS without any corresponding checks or balances on ISS, presents the hallmark problem of ‘agency cost,’ that has plagued corporate law scholars for years.”

In a roundtable on Nov. 15, 2018, the SEC took the first steps toward remedying that “hallmark problem,” by suggesting increasing regulatory oversight and forcing PA firms to assume more fiduciary responsibility for their advice. In all this, the SEC should not lose sight of the content of the firms’ recommendations.

PA firms are conduits. They advise fund managers to take pro-ESG votes on proxy questions, and those votes – or even the threat of such votes – push U.S. corporations to adopt ESG policies.

The essential question is whether the ESG policies advocated by proxy advisory firms actually enhance returns. That question is so far unanswered. Proxy advisors have shown little interest in examining whether their policies produce better financial results for companies and their shareholders. ISS, for example, uses the phrase, “enhancing long-term shareholder and stakeholder value,” a phrase that has no precise meaning and so cannot be tested against research.

The limited research on popular social and corporate governance initiatives is not encouraging for ESG advocates. Consider “say on pay,” a policy of giving shareholders the right to vote their view on the compensation of corporate executives. David Larcker, Allan L. McCall, and Gaizka Ormazabal, in a paper for the Rock Center for Corporate Governance at Stanford, found that companies are influenced by the prospect of a negative proxy vote to change their pay policies, and, when that happens, the “stock market reaction to these compensation program changes is statistically negative.”[17]

There is little doubt of the influence of PA firms on “say on pay.” In 2012, a survey conducted by the Conference Board, NASDAQ, and Stanford University reported that over 70% of directors and executive officers reported that their compensation programs were influenced by the policies or guidelines of proxy advisory firms.[18]

PA firms should themselves be commissioning objective research on the question of whether their recommendations enhance shareholder value.

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14 https://www.sec.gov/rules/final/33-8188.htm
15 https://www.mercatus.org/publication/how-fix-our-broken-proxy-advisory-system
16 https://www.sec.gov/comments/s7-14-10/s71410-183.pdf
17 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453
18 https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2012-proxy-voting_0.pdf

THE "E" IN "ESG"

Research, however, does not seem to be the basis on which ISS and Glass Lewis prefer to act when it comes to the "E" (that is, environment) portion of ESG. The two PA firms are becoming more aggressive. Environmental concerns have ranked number-one among topics of shareholder proposals for several years now, according to research by the Manhattan Institute.[19]

For the 2019 proxy season, ISS has revised its policies on recommendations to take into account, "Whether there are significant controversies, fines, penalties, or litigation associated with the company's environmental or social practices." Of course, a "controversy" is something that can be manufactured by the creator of the proxy proposal itself. (See page 10.[20]) The result of this change in policy is that ISS is almost certain to side with more shareholder proposals on aggressive environmental issues.

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Glass Lewis is vague in its environmental guidelines. A summary of 2019 practices by the law firm Gibson Dunn states that when the proxy advisor "believes that a company has not properly managed or mitigated environmental or social risks 'to the detriment of shareholder value,' Glass Lewis may recommend votes 'against' directors who are responsible for oversight of environmental and social risks."[21]

Both advisory firms are now using ratings scores related to the environment in their voting recommendations. ISS employs a numerical system, with "1" the best (meaning top decile) and "10" the worst in five different categories: management of environmental risks and opportunities, carbon and climate, natural resources, and waste and toxicity.[22] The proxy advisory firm is scoring 5,000 companies.[23]

ISS's public documents do not go into detail except to say that the ratings are "informed by recent developments in disclosure standards and frameworks, such as the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB) standards and the Task Force on Climate-related Financial Disclosures (TCFD)."

The thrust of efforts by these groups is summed up in a 2017 report by TCFD, which is chaired by former New York Mayor Michael Bloomberg: "Warming of the planet caused by greenhouse gas emissions poses serious risks to the global economy and will have an impact across many economic sectors.[24] It is difficult for investors to know which companies are most at risk from climate change, which are best prepared, and which are taking action."

The strategy seeks to force companies to make extensive disclosures, which can then become fodder for future legal actions – and to get them to overstate the dangers of climate change to their bottom lines in order to avoid criticism by activists. Activists see forced disclosure as one of their most potent weapons, and proxy advisory firms have become their allies.

19 http://www.proxymonitor.org/Forms/pmr_15.aspx
20 https://www.issgovernance.com/file/policy/active/specialty/SRI-US-Policy-Updates.pdf
21 https://www.gibsondunn.com/glass-lewis-issues-2019-proxy-voting-policy-updates/
22 https://www.issgovernance.com/esg/rankings/environmental-social-qualityscore/
23 https://www.issgovernance.com/iss-announces-launch-of-environmental-social-qualityscore-corporate-profiling-solution/
24 https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf

CONCLUSIONS

The conclusions that the above research demonstrates is clear: ESG investing is not yet a proven means of adding alpha, or value. While ESG investing may make sense for individual investors, the overall impact on public pensions is more negative, and requires a detailed deliberation before a fund chooses to invest based on ESG values screens.

In summary:

- Divesting categories of stocks from a portfolio or banning those stocks in the future is an almost certain route to lower returns.
- Analysis and judgment about the corporate social responsibility of individual firms may produce higher returns, but the investment selection process must occur at the firm level. One size does not fit all.
- There is strong research indicating the power of proxy advisory firms to influence fund decisions on proxy votes -- but very little research on whether specific ESG policies, as advocated by these PA firms, enhance shareholder returns.
- PA firms have adopted the strategy of environmental activists in an attempt to shape the policies of global businesses.

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1700 N. Moore St. Suite 2100 Arlington VA 22209