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The end of ESG

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Abstract

ESG is both extremely important and nothing special. It's extremely important because it's critical to long-term value, and so any academic or practitioner should take it seriously, not just those with "ESG" in their research interests or job title. Thus, ESG doesn't need a specialized term, as that implies it's niche—considering long-term factors isn't ESG investing; it's investing. It's nothing special since it's no better or worse than other intangible assets that create long-term financial and social returns, such as management quality, corporate culture, and innovative capability. Companies shouldn't be praised more for improving their ESG performance than these other intangibles; investor engagement on ESG factors shouldn't be put on a pedestal compared to engagement on other value drivers. We want great companies, not just companies that are great at ESG.

KEYWORDS
CSR, ESG, responsible business, SRI, sustainable investing

1 | INTRODUCTION

Now is the peak of ESG. It's front and center in the minds of executives, investors, regulators, business students, and even the public. Major corporations are appointing Chief Sustainability Officers to the C-suite, justifying strategic decisions based on their ESG impact, and tying executive pay to ESG metrics. A total of 4375 investors managing $121 trillion had signed the Principles for Responsible Investment ("PRI") by the end of 2021, dwarfing the 63 investors overseeing $6.5 trillion who helped found the PRI in 2006. Regulators are establishing taxonomies of which corporate activities may be labeled "sustainable," and tiering funds by their ESG incorporation. Business schools are rushing

to introduce ESG courses, establish ESG centers, and reinvent faculty as ESG experts. Newspapers are publishing dedicated ESG newsletters, and customers are increasingly basing their purchasing decisions on a company's ESG impact.

With this context, it seems crazy to title an article "The end of ESG." But this title intends not to signal ESG's death, but ESG's evolution from a niche subfield into a mainstream practice. The biggest driver of this ascent is the recognition that ESG factors are critical to a company's long-term (financial) value. But then *all* executives and investors should take them seriously, not just those with "sustainability" in their job title. Considering long-term factors when valuing a company isn't ESG investing; it's investing. Indeed, there's not really such a thing as ESG investing, only ESG analysis.

The value relevance of ESG was how I got into the topic in the first place, back in my PhD days when ESG was still niche. My job market paper was a theory of how blockholders (large shareholders) enhance a company's long-term value (Edmans, 2009). The model showed that blockholders don't just assess a company by its quarterly earnings; instead, they do a deep dive into its intangible assets, such as its corporate culture, customer loyalty, and innovative capability. Doing so is costly and time consuming, but their large stakes make it worthwhile. In turn, if a company knows that its key shareholders will assess it on long-term value not short-term earnings, this frees it to focus on the former and not fret so much about the latter.

Importantly, the shareholders were just that—shareholders. They weren't ESG investors; they weren't analyzing a company's long-term value because they were forced to by regulation or pressured to by clients. They just wanted to beat the market, and you can only do so with information that's not already in the price. Quarterly earnings are publicly available, but it's long-term factors that are hidden treasure. When seminar audiences asked me for examples of such investors, I'd reply Warren Buffett, Bill Miller, and Peter Lynch. None of these are ESG investors; they're simply long-term-oriented investors.

But there was one question I didn't yet have a good answer to. Why are blockholders needed at all—why companies can't just disclose the value of their intangible assets? I replied that intangibles were difficult to report credibly; there are few verifiable measures of items such as corporate culture. And even if there were, small shareholders might not understand their value relevance, or know how to change cell C23 in their model upon learning that a firm actively encourages dissenting viewpoints.

Yet I only had common sense to buttress my responses; back then, there was no evidence either way. So, in the final months of my PhD, I started a new paper. I took the "100 Best Companies to Work For in America" and found that they delivered higher shareholder returns than their peers over a 28-year period. The Best Companies list is highly visible. If markets were efficient, the Best Companies' stocks would jump as soon as the list came out, preventing future outperformance. The superior returns imply that the market failed to fully incorporate employee satisfaction.

I initially published the paper in a finance journal (Edmans, 2011); a management journal then invited me to write a management-oriented version (Edmans, 2012). Neither article mentioned ESG even once. I didn't study employee satisfaction because it's an ESG factor, but because it's a value-relevant factor. I wanted to show that the market overlooks important value drivers, and titled the finance paper "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices." Serendipitously, Lloyd Kurtz, who chaired the Moskowitz Prize for Socially Responsible Investing ("SRI"), invited me to submit my paper to the competition. I'd never thought of my research as being about SRI, but did some digging after Lloyd's email and found that many SRI investors indeed scrutinize worker welfare. I added some SRI implications into the paper, but doing so opened a mini Pandora's box. If the paper was about SRI, why study employee satisfaction and not other SRI screens such as Catholic values and animal rights? I stressed that human capital theories provide strong reasons for why employee satisfaction might be value relevant, but there weren't as clear justifications for those other factors, so any correlation might result from data mining.

If ESG is a set of value-relevant factors, then it's both extremely important and nothing special. ESG is extremely important because *any* academic or practitioner should care about the drivers of long-term value, particularly (for investors) ones that are mispriced by the market. Indeed, the title of this article is inspired by Thaler's (1999) "The End of Behavioral Finance," which predicted that behavioral finance would become mainstream—to understand asset prices, it would become widely accepted that you need to study not only cash flows and discount rates, but also

investor behavior. The same is true for ESG. Critics of capitalism argue that finance textbooks focus on short-term profit and need to be overhauled to incorporate ESG. As the new co-author adding ESG into a long-standing textbook (Brealey et al., 2022), I'd love to claim I'm radically reforming business education. But Finance 101 has always stressed how a company's worth is the present value of *all* its cash flows, including those in the very distant future. A company's relationships with its employees, customers, communities, suppliers, and the environment are highly value relevant; there's nothing particularly cultish, liberal, or—dare I say it—"woke" in considering them.

But this article aims to go beyond just applying Thaler's analogy to ESG. And that's where the second point comes in—that ESG is "nothing special." This isn't meant to be disparaging, but to highlight how ESG is no better or worse than other factors that drive long-term value. This matters for several reasons. First, ESG shouldn't be put on a pedestal compared to other value drivers. Companies and investors are falling over themselves to demonstrate their commitment to ESG, with company performance on ESG metrics given a special halo, and investors praised even more for engaging on ESG issues than productivity, capital allocation, and strategy. In some cases, such as Danone and the very many ESG funds that underperform, this may lead to ESG being prioritized at the expense of long-term value. Second, practitioners shouldn't rush to do something special for ESG factors that they wouldn't for other intangibles, such as demand that every company tie executive pay to them, or reduce them to simple quantitative metrics. Third, many of the controversies surrounding ESG become moot when we view it as a set of long-term value factors. It's no surprise that ESG ratings aren't perfectly correlated, because it's legitimate to have different views on the quality of a company's intangibles. We don't need to get into angry fights between ESG believers and deniers, because reasonable people can disagree on how relevant a characteristic is for a company's long-term success. On the flipside, if ESG is nothing special, then some practices we implement for ESG could be rolled out to other areas of finance. Regulators are cracking down on ESG funds that are greenwashing—and they should similarly scrutinize other investors who aren't doing what they say, such as actively managed funds that are closet indexers.

This article discusses how our perspectives on topical ESG issues change when we view them through a *long-term value lens*—as drivers of long-term value, no more, no less—rather than an *ESG lens*—as a magic set of factors that companies, investors, and even professors need to demonstrate their commitment to over and above other value drivers.

2 | ESG METRICS

Investors, regulators, and other stakeholders are increasingly demanding that companies report their performance along various ESG metrics. Many are calling for a common set that all firms be compelled to disclose, as well as standards to ensure they're all measured in the same way.

Under the ESG lens, this is a no-brainer. Companies need to report their ESG performance to prove they're walking the walk, rather than just talking the talk. And just like financial statements, they should be comparable so that shareholders can see how firms stack up to their peers. In turn, investors can demonstrate to their clients how truly green they are, if their portfolio ticks more ESG boxes than their competitors'.

It might seem that ESG metrics are also a no-brainer under the long-term value lens—if ESG drives long-term value, then investors need ESG metrics to be able to estimate long-term value. Indeed, this was the solution that my job market audiences proposed. If companies disclosed measures of long-term value, then the market will focus on them rather than short-term earnings.

But if ESG drives long-term value, then it's no more special than any other intangible assets that do so. And it's particularly nonspecial since we've known for at least 30 years that the value of a company depends on more than just financial factors. Kaplan and Norton (1992) introduced the "balanced scorecard" that "complements the financial measures with operational measures on customer satisfaction, internal processes, and the organization's innovation and improvement activities—operational measures that are the drivers of future financial performance." Kaplan and Norton stressed the importance of reporting measures not because they're part of a framework or a box to be ticked,

but because they "are the drivers of future financial performance"—their article is entitled "The Balanced Scorecard—Measures That Drive Performance."

ESG has helped advance the balanced scorecard from Kaplan and Norton's time. It highlights how the value of a company depends not only on its financial and operational performance, but also its stakeholder relationships. But viewing metrics through a long-term value lens rather than an ESG lens shifts our thinking in two ways. First, it widens our perspective, because many value drivers don't fall under the narrow umbrella of ESG. Companies should tune out the noise created by reporting frameworks and stakeholder demands and instead ask—what are the attributes that we ourselves want to monitor, because they're "measures that drive performance?" In other words, what are the Key Performance Indicators ("KPIs"), or leading indicators, that help us assess whether our company is on track? These KPIs will certainly include ESG metrics, such as carbon emissions for an energy company, but they'll also include other dimensions such as customer net promoter scores or new patent generation. This perspective moves ESG from a compliance exercise—a set of boxes to be ticked—to a value creation tool.

The most important broadening is that most ESG metrics capture "do no harm"—the amount of damage a company inflicts upon society, such as water usage, particulate production, and worker injuries. That's certainly important, but long-term value is much more about whether a company "actively does good"; in Edmans (2020), I refer to the latter as growing the pie, and the former as splitting the pie fairly. The measures that track value creation will be specific to a company's strategy. Unilever gauges the number of citizens it reaches through its hygiene campaigns, Olam measures the number of smallholder farmers who participate in its sustainable farming programs, and MYBank reports the number of start-ups that it lends to who'd never obtained a bank loan before.

A common set of ESG metrics doesn't stop companies from going further and reporting additional bespoke factors. But common measures will likely get most focus, since everyone reports them—that's why some investors fixate on quarterly earnings, even though companies have been disclosing nonfinancial dimensions for decades. In turn, if investors prioritize these common measures, this will encourage executives to do so too because they'll be evaluated on them, at the expense of the dimensions that actually create value (Edmans et al., 2016).

Common measures are also easy to compare as they don't require expertise. Even if I have no knowledge of basketball, I can still see which NBA players score the most points, even though they're only one dimension of quality. Similarly, an investor who knows little about a company's business model can still notice that 8 tons of emissions are higher than 5. Indeed, some of the biggest calls for common metrics are from people late to the ESG bandwagon, because reducing an art to a number comparison exercise allows everyone to join the party.

Second, replacing the ESG lens with the long-term value lens focuses our perspective, as it suggests that companies should report ESG factors *only if* they "drive performance"—a leading indicator is one that leads to future outcomes.[1] The first shift in thinking stressed that driving performance is a *sufficient* condition to report a KPI; it doesn't matter if it's an "ESG" metric or not. This second shift highlights that it's also a *necessary* condition. This focus is important, because there are literally hundreds of ESG metrics that companies could report. Not only would this divert a company's attention from actually creating value to reporting on value, it would ironically reduce transparency to investors and stakeholders as they won't know where to look.

2.1 | ESG-linked pay

Many companies are going beyond simply reporting ESG metrics to linking pay to them. A PwC (2022) study found that 92% of large U.S. companies and 72% of large U.K. firms are using ESG metrics in their incentive plans. Some investors, on both sides of the Atlantic, argue that all firms should tie executive pay, at least in part, to ESG. Regulators are contemplating requiring such a link.

[1] These need not be financial outcomes, but other outcomes (such as patents) that matter for long-term performance.

Such ties make sense under the ESG lens. Companies obtain a public relations boost from linking pay to ESG, as it suggests they care so much about ESG that they pay for it. Investors who loudly call for every company to incorporate ESG metrics in bonuses are seen as ESG pioneers. But under the long-term value lens, it's far from clear cut. The balanced scorecard stressed the importance of paying close attention to nonfinancial metrics, but Kaplan and Norton (1992) never advocated putting them into compensation contracts. Doing so is unnecessary—if ESG metrics are indeed relevant for long-term value, then tying pay to long-term value is sufficient to encourage executives to bolster them, as found by Flammer and Bansal (2017). Even worse, they could backfire by prompting CEOs to focus only on the ESG dimensions in the contract, and not the myriad of other value drivers, as predicted by the multitasking model of Holmstrom and Milgrom (1991). For example, paying an executive based on demographic diversity may discourage her from hiring White males who bring socioeconomic or cognitive diversity, or lead her to focus on diversity and not inclusion. Since only quantitative metrics can be put into a contract, ESG-linked pay may cause CEOs to focus on them at the extent of the qualitative. They'd hit the target, but miss the point.

For most drivers of long-term value, such as patents, net promoter score, and customer attrition, companies will report them—and scrutinize them very carefully, not just looking at whether they've gone up or down but understanding why. However, they'll stop short of linking pay to them. This should generally be the approach for ESG metrics.[2]

2.2 | The other motive for ESG

But there's an elephant in the room. I've explained that the main reason for the rise in ESG is its relevance to long-term value. Yet that's far from the only reason—we care about ESG because of the *externalities* it imposes on society. A 2013 Trucost report estimated the environmental costs created by business at $4.7 trillion per year, and this figure has likely soared since then (Trucost, 2013). Beyond the environment, business workplace practices can lead to burnout, physical injuries, and even deaths; whom companies hire and promote affects social inequality and inclusion. By definition, externalities don't affect a company's profits, even in the long run. Thus, ESG advocates argue that we should require companies to disclose externalities, so they can be held accountable for reducing them; tying CEO pay to externalities will further incentivize such a reduction.

But intangible assets also have substantial externalities: Haskel and Westlake's (2017) book on intangibles highlights "spillovers" and "synergies" as two of their defining features. An innovative new product creates consumer surplus above and beyond what customers pay for it, suppliers earn producer surplus from selling inputs for more than their cost, and competitors build on the innovation to launch their own versions. Training employees increases their human capital, and many of the benefits won't be captured by the firm providing the training: they may leave for a competitor, relocate for family reasons, or be more likely to find another job if their current employer shuts down—attenuating the large social costs suffered when a major local employer closes (e.g., Goldstein, 2017). Turning to a negative externality, a sluggish executive team can impose huge costs on society—Kodak went bankrupt after missing the digital revolution; it had been worth $31 billion to its shareholders at its peak and employed 150,000 people at one point.

Just as for financial returns, ESG shouldn't be treated differently from other drivers of social returns. One could justifiably argue that the externalities arising from some ESG issues, such as climate change, are particularly important, but this changes the magnitude of the response, not the type. All externalities are a market failure, and thus are best dealt with through government intervention to correct this failure. Governments can provide public goods themselves, or subsidize, tax, or regulate externality-producing activities, such as taxing carbon emissions, imposing minimum wages, and introducing diversity quotas. It's the government that is best placed to address these

[2] See Bebchuk and Tallarita (2022) for an extensive analysis of the potential problems with ESG-linked pay. The practice might be justified if there is one ESG factor that trumps all other factors, such as carbon emissions for an energy company, and there is little disagreement on how to measure it (Edmans, 2021).

externalities, since it's democratically elected by a country's citizens, whereas investors disproportionately represent the elites and thus may underweight, for example, the impact of decarbonization on blue-collar oil and gas jobs.

But real-life governments don't address all externalities. First, even if they're well-functioning, governments can't regulate qualitative factors such as corporate culture or management initiative, because they're hard to measure. Investors thus have a particular role to play in monitoring these issues, but can only do so effectively if they don't reduce them to simple numbers. The government should regulate all quantitative ESG issues, and so the only ones for investors to address are qualitative, highlighting the inconsistency of a metrics-driven approach.

Second, the government may not be well-functioning—it may fail to regulate externalities that the electorate cares about due to lobbying or sluggishness. As a result, companies could legitimately argue that they should pursue ESG, even it doesn't improve long-term value, due to its externalities. This is the one case in which this article's thesis no longer applies—ESG investing is different from investing, and ESG is different from other value drivers, because it's pursued to achieve societal goals even at the expense of shareholder returns. Then, the implications are quite different. Companies should be up-front that they're pursuing sacrificing shareholder returns to pursue ESG, and thus need a clear mandate from shareholders to do so. Investors may be happy to give such a mandate—pension funds might rationally sacrifice a few basis points of financial return to reduce a company's carbon emissions, because pensioners care not only about their income in retirement but the state of the planet. There is a trade-off, but shareholders believe that the trade-off is more than worth it. In turn, funds that intend to sacrifice financial returns to pursue societal goals should be transparent about this to their clients.[3]

We've discussed how the defining feature of ESG is not its link to long-term returns, nor its positive externalities, both of which are shared with intangible assets. If, instead, the defining feature of ESG is the fact that it's sometimes at the expense of long-term value, then it might not be put on such a pedestal.

3 | ESG FUNDS

Money is pouring into ESG funds. In 2020, $17.1 trillion ($1 in every $3 under professional management) was invested in ESG strategies in the United States—that is 42% higher than in 2018, and 25 times as high as in 1995—with similar growth around the world. Hartzmark and Sussman (2019) find causal evidence that investors flood into ESG funds with higher Morningstar globe ratings.

One reason for their popularity is the belief that ESG investing systematically outperforms. The United Kingdom's largest retail broker emailed all its clients claiming that "study after study shows that businesses with positive ESG characteristics have outperformed their lower ranking peers." The evidence is far more ambiguous than claimed (see the survey of Matos, 2020), but even if it were clear-cut, academic research has documented a huge number of other investment strategies that outperform (see, e.g., McLean & Pontiff, 2016). If savers are interested in alpha, then they shouldn't prioritize ESG over other characteristics that create alpha.

Of course, long-term financial returns aren't the only motive to invest in ESG funds. Another is to change company behavior—improve its ESG performance, thus creating more positive externalities. Impact can be achieved through two channels: exit and voice (see the surveys of Edmans [2014] and Edmans & Holderness [2017]). Exit involves divesting from an ESG laggard, driving down its stock price. Ex post, this increases its cost of capital and hinders its expansion; ex ante, the company might boost its ESG performance to avoid being sold (Edmans et al., 2022). However, this channel works for *all* measures of performance, not just ESG ones. Investing in innovative companies with great management teams and strong cultures helps them create more positive externalities, as well as encouraging firms to improve these dimensions in the first place. Voice involves engaging with a company through voting, private meetings, and—if necessary—public activism, to cut its carbon footprint or improve its employee diversity. Such actions can indeed create value for both shareholders and society (Dimson et al., 2015; Hoepner et al., 2022), but so can

[3] For example, Barber et al. (2021) find that venture capital funds with both societal and financial goals earn 4.7% lower returns than traditional funds.

engagement on other topics (Brav et al., 2015, 2018). Cutting unnecessary costs improves investor returns, reduces resource usage, and increases a company's resilience, but shareholders obtain far less credit for it than ESG engagement.

Regulators, the media, and investors are cracking down on ESG funds for not being ESG enough—for holding stocks in brown industries, and for sometimes voting against ESG proposals. But blanket divestment is often not the most effective way to improve corporate ESG behavior (Edmans et al., 2022) and many ESG proposals do not create long-term value (Gantchev & Giannetti, 2021). Even setting aside these concerns, funds should absolutely be held to account for doing what they say. Yet it's not clear why investors in non-ESG funds deserve any less protection. Any thematic fund claims to follow a strategy. Does the Jupiter Global Financial Innovation hold only companies that are truly financially innovative? Does the Capital Group New World fund only invest in the most frontier economies? Should a value fund be punished for buying stocks that aren't actually good value? What about a growth fund who owns firms that don't end up growing? Cooper et al. (2005) find that funds that changed their name to match current "hot" styles (e.g., adding "Cautious" in a downturn or "Growth" in an upswing) enjoyed abnormal inflows of 28% over the next year—even if their actual holdings didn't change.

And it's not just thematic funds that make pledges—*any* actively managed fund claims to beat the market. But a fund that underperforms the market 5 years in a row, costing its investors thousands of dollars in retirement savings, is unlikely to be as publicly shamed as a manager of a sustainable fund who opposes a high-profile ESG proposal. Funds that consistently underperform, actively managed funds that are closet indexers, and thematic funds that persistently deviate from their theme should be scrutinized as much as their ESG counterparts.

4 | ESG CONTROVERSIES

4.1 | ESG ratings

Viewing ESG as a set of long-term value drivers also helps defuse many of the controversies surrounding it. One is the significant disagreement between ESG rating agencies (Berg et al., 2022). Critics interpret this as evidence that rating agencies are failing—why can't they agree about a company's ESG, like S&P, Moody's, and Fitch do about creditworthiness? But reasonable people can disagree about the long-term value potential of a company's ESG—which factors are relevant (will companies suffer financially from producing electromagnetic radiation?), how to assess them (how inclusive is a company's corporate culture?), and the relative weight to put on each. An ESG rating isn't fact; it's opinion.

Credit ratings aren't a good analogy as there is no ambiguity on what they're trying to measure—whether a company will repay its debt. There might be different views on how to assess it, but the object of the assessment is clear. For ESG, it's not even clear which factors should be measured to begin with. The better analogy is to equity research reports, which also try to measure long-term value.[4] No one would argue that stock analysts can't do their job because Goldman Sachs says "Buy" and Morgan Stanley recommends "Sell." Indeed, another word for disagreement is "diversity," ironically something ESG advocates should embrace rather than lament. A diversity of opinion is far more informative than if everyone said the same thing. The main complaints are from ESG-by-numbers investors who want a single unambiguous ESG rating they can use for portfolio selection. But a mainstream investor would never automatically buy just because Goldman Sachs says so; she'd read the reports of different brokers, use her expertise to evaluate whose arguments are most convincing, and supplement them with her own analysis.

[4] The two main differences are that equity research studies the long-term value of a company from all sources, not just ESG sources, and also compares the estimated value to the current price to make an investment recommendation.

4.2 | ESG classifications

Prior to Russia's invasion of Ukraine, many investors considered defense companies as "non-ESG." Afterward, many did a hasty U-turn, rewriting their investment policies to redefine defense as ESG. A *Financial Times* article—"Are Defence Stocks Now ESG?"—describes this binary thinking. The less black-and-white we make our classifications, the less inflexible they'll be, and the less back-tracking we'll need to make if the world changes.

It makes even less sense to classify stocks as ESG or non-ESG when we view them through the long-term value lens. Some companies might have more value-creation potential than others, but it's a continuum, not a binary classification. Moreover, thinking of ESG as intangible assets reduces the temptation to see it in such a binary way. The value of any asset must be compared to its price. Yet many ESG advocates would give three cheers to environmentally friendly, diverse companies that donate generously to charity without any regard for its price, which can lead to ESG bubbles (as we've seen with electric cars).

Some ESG factors may be best thought of as risks rather than assets. However, risks must also be compared against their price. A common phrase is "climate risk is investment risk," and used to imply that investors are imprudent (from a purely financial perspective) if they don't completely decarbonize their portfolio. But if climate risk is priced in, as found by Bolton and Kacperczyk (2021), then investors earn a return for bearing that risk. Holding stakes in young firms, tech companies, and emerging markets bears investment risk, but that risk is compensated for by a return. If an asset manager wanted to avoid investment risk, it would ironically eschew clean energy and carbon capture. Even if ESG risks aren't fully priced in, they shouldn't lead to an investor automatically excluding an ESG laggard; it may remain a good investment if it has other valuable and unpriced intangible assets.

In 2021, Nasdaq aimed to prohibit firms without sufficient board diversity from listing on the market, claiming this would protect investors. The evidence for the value of board diversity is mixed or negative (Fried, 2021), but even if it were unambiguously positive, regulation wouldn't be needed to protect investors as nondiverse firms would trade at a discount. Even if they didn't, there'd be no more reason to regulate diversity than any other less-than-fully-priced drivers of value. It's not clear why a company with a diverse board but poor capital allocation, strategy, and innovation should be deemed investible but one with the opposite characteristics should not.[5]

Similarly, classifications into ESG and non-ESG buckets are typically based on current status rather than future potential. This highlights another problem with the metric-driven approach: metrics only capture what is happened in the past. Any analysis of long-term value would focus on a company's future potential; certainly, historic data are useful, but only to the extent it helps you forecast future cash flows. If ESG were viewed through the long-term value lens, assessments might not be so backward looking. Naturally, different investors (or rating agencies) may have different opinions about future performance, but this diversity is to be embraced rather than lambasted as inconsistent.

4.3 | The politicization of ESG

Recognizing that ESG is no more or less than a set of long-term value drivers will hopefully defuse the worrying politicization of ESG. ESG critics label its advocates as the woke Left; devotees accuse anyone who questions the value relevance of ESG as being a conservative corrupted by lobbyists. Reasonable people can disagree about how relevant a factor is for both financial and social returns, but views on ESG often move beyond opinion to ideology.

[5] One argument for regulating diversity in particular might be that it is easy to measure, and thus regulate. However, demographic diversity is a poor proxy for cognitive diversity, which many argue to be more relevant for firm value. Moreover, there are many measurable non-ESG factors that are positively or negatively correlated with firm value, such as diversification (Berger & Ofek, 1995; Lang & Stulz, 1994).

A senior ESG practitioner who teaches at a top university messaged me "Hiya Alex. You want to fight?! Me and Aswath Damodaran about to get in boxing match about his ESG takedown piece. Please consider co-writing a counterpoint op-ed with me?" But my initial instinct was not to fight; if someone dubbed the "Dean of Valuation" has a differing view on the relevance of ESG for valuation, I'd like to learn from it. A Managing Director at a large investment bank wrote to me: "See *The Economist* Special report on ESG this w/e—why do you think these papers give anti-ESG rhetoric oxygen? … They fan flames of the deniers." Yet those who recognize that ESG has cons as well as pros aren't necessarily driven by rhetoric; instead, they're able to see both sides of an issue. Most people aren't "believers" or "deniers"—language that focuses on ideology—but academics or practitioners who've developed their own view through a combination of evidence and experience.

It's unprofessional for ESG critics to label its supporters as "woke," or portray them as hippies with no clue about business—in contrast, understanding ESG is critical to understand the value of a business. Some ESG skeptics pat themselves on the back for crushing the woke crowd, when they should view their contribution as providing a different perspective on what creates long-term value. But respondents don't need to stoop to their level. One practitioner, whom I'll name Hugo, labeled concerns as "just complete BS" that spread "nonsense around ESG." A professor whom I greatly respect and whose writings I've learned a lot from called skeptics "Taliban" and "Flat Earthers"; he titled a separate article "A Tutorial On ESG Investing In The Oil And Gas Industry For Mr. Pence And His Friends." In addition to slighting the target audience, suggesting they needed a tutorial but others don't, it politicized the issue, implying that true conservatives should be anti-ESG, thus reducing the article's effectiveness. Research by the Yale Cultural Cognition Project (e.g., Kahan, 2015) finds that the more you associate an issue with an identity (such as climate change with political affiliation), the less persuasive your arguments are, as people base their view on their identity than your content. Another practitioner wrote "Thank heavens for this excellent piece from Hugo, who tells it like it is: "I don't know about you, but when I see the likes of Ted Cruz, Marco Rubio, Greg Abbott, Mike Pence, and Elon Musk railing against 'ESG', I know ESG must be doing something right." " But "telling it like it is" involves using arguments based on facts, data, and evidence, not telling other people off. The criterion for the success of ESG is whether it creates long-term value for shareholders and society, not whether it riles conservatives. (The piece by Hugo was called "Why the Right Hates ESG" and the strapline began with "It's all about them wanting to protect the fossil-fuel industry." Instead, skeptics may simply have healthy doubts, rather than hatred, and have reached their stance after considering both sides of the issue, rather than being oil and gas lobbyists.)

Unfortunately, many ESG supporters herald as heroes those who display the most extreme outrage rather than use the most convincing evidence. If you view ESG as understanding what drives long-term value, you celebrate the people who contribute most to your understanding, by helping you see both sides of an issue. But if you view ESG as a political fight, you cheer the people who fight most aggressively. Another academic wrote an article that ended with "Climate risk is investment risk. There is no credible other side, only an ideological opposition cynically seeking a wedge issue for upcoming political campaigns… Which side are you on?" But ESG is not a debate on which you have to take a "side"—it's a subject, just like business is a subject; people's stance on a subject should evolve with the evidence rather than being anchored on a side. To be closed to the possibility of valid concerns is contrary to a culture of learning, and to assume people who voice concerns are "cynically seeking a wedge issue" is itself cynical. It's surprising that academics contribute to this polarization since they should appreciate the value of scientific enquiry and the importance of listening to different viewpoints. Indeed, there's an entirely credible other side—many people believe the core problem is that climate risk is *not* investment risk, because the absence of a global carbon tax means that companies can pollute with few consequences.

One justification of a streetfighter approach is that ESG issues are so important to society that we need to get them right. But topics such as unemployment, free trade, and government spending also have huge impacts on both people and planet; academics have punched hard, but not below the belt. Critical fields such as environmental economics, health economics, and economics of children have been around for decades, and advanced through reasoned debate rather than hyperbole and point-scoring. It's precisely that ESG is so important that we need to use the best evidence

to guide us, which involves listening to other viewpoints—and doing so with the intent to understand, not the intent to reply. Doing so isn't betraying our ideals; as is commonly attributed to Aristotle, "it is the mark of an educated mind to be able to entertain a thought without accepting it." Even if 90% of what skeptics say is wrong, in our eyes, 10% might be right, and that 10% means we come away more informed than we were beforehand. But if ESG is a political issue, we see any counterargument as a threat to our identity, just like a different perspective on abortion or gun control. Both sides can do better.

5 | IMPLICATIONS FOR RESEARCH

Viewing ESG through a long-term value lens has several implications for academic research. The first is to be *more broad*. The long-term value lens highlights how we can study issues because they create value, regardless of whether they fit into an ESG bucket—indeed, I stumbled into ESG by exploring whether investors can support companies' pursuit of the long term, and whether intangible assets are priced by the market. Sometimes, intangible assets other than ESG may be more relevant for answering a particular question—for example, a company's responsiveness to a changing economic environment might depend on its human, organizational, or innovation capital more than its ESG. Similarly, a broader perspective might warn us that a certain research topic is less promising as it's already been addressed in a general context. Lots of ink has been spilled repeating widely documented results for the specific case of ESG. For example, it's well known that scandals worsen a CEO's reputation, so it's not too surprising that ESG scandals do too. If there's no clear reason why a result might not automatically extend to ESG, the contribution from explicitly extending it is relatively minor.

As we've discussed, a major reason for the rise in ESG is its impact on externalities, yet externalities aren't unique to ESG. Future research can similarly study the externalities created by companies and investors, even if their actions don't fall under the ESG umbrella. This may involve studying the impact of corporate decisions on other stakeholders (e.g., Bernile & Lyandres [2019], Cunningham et al. [2021], and Testoni [2022] for M&A) or the spillover effects of engagement from non-ESG investors (e.g., Agrawal & Tambe [2016], Bernstein & Sheen [2016], Cohn et al. [2021], and Fracassi et al. [2022] for private equity).

The second is to be *more granular*. Sweeping questions such as "Does ESG work?" are unlikely to be fruitful. No scholar would write a paper entitled "Does investment pay off?" because it depends on what you're investing in; similarly, the value relevance of ESG depends on the type of ESG. ESG is an umbrella term, capturing many potentially contradictory factors. E and S is primarily about stakeholders, whereas G often ensures that managers act in shareholders' interest (rather than their own). Closing a polluting plant is good for the environment, but bad for employees (an S factor). In Edmans (2011, 2012), I had to explain why I was studying employee satisfaction and *not* other ESG factors—because there's a strong theoretical motivation for its link to long-term returns. Similarly, future research could focus on the ESG dimensions most relevant for the research question being studied. Yet empiricists often use aggregate ESG scores, even if the question or identification strategy focuses on a specific issue. For example, a paper might study how a company's response to climate change news depends on its ESG rating. However, it may only be the E dimension that's relevant—and, within that E score, the components most relevant to climate change rather than other environmental factors such as noise pollution. Few reseachers would use aggregate ESG scores to measure governance, yet many do so to gauge environmental performance.

Granularity applies not only to the variables studied, but also to the implications claimed. A research paper should not have ESG in its title or abstract unless it pertains to all three ESG dimensions. For example, a theory model where investors have tastes for non-financial factors, which they trade-off against financial returns, could apply to environmental and social preferences. However, it's unlikely to apply to governance, as investors typically pursue

governance for the exclusive objective of improving returns. Thus, it's a model of ES investing or SRI, rather than ESG investing.[6]

The third is to be *more situational*. While granularity is about focusing on specific ESG dimensions, situationality involves studying the contexts in which a relationship holds and, equally importantly, where it doesn't. An early attempt was Khan et al. (2016), who claimed that ESG factors are only linked to long-term returns if they are material for a company's industry. While Berchicci and King (2022) later showed that these results disappear under different modelling choices, Khan et al.'s hypothesis that the value of ESG is situation specific was worth testing. Edmans et al. (2022) document that employee satisfaction is positively associated with long-term stock returns in countries with flexible labor markets, but not those with rigid labor markets, potentially because regulations already ensure a minimum standard for worker welfare.

Moreover, if ESG is like any other asset, then companies may overinvest in it—Servaes and Tamayo (2017) use "social capital" to describe some dimensions of ESG, and the return on any form of capital can be below its cost. Thus, the value created by ES may depend on G—Krüger (2015) finds that the market responds negatively to positive ES events that are likely to result from agency problems. Similarly, research can relate governance to ES practices, without ascertaining whether they are positive or negative for firm value. For example, Cronqvist et al. (2009) find that entrenched CEOs pay higher wages.

The fourth is to be *less monotonic*. Many papers use an ESG variable assuming that more is always better (even within the same context)—higher ESG scores, more frequent votes for ESG proposals, or tying pay to more ESG metrics. But, as discussed, companies can overinvest in ESG (Masulis & Reza, 2015), and investors might overly micromanage it (Gantchev & Giannetti, 2021). Moreover, in addition to U-shaped or hump-shaped results, insignificant results can significantly advance knowledge—as is commonly attributed to Thomas Edison, "I have not failed. I've just found 10,000 ways that won't work." To help companies and investors focus on the drivers of long-term value, it's important to identify the factors that are unrelated to long-term value. However, under the ESG lens, we'd torture the data to squeeze out unambiguously positive or negative results, to attract the attention of ESG cheerleaders or naysayers.

The fifth is to be *less quantitative*. This, in turn, can lead to research in two directions. One is to gather qualitative ESG assessments, such as the Best Companies to Work For survey, just as qualitative analysis has been used for other indicators of long-run value (see Loughran & McDonald [2016] for a survey of the research on textual analysis). Given that some investors are adopting ESG-by-numbers approaches, qualitative factors are particularly likely to be mispriced by the market and thus associated with long-term returns. The other is to still use numerical data, but to pay attention to quality rather than just quantity. Using an example on intangible assets rather than ESG, Cohen et al. (2013) measure the quality of innovation based on the payoffs from past R&D expenditures. This quality-based measure significantly predicts future stock returns, while the mere quantity of R&D spending does not.

The final potential direction is to *consider interactions* between ESG and other drivers of long-term value. If putting ESG on a pedestal leads to companies paying less attention to these other factors (similar to Schoar's [2002] "new toy" effect when firms diversify away from their core business), then ESG might be a substitute for other intangible assets such as innovation. In contrast, if a focus on ESG encourages management to look beyond short-term earnings to long-term value more generally, then it may complement other intangibles.

6 | IMPLICATIONS FOR TEACHING

Some business school rankings are now evaluating the ESG content of courses, for example, by asking core professors to report how many hours they dedicate to ESG. There are several problems with this practice, which parallel those for business.

[6] How does "more granular" square with the suggestion to be "more broad"? The latter highlights the value of considering factors outside the ESG umbrella; the former emphasizes the importance of considering a focused set of factors—either a focused set of ESG factors or non-ESG factors.

First, it reinforces the impression that ESG is niche; courses need separate teaching hours tailored to ESG since the core material just isn't relevant. This is incorrect. As we've discussed, a basic principle of Finance 101 is that a company is worth the present value of *all* its cash flows. Thus, a carbon capture project or a wind farm can be analyzed by established finance techniques. Indeed, it can be justified by them—Finance 101 stresses how projects should be evaluated with NPV, taking into account all future cash flows, rather than the payback period or accounting rate of return, which focus on the short term. Another basic finance principle is that the relevant risk of a project is not its idiosyncratic risk, its risk in isolation, but systematic risk that is correlated with the rest of the economy. Climate solutions bear significant technological risk. But whether the technology fails or succeeds is unlikely to depend on the state of the economy; moreover, since these solutions are crucial for humanity, the need for clean energy should not be sensitive to whether we're in a boom or recession. Teaching these core finance principles really, really well may encourage the future leaders of this world to invest in ESG more than dedicated ESG content would.

Certainly, there's a huge wealth of ESG-specific material that won't be covered in the standard core, such as ESG regulations and data sources. But such material may be better suited for electives. Particularly in a core class, carving out specific ESG material may backfire. It gives the impression that the core business principles, which have been researched and taught for decades, don't apply to ESG, and so an executive or investor who wants to prioritize ESG has to swing in the wind. It also suggests that ESG is a separate topic from creating long-term value, and so it's only relevant for students who want ESG jobs.

A second concern is that the ranking inputs are entirely self-reported, and thus prone to greenwashing. A finance professor could teach how to calculate NPV of a car factory. Simply by adding a single word, so that it now becomes the NPV of an electric car factory, without changing any of the cash flows, he can now claim he's teaching ESG. Or he can change the name of a protagonist in a case study to minority and count this as diversity and thus "S" content. Such a superficial way to evaluate courses will allow schools to move up the rankings through window-dressing, rather than actually improving the content of their courses.

Third, rankings are entirely right to scrutinize the quality of business school teaching. But to adapt a phrase from earlier, as a society we want great teaching, not just professors who teach ESG. There are far more critical ways to improve teaching than adding more ESG content (see Edmans, 2022). Most business schools put very little weight on teaching in tenure evaluations; some even put a negative weight, at least implicitly, by assuming that if you're winning teaching awards you can't be serious about research. Teaching ratings predominantly reward entertainment and popularity rather than challenging and stretching students. They're also given straight after the course, rather than at the end of the degree that would allow students to evaluate whether core classes provided a good foundation for the electives, job interviews, and internships—indeed, one of the core principles of ESG is the importance of long-term outcomes. There are no ratings for whether your teaching is based on rigorous academic research; whether it uses current, real-life examples; and whether it's practical rather than just theoretical. If you teach the CAPM, you best create social value by teaching the CAPM really, really well—explaining where to get the inputs in the real world, when they're not handed to you in a homework problem; discussing what to do when the CAPM assumptions don't apply, such as investors being undiversified; and explaining how to make decisions when the CAPM predictions don't hold, such as the market being overvalued or undervalued.

Finally, rewarding core professors for teaching ESG disrespects the topic, by suggesting that anyone can teach it, regardless of expertise. One business school ranking has added the question "How many of your core teaching hours contain climate solutions for how organizations can reach net zero?" Net zero is indeed important, but it's so important that it shouldn't be taught by a professor who reads Wikipedia for an hour to create a couple of new slides. How to reach net zero is extremely complex and many solutions are technological ones that should be taught by climate scientists or engineers. There are certainly finance-related elements, but challenges such as the difficulty in even measuring "net" or "zero," the potential conflict between net zero and asset manager fiduciary duty (see Gosling & MacNeil, 2022), and the trade-off between net zero and other ESG issues, such as mass unemployment of energy sector workers, many of whom can't easily be retrained, require expertise. Schumacher (2020) coined the term

"competence greenwashing" to describe non-experts claiming to be authorities on ESG; this can apply both to professors teaching ESG material with limited knowledge of ESG research and practice, or practitioners highlighting their ESG certificates (sometimes awarded for courses taught by such professors). Artificial intelligence, machine learning, and FinTech are also very important topics for the future, and thus could be considered core, but not all core professors should teach them.

Moreover, for the ESG issues that are finance related, finance expertise is needed to teach them correctly. The professor who claimed that "Climate risk is investment risk. There is no credible other side" is a leading expert in other business fields, but has not published any papers in finance. As discussed earlier, Finance 101 tells us that risks are rewarded, so there's no financial reason to avoid emitting companies. Extremism and refusal to consider other viewpoints are sometimes used to compensate for lack of expertise.

7 | CONCLUSIONS

ESG is both extremely important and nothing special. It's extremely important since it affects a company's long-term shareholder value, and thus is relevant to all academics and practitioners, not just those with ESG in their research interests or job title. It also affects a company's impact on wider society. This is relevant for anyone who cares about more than just financial returns, as well as for ensuring that capitalism works for all and safeguarding the public's trust in business.

But ESG is also nothing special. It shouldn't be put on a pedestal compared to other intangible assets that affect both financial and social value, such as management quality, corporate culture, and innovative capability. Like other intangibles, ESG mustn't be reduced to a set of numbers, and companies needn't be forced to report on matters that aren't value relevant. Funds that use ESG factors to guide stock selection and engagement shouldn't be lauded over those who study other value drivers, and investors in the latter deserve the same protection. We can embrace differences of opinion about a company's ESG performance just as we do about its management quality, strategic direction, or human capital management. And, perhaps most importantly, ESG needn't be politicized. Aggression and hyperbole are signs of weakness, not strength; as Karl Popper noted, "Whenever a theory appears to you as the only possible one, take this as a sign that you have neither understood the theory nor the problem which it was intended to solve." Instead, reasonable people can disagree with each other about the factors that create value for both shareholders and stakeholders. More than that, they can learn from each other, thus enriching our knowledge on some of the biggest challenges facing business and society today.

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