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ESG Investing: A Skeptical Look

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"We are going to the zone where the positive impact of the ESG buzz on prices is coming to the end of its cycle. Soon we will be at the stage where the relationship between ESG and performance will be negative as it [logically] should be."
— Abraham Lioui, Edhec Business School

Introduction

Environmental, Social, and Governance (ESG) investing has become one of the most debated trends in finance over the past two decades. Promoted as a way to align your investment portfolio with your values—or as a tool to manage non-financial risks—ESG investing is everywhere: in mutual funds, ETFs, and even in the marketing of blue-chip companies. But does it live up to the hype? Is it truly different from the "socially responsible investing" (SRI) movements of the past? Let's take a clear-eyed look at the data, the history, and the behavioral realities behind ESG, with an eye toward what matters for individual investors.

The Roots: From Socially Responsible Investing to ESG

Long before ESG became a buzzword, investors were already trying to align their money with their morals. Socially responsible investing traces its modern roots to the 1950s and 1960s, when religious groups and activists began avoiding "sin stocks" like tobacco, alcohol, and weapons manufacturers. The Vietnam War, civil rights, and environmental disasters in the 1970s and 1980s—think Bhopal, Chernobyl, and Exxon Valdez—fueled the movement further. SRI funds like the Pax World Fund (1971) and the Domini Social Index (1990) gave investors a way to avoid companies they found objectionable, while shareholder activism sought to change corporate behavior from within[214].

But SRI faced a persistent problem: performance. Excluding large swaths of the market often led to portfolios that lagged broader indices, especially in bull markets driven by the very sectors SRI avoided. As a result, SRI remained a niche for decades, with many investors concluding that "doing good" often meant earning less[2].

The Rise of ESG: Systematizing Non-Financial Risks

ESG investing emerged in the early 2000s as an attempt to move beyond values-based exclusions. The United Nations' 2004 "Who Cares Wins" report introduced the ESG framework, arguing that environmental, social, and governance factors could be material to long-term financial performance[114]. The idea was to systematically measure and manage risks—like climate change or labor disputes—that traditional financial analysis might miss.

By 2006, the UN Principles for Responsible Investment (PRI) formalized ESG as a global movement, attracting large institutional investors and asset managers. The pitch shifted: ESG wasn't just about ethics, but about prudent risk management and the potential for better risk-adjusted returns[114].

ESG, SRI, Sustainable, Impact: A Confusing Alphabet Soup

Today's sustainable investing landscape is a tangle of overlapping terms:

- **SRI (Socially Responsible Investing):** Traditionally values-driven, focused on exclusions.
- **ESG Investing:** Seeks to systematically assess non-financial risks and opportunities.
- **Sustainable Investing:** A broad umbrella, sometimes used interchangeably with ESG, sometimes not.
- **Impact Investing:** Targets measurable positive social or environmental outcomes, often with private equity or debt.

This confusion isn't just academic. The lack of standard definitions means that two "ESG" funds might have wildly different holdings, methodologies, and objectives[13].

How ESG Strategies Work: Exclusionary vs. Best-in-Class

The two main approaches to ESG investing are:

- **Exclusionary (Negative Screening):** Avoids companies or sectors deemed harmful (e.g., fossil fuels, tobacco, weapons, gambling). This is the direct descendant of SRI[5615].
- **Best-in-Class (Positive Screening/ESG Integration):** Invests in companies that are leaders on ESG criteria within their industry, regardless of sector. This approach often results in portfolios that look very similar to broad market indices, with only modest tilts toward or away from certain companies[5616].

Approach	How it Works	Typical Outcome
Exclusionary	Removes “bad” sectors/companies	Misses entire industries
Best-in-Class	Picks ESG leaders in each sector	Looks like broad index, minor tilts

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ESG Indices: Different Name, Same Portfolio?

A common criticism is that many ESG funds and indices are little more than rebranded versions of the S&P 500 or MSCI World, with a handful of exclusions or small weight changes[717]. Academic studies comparing ESG indices to conventional benchmarks over three- and five-year periods find little to no significant difference in performance or sector composition[717]. In other words, you may be paying higher fees for a product that behaves almost identically to a plain-vanilla index fund.

The Data Dilemma: Confusion and Contradiction in ESG Ratings

One of the most glaring problems with ESG investing is the lack of agreement over what “good” ESG performance even means. Different ESG ratings agencies—MSCI, Sustainalytics, S&P, ISS, and others—use different criteria, weights, and data sources. This leads to huge divergences in ratings for the same company[818].

Tesla's Case Study: In 2022, Tesla was dropped from the S&P 500 ESG Index, despite being a leader in electric vehicles and decarbonization. S&P cited concerns over workplace practices, governance, and accident investigations. Meanwhile, ExxonMobil remained in the index, leading to widespread confusion and criticism[9,19]. Sustainalytics and other raters also gave Tesla low marks on social and governance, despite high environmental scores.

This isn't an isolated case. Studies show that correlations between ESG ratings from different providers are often as low as 0.5 or below, and sometimes even negative[8]. A company might be a top ESG pick for one fund and a pariah for another.

Greenwashing: When ESG Is Just Marketing

With the explosion of ESG-branded funds, the temptation for "greenwashing"—making exaggerated or misleading claims about sustainability—has grown. Regulators and investors have flagged numerous cases where funds or companies marketed themselves as ESG-friendly without meaningful changes to their actual practices[11,12].

Examples include:

- **H&M:** Sued for promoting a "Conscious Collection" that was no more sustainable than its regular products[12].
- **Decathlon:** Penalized for vague and unsubstantiated sustainability claims[12].
- **Investment Funds:** Studies of fund disclosures reveal widespread inconsistencies, omissions, and confusing terminology, making it hard for investors to know what they're really buying[11].

This undermines trust and makes it difficult for investors to align their portfolios with their values or sustainability goals.

Whose Values? The Challenge of Personalization

Perhaps the most intractable problem for ESG and SRI is that everyone's values are different. Some investors want to avoid fossil fuels, others care more about labor practices or animal welfare. For every investor who wants to exclude defense stocks, there's another who sees them as essential. No single ESG or SRI product can satisfy all preferences[13].

This fragmentation makes it hard for ESG funds to find a broad audience, and may explain why flows into ESG products have slowed or reversed in some regions since 2022, especially in the U.S.[3].

Performance: Does ESG Add Value?

The evidence on ESG performance is, at best, mixed. Some studies and fund reports claim that ESG funds have matched or outperformed conventional funds, especially during periods of market stress[4]. However, longer-term and broader academic analyses find no consistent performance advantage for ESG strategies; in fact, the differences are often negligible[7][17][13].

A key reason is that most ESG funds are highly diversified and closely track the market, so any "ESG premium" is diluted. Moreover, the lack of standardization in ESG ratings and methodologies makes it almost impossible to draw clear conclusions about performance[13].

Recent Performance: 2022–2024

2022:
ESG funds notably struggled during 2022. The underperformance was largely attributed to style biases: ESG portfolios tend to overweight growth sectors like Technology and underweight value sectors such as Energy and Financials. When value stocks outperformed growth—as they did in 2022—ESG funds suffered. This sector tilt, combined with a general market pivot away from growth, led to ESG funds lagging their conventional peers[1].

2023:
The trend continued in 2023. According to Man Group research, the average Article 8 ESG fund in Europe underperformed its stated benchmark by 0.84%, while the more restrictive Article 9 funds lagged even further. Active ESG managers, in particular, struggled relative to both their non-ESG peers and their benchmarks. Several factors contributed, including poor performance of ESG-favored stocks, sector exposures, and rising anti-ESG sentiment[3].

2024:

Morgan Stanley's "Sustainable Reality" report found that sustainable funds underperformed traditional funds in the second half of 2024 for the first time since early 2022. Median returns for sustainable funds were 0.4%, compared to 1.7% for traditional funds in H2 2024. Sustainable funds investing globally and in Europe underperformed their traditional peers by 25 and 42 basis points, respectively. Equities were the weakest asset class: sustainable equity funds returned just 0.7% versus 3.4% for traditional equity funds[49].

Fund Type	Median Return (H2 2024)	Traditional Fund Return	Underperformance
Sustainable Equity	0.7%	3.4%	-2.7%
Sustainable Fixed	0.6%	1.4%	-0.8%
Sustainable Other	-0.2%	1.1%	-1.3%

Long-Term Evidence: 10-Year and Academic Studies

A 2019 analysis by the Pacific Research Institute reviewed 18 ESG funds with a 10-year track record and found that a $10,000 investment in an ESG portfolio would be 43.9% smaller after ten years compared to an S&P 500 index fund. Only two of the 18 funds outperformed the S&P 500 over the decade. The study also highlighted higher risks (less diversification) and higher fees for ESG funds, both of which eroded returns further[8].

A 2024 Fraser Institute study, tracking 310 companies on the Toronto Stock Exchange from 2013 to 2020, found no statistically significant relationship between ESG rating changes and stock market performance. This suggests that ESG ratings, as currently applied, are not predictive of future returns—and that ESG investing does not reliably produce above-average results[7].

Academic reviews reinforce these findings. Many studies, including those by Avramov et al. (2021), Fama and French (2007), and Berk and van Binsbergen (2021), show a negative expected return relationship for ESG investments in equilibrium models. Empirical evidence is mixed, but several studies (e.g., Baker et al. 2022, Bolton and Kacperczyk 2021, Hong and Kacperczyk 2009) find that "green" firms underperform "brown" firms over time[5].

Why the Underperformance?

- **Sector Bias:** ESG funds often underweight sectors like energy, financials, and sometimes technology. When these sectors outperform, ESG funds lag[13].
- **Higher Fees:** ESG funds typically charge higher expense ratios than index funds, further eroding net returns[87].
- **Less Diversification:** ESG portfolios are often more concentrated, increasing risk without a corresponding increase in return[8].
- **Style Cyclicality:** ESG strategies tend to favor growth stocks, which can underperform in certain market environments[13].

Behavioral Realities: Value vs. Values

A final source of confusion is the dual motivation behind ESG investing:

- **Value-based:** Seeking better risk-adjusted returns by considering ESG risks.
- **Values-based:** Wanting to align investments with personal ethics or social goals[13].

These motivations often get mixed up, leading to unrealistic expectations or disappointment when ESG funds don't deliver either superior returns or perfect alignment with personal values.

Points to Remember

- ESG investing grew out of SRI's exclusionary roots, but now includes a confusing mix of approaches and definitions.
- Many ESG funds closely resemble conventional indices, with only minor tilts or exclusions.

- There is no consensus on what constitutes "good" ESG performance. Ratings for the same company can vary dramatically depending on the provider.
- Greenwashing is widespread, with many funds and companies making sustainability claims that don't stand up to scrutiny.
- The diversity of investor values makes it impossible for any one ESG product to satisfy everyone.
- Long-term data shows little to no consistent performance advantage for ESG strategies over conventional investing.
- Investors should be skeptical of ESG marketing claims and focus on transparency, methodology, and alignment with their own priorities.

Actionable Insights for Individual Investors

If you're considering ESG investing:

- **Read the fine print:** Understand exactly how a fund defines and implements ESG. Don't rely on labels.
- **Check the methodology:** Look for transparency in how ESG scores are calculated and what data is used.
- **Align with your values:** If exclusions matter to you, consider building a custom portfolio rather than relying on generic ESG funds.
- **Watch the fees:** Don't pay extra for ESG funds that simply mirror the market.
- **Stay skeptical:** Remember that ESG is a work in progress, with many unresolved issues around definition, measurement, and impact.

Conclusion

ESG investing's promise remains largely unfulfilled. For individual investors, the best approach is to stay informed, ask tough questions, and recognize that, for now, ESG is more about marketing and marginal tweaks than about transformative change or superior returns.

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