RETIREMENT

Should The SEC Ban ESG Funds?

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Oct 12, 2022, 09:20am EDT

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In the mid-1990s, a plethora of regional mutual funds popped up across America. Today, when you think of a “regional” fund, you think of broad global regions. But, three decades ago, a “regional” fund might have also referred to so-called “cheerleader” funds that promoted a particular state in whole or part.

Think of these as something the local Chamber of Commerce might support. These funds were designed to advance the social good of a community. The SEC required these funds to specifically define the criteria for potential investments, including the geographic footprint (whether by state or county) as well as how a security would qualify to be included in that geographic area.

Likewise, and popular a decade or so earlier, "SRI" funds popped up. Primarily but not exclusively used to encourage investing in anti-Apartheid companies, this form of "Socially Responsible Investing" specifically delineated which companies qualified as potential investments.

Over time, these funds faded away as investors preferred higher returns to perceived moral principles or even boosting their hometowns.

Today we have a powerful marketing phenomenon known as "ESG." This push elevates "environmental," "social," and "governance" factors when evaluating products and purchasing decisions. These include investment decisions.

Whenever you mix "marketing" and "investing," you increase the risk of misleading investors. Perhaps that's why the SEC last spring announced it would be examining disclosure requirements for funds marketing themselves under the ESG banner. In that press release, SEC Chair Gary Gensler said (in part), "ESG encompasses a wide variety of investments and strategies. I think investors should be able to drill down to see what's under the hood of these strategies. This gets to the heart of the SEC's mission to protect investors…"

Rather than repair with disclosure, given the current state of confusion regarding ESG, perhaps the SEC should consider

prohibiting funds from using the term "ESG" from its prospectus and other marketing material.

"It cannot be fixed," says Terry Morgan, President of Ok401k in Oklahoma City. "ESG is the most un-American poisonous ambiguous philosophy to ever come to the investment world since CDOs funded by junk mortgages."

Does ESG investing really make a difference?

Yet, the allure of ESG taps into the conscience of the investing public. According to Morningstar, the number of funds increased five-fold over the last ten years (ending in 2021). More impressively, assets have grown by more than four times in the last three years.

But does ESG investing really make a difference?

Sanjai Bhagat is Provost Professor of Finance at the University of Colorado, and author of *Financial Crisis, Corporate Governance, and Bank Capital*, citing research done by the University of Chicago based on Morningstar sustainability ratings, recently wrote in the *Harvard Business Review*, "Although the highest rated funds in terms of sustainability certainly attracted more capital than the lowest rated funds, none of the high sustainability funds outperformed any of the lowest rated funds."

Performance alone doesn't measure the value of an ESG fund. For the most part, investors want to make a statement with their investments.

Is that statement being made?

Mark Neuman, based in Atlanta and CIO and Founder of Constrained Capital which just launched the ESG Orphans ETF

(ORFN), says, “70-80% of ESG funds hold Amazon AMZN +0.6% (AMZN), which has the top global carbon footprint and is the #3 holding at ESGU ESGU -0.2% and ESGV ESGV -0.2% (Blackrock’s and Vanguard’s ESG flagships respectively).”

It’s not just popular tech companies. You can often find long-vilified stocks scoring high in sustainability rankings.

“Tobacco companies are commonly understood as not fitting into Socially Responsible Investing portfolios, but Philip Morris has a higher Environment Risk Score than Tesla (per Sustainalytics),” says Jason R. Escamilla, Founder and CIO of ImpactAdvisor in San Francisco. “One might feel the same about Big Sugar.”

On that last point, Neuman agrees. He says, “Nuveen prioritizes dividends over ESG with its Large Cap ESG Fund, as Coke and Pepsi are its top two holdings. Type-2 diabetes and obesity cost our society over $1 trillion a year, vending machines in kids’ schools are filled with these sugary sodas, and the soft drinks generate plastic bottles that aren't environmentally friendly.”

Now, before you get too critical, consider how this same “expansion of definition” appears in other investing disciplines, too.

Mark Sievers, President of Epsilon Financial Group, Inc. in Fairfield, California, says, “This is a situation similar to other approaches, for example, when Value investing migrates to holdings which are not Value, or only Value by some rather odd definition.”

What are the disadvantages of ESG?

It’s inconsistencies like this that have investors wondering if the bloom might be off the ESG rose. For one thing, when you see fossil

fuel companies in the last few years popping up in ESG funds, it's natural to wonder why.

"ESG Funds—'Environmental, Social, and Governance'—sounds great, but have you ever tried spreading ideals on a cracker?" says Harold Evensky, Founder of Evensky & Katz in Lubbock, Texas. "It doesn't work. First, without specific criteria, you have no idea what will be in the portfolio. You may be investing in a pig in a poke. Next, returns may be a tad volatile. Just look at Gabelli ESG Fund's 1-year returns. Returns of the largest ten positions ranged from -0.75% to -36%. Finally, ESG investments tend to have relatively high expense ratios."

Again, you don't want to emphasize performance with ESG because you're not picking investments based on financial analysis; you're selecting them based on philosophy. Ironically, better performance returns in the last few years may have spoiled ESG investors.

"The real issue is that no ESG fund can promise to 'beat the market,'" says Sievers. "The investor must realize the tradeoff by overlaying their personal preferences on their investing. There is a cost."

One of the oldest SRI/ESG funds, the Ave Maria flagship fund, once touted for its outstanding performance, has lagged its benchmarks over the last ten years.

"Religious funds may be more SRI than others because they tend to tell investors the truth, such as Islamic finance vehicles that know that returns will be less than non-Islamic funds because there's a cost to being virtuous, which investors know up front," says Neuman.

Of course, there might be a flipside to poor performance. Bhagat pointed out, “when managers underperformed the earnings expectations (set by analysts following their company), they often publicly talked about their focus on ESG.”

Is it good to invest in ESG funds?

More to the point, the terms embedded with ESG have become so slippery they no longer have any real meaning.

Neuman says, “There is no consensus on anything ESG and no accurate way to measure the collective E, S, or G as parts or as a whole. The fix is for all ESG funds to tell the truth—you can ‘do good’ in your ESG investments, but there’s a cost in that lower returns, and the objectives still may not be met.”

Just as SRI evolved into ESG, it’s possible ESG, when it runs its course, may evolve into something else, something that resolves some of the significant issues.

“ESG/Impact/Responsible Investing is still developing,” says Escamilla. “With ESG, the biggest flaw is the lack of a single definition—the concept represented by the letters ‘ESG’ differs widely among investment professionals, politicians, retail investors and Elon Musk. Tesla has been the single most important force in the electric vehicle transition for decades. But its low ‘G’ and ‘S’ scores got the company kicked out of the S&P 500 ESG index.”

Of course, there are those who believe Tesla’s removal from the index had less to do with the company’s ESG scores and more to do with Musk’s politics. The potential for vindictive subjectivity presents a real problem for ESG investing.

“As time goes on, it is likely that more and more industries will be excluded from ESG lists, and that ESG approved companies will be

‘government approved/government favored’ companies, not necessarily acting in the best interests of the stockholders,” says Doug Rongo, Owner at Blue Ridge Wealth Services in Hickory, North Carolina.

Is ESG investing greenwashing?

The current emphasis on ESG may present perverse opportunities to publicly traded companies. The temptation to give customers what they want may lead to what has been termed “greenwashing.”

Allison Herren Lee, former Acting Chair of the SEC, wrote several months ago, “‘greenwashing,’ or exaggerated or false claims about ESG practices… can mislead investors as to the true risks, rewards, and pricing of investment assets.”

Yes, you need to ask the question as to whether a company’s “ESG” claims can be confirmed, but that’s not the only thing you should be asking. This same circumstance can happen with mutual funds, albeit in a different manner.

“The more interesting question,” says Sievers, “is whether the prospectus agrees with the actual holdings. Also, does a stock meet one metric but violate another?”

During periods of good performance, nobody pays attention to things like greenwashing. But once performance sours, that’s when investors seek their pound of flesh.

Indeed, the Harvard Law School Forum on Corporate Governance has suggested greenwashing is such a serious breach it poses the potential of serious litigation risk.

Should the SEC Ban ESG Funds?

So, why not just head this all off at the pass? The SEC can do this simply by banning the use of the term "ESG" and any of its derivatives from a fund's prospectus and marketing material.

A. Seddik Meziani, Professor of Finance in the Department of Accounting & Finance at the Feliciano School of Business in Montclair, New Jersey and whose ETF research includes looking at ESG funds, says, "Although ESG-focused funds admittedly don't do well in terms of their compliance with regard to ESG factors, we shouldn't, so to speak, throw out the baby with the bath water. Banning them altogether is quite extreme when the issuance by the SEC of some rule proposals establishing a clear and sturdy framework for their use could largely suffice."

This is precisely what the SEC hopes to achieve.

"Banning ESG funds seems like overkill, but the SEC is understandably concerned that the imprecise scope of ESG funds makes investment in them potentially misleading to investors," says Marcia S. Wagner of The Wagner Law Group in Boston. "If a fund labels itself as an ESG fund, it needs to state with some precision what it is taking into account with each of these factors and how it is weighing them."

One solution might be to require very specific criteria or investment methodology to be listed in the fund's prospectus. For example, the long-running Ave Maria Fund states it "is designed to avoid investments in companies believed to offer products or services or engage in practices that are contrary to core values and teachings of the Roman Catholic Church."

The fund's prospectus further specifies, "The Catholic Advisory Board sets the criteria for screening out companies based on religious principles. In making this determination, the Catholic

Advisory Board members are guided by the magisterium of the Roman Catholic Church. The magisterium of the Roman Catholic Church is the authority or office of the Roman Catholic Church to teach the authentic interpretation of the Word of God, whether in its written form or in universal faith and moral practices. This process will, in general, avoid four major categories of companies: (i) those involved in the practice of abortion; (ii) those whose policies are judged to be antifamily, such as companies that distribute pornographic material; (iii) those that contribute corporate funds to Planned Parenthood; and (iv) those that support embryonic stem cell research."

Granted, as mentioned, the Ave Maria equity funds have lagged their benchmarks over the last ten years, but for some investors, these moral principles are worth the price.

It should also be noted, and like many regional funds, the Ave Maria Fund does not reference either "ESG" or "SRI" in its prospectus.

Perhaps that's the model other funds should use.

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