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First and foremost, I would like to thank my family for their never-ending support. Thank you for encouraging me to find my passions and to pursue them to the best of my ability. Thank you for always pushing me to do my best. I would also like to extend my appreciation to Dr. Kevin Sylwester for mentoring this thesis. Dr Sylwester has challenged me many times to better understand the complex relationship between business, economics, and the environment. I would also like to thank my many finance and environmental study professors whose knowledge and shared experiences have greatly enhanced my undergraduate experience. The University has invested in my education in multiple ways, and I would be remiss to not thank them for the honor of receiving the Excellence Scholarship. I am extremely grateful to the University Honors Program that encourages diversity of thought, inclusion of multiple disciplines, and broader thinking for the sake of problem-solving real-world issues. Their approach to interdisciplinary education has positively impacted me and helped me to define my career aspirations.

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ESG Investing is a Fiduciary Duty

Katherine Held

A thesis submitted to the University Honors Program in partial fulfillment of the requirements for the Honors Certificate with Thesis.

Approved by

Dr. Kevin Sylwester

Professor, Interim Director of the School of Analytics, Finance, and Economics

Southern Illinois University, Carbondale

December 2022

Acknowledgements

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Biographical Note

Katherine Held is a senior at Southern Illinois University Carbondale pursuing a degree in Finance as an Honors Pre-Law Scholar with minors in Spanish, Environmental Studies, and Economics. Kate gained much of her educational experience through the Saluki Student Investment Fund (SSIF) as a sector leader. In addition to SSIF, Kate is a member of the Division I SIU Women's Soccer team; a member of Delta Zeta Sorority, the Student Alumni Council, the SIU Sustainability Council, and a University Innovation Fellow. She is also a student worker at the university's Office of General Counsel.

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Abstract

This Thesis defends the validity of ESG Investing (Environmental, Social, Governance Investing) as an advisor's fiduciary responsibility. The financial industry is increasingly including ESG considerations when calculating the intrinsic value of a stock. In opposition to this valuation trend, nineteen state attorney generals (Nineteen) have attacked ESG, challenging its legality by claiming that it violates state and federal law and the fiduciary responsibilities that hold investment advisors accountable to their clients. After identifying key elements of fiduciary responsibility that are being ignored by the Nineteen's position, several key and relevant United States statutes are reviewed and applied to their argument. In doing so, it becomes evident that the Nineteen do not have the best interest of investors in mind not only because they violate key fiduciary elements but also because their position would prevent investors the opportunity to benefit from higher yielding Return on Equity portfolios.

Introduction

ESG Investing stands for Environmental, Social, and Governance Investing. ESG valuation is a tool that investors use to mitigate risk, diversify investment portfolios, and increase return for their clients. Although the term "ESG" is relatively new, its roots trace back several centuries ago to ethical investing. Religious groups screened out negative stocks. Ethical investing then went more widespread during the 1960s. The United Nations (UN) began giving investing guidelines in the 1980s. This buildup of impact investing carved ESG into what it is today. In 2022, the Nineteen have argued against ESG Investing as they believe that ESG hinders best possible returns and is acting against the best interest of the client. Through evaluating the Investment Advisers Act of 1940, the Employee Retirement Income Securities Act (ERISA) of 1974, and the Dodd Frank Wall Street Reform and Securities Act, these laws specify who an

investment adviser is and how an investor fills fiduciary duty. Through evaluating climate and biodiversity risks, internal and external management of human capital, and stakeholder well-being, I show how ESG bolsters a portfolio for long-term success. Data is then analyzed from the S&P 500 which shows that the majority of sectors including ESG criteria outperform portfolios that do not.

Anti-ESG Coalition

As efforts to mitigate climate change have increased, persistent politically-motivated opposition follows. In 2022, nineteen State Attorney Generals (Nineteen) publicly criticized Environmental, Social, and Governance (ESG) Investing. In May of 2022, Attorney General Daniel Cameron's office published the *Opinion of the Attorney General OAG 22-05*. The document starts "There is an increasing trend (ESG Investing) among some investment management firms to use money in public and state employee pension plans- that is, other people's money- to push their own political agendas and force social change"[1]. The article questions if ESG is consistent with Kentucky and federal law. Kentucky's Attorney General cites members of the Steering Committee for the Glasgow Alliance for Net Zero (GANZ) as potential culprits. GANZ states that the entire financial system must make ambitious commitments and act on said commitments to alter the climate change trajectory. Kentucky speculates that ESG efforts to mitigate climate change could violate the law.

Kentucky's attorney general is one of the nineteen state attorney generals forming a coalition against ESG. In August 2022, the state attorney generals from Alabama, Arizona, Arkansas, Georgia, Idaho, Indiana, Kansas, Kentucky, Louisiana, Mississippi, Missouri,

[1] Kentucky Attorney General

Montana, Nebraska, Ohio, Oklahoma, South Carolina, Texas, Utah, and West Virginia sent a letter to Larry Fink, the CEO of BlackRock Inc. in response to a letter BlackRock sent to various chief executives. BlackRock is the world's largest investment management company overseeing $10 trillion in assets. In the letter sent to various chief executives Larry Fink stated that the firm would increase ESG considerations when evaluating and recommending investments as part of their plan to operate under the goals of the Paris Agreement. One of those goals is to limit global warming to less than 2 degrees Celsius. In a parallel letter to clients, Fink committed to divesting from companies that generate more than 25% of their revenue from coal production[2]. In the Nineteen's letter to BlackRock, the state attorneys articulate "Based on the facts currently available to us, BlackRock appears to use the hard-earned money of our states' citizens to circumvent the best possible return on investment, as well as their vote"[3]. They voice that BlackRock is exploiting citizens' assets to pressure companies to comply with international agreements like the Paris Agreement. They believe the Paris Agreement will phase out fossil fuels, increase energy prices, drive inflation, and weaken the United States' national security. The Nineteen believe that if an investment firm follows the guidelines of the Paris Agreement, they breach neutrality, their duty of loyalty, and their duty of care. All of these are encompassed in fiduciary duty. The Nineteen speculate that fiduciary duty is not satisfied since BlackRock is circumventing the best possible return on investment and not discharging their duties in the interest of the beneficiaries.

Spearheaded by Missouri Attorney General Eric Schmidt, the Nineteen also started legal proceedings against seven banks by serving a Civil Investigative Demand to Bank of America,

[2] ESG Investing
[3] Paxton

Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, and Wells Fargo. The Nineteens' offices subpoenaed information speculating a breach of fiduciary duty through ESG implementation. Schmidt states "We are leading a coalition investigating banks for ceding authority to the U.N., which will only result in the killing of American companies that don't subscribe to the woke, climate agenda"[4]. The seven banks are members of the *Net-Zero Banking Alliance* initiated by the United Nations. The initiative accelerates and supports the implementation of decarbonizing strategies supported by pioneering banks. Each of the seven members signed a Commitment Statement agreeing to "transition all operational and attributable GHG (greenhouse gases) from our lending and investment portfolios to align with pathways to net-zero"[5]. In each instance, the Nineteen are citing a breach of fiduciary duty for implementing ESG. They claim that ESG considerations do not act on the behalf of a client's best interest. This coalition believes that ESG cannot earn the best possible return. This Thesis analyzes ESG and its impact on returns. It also analyzes key elements of fiduciary duty. In both instances, the Nineteen's position does not correlate to sound and appropriate investment advice.

ESG and its History

Environmental, Social, Governance (ESG) investing is a type of investment screening that considers sustainability and the societal impacts of a business. The "E" captures factors of natural resources. "S" includes management of human capital, treatment of non-human animals, and impact on local communities and clients. "G" pertains to stakeholder well-being and how well a business follows various levels of jurisdiction. Investors utilize ESG to correctly identify, evaluate, and price companies. For example, if an investor determines that two companies have

[4] Sherman
[5] Net Zero Banking Alliance

roughly the same expected return, the investor could turn to ESG to determine the risk of the company. If a company heavily pollutes, has high employee turnover, or does not follow regulations amongst many other potential risks, the risk of the company increases. Since the investor can earn approximately the same return with lower risk, they would opt for the less risky, more ESG stock. Through this type of fundamental analysis, asset managers attempt to mitigate risk and build their clients' portfolio for long-term success. ESG has revolutionized the landscape of the investment world as it recognizes the direct relationship that adequate natural resources, healthy human capital, and laws designed for the betterment of communities have on the long-term sustainability and viability of business. Before this recognition, many investors only considered the direct, immediate, and therefore, short-term financial results. Now, however, investors are still looking at financial returns (short-term as well as now long-term) while also evaluating how a business impacts the fundamental building blocks that make their business sustainable and viable for the long run. Through this increasing type of analysis, Bank of America estimates that millennials could invest approximately $15 trillion to $20 trillion of assets into ESG investments. Millennials' investment has the potential to double the size of the entire US equity market[6]. This should come as no surprise since a survey revealed that 90% of millennials plan to allocate their funds to responsible investments[7]. In 2019, the Global Impact Investing Network (GIIN) published "Sizing the Impact Investing Market". The report estimated that there is $502 billion in the global impact investing market. In GIIN's annual survey, they discovered that 66% of investment firms are pursuing ESG investing while simultaneously earning competitive, market-rate returns[8].

[6] Making an Impact through Community Projects & Impact Investing
[7] ESG Investing
[8] Annual Impact Investor Survey

To grasp how this finance megatrend started, it is essential to look at ESG's roots. Beginning several centuries ago, the seeds of impact investing were started by religious groups. John Wesley, the founder of the Methodist Church, is accredited as the founder of ethical investing. In one of his most famous sermons, Wesley spoke on "The Use of Money". He encouraged Methodists to avoid businesses that could be socially harmful. Methodists typically refrained from companies operating in tobacco, alcohol, or firearm distribution[9]. Towards the end of the eighteenth century, the New York Stock Exchange traded its first securities in 1792. The Quakers were among the first religious groups to invest in stocks. In line with their pacifist beliefs, Quakers screened out weapon manufacturing stocks[10]. Into the 1900s, the Pioneer Fund was the first ethical mutual fund to apply screens based on religious criteria[11].

The 1960'marked the modern institutionalism of ethical investing. Large audiences outside of religious groups began applying ethical considerations to their investments. As opposition to the Vietnam War grew, people sought to put their funds into companies that did not benefit from the war. In 1971 the "Pax World Fund" (now IMPAX) was created. The fund offered an alternative investment plan for those against the Vietnam War. The fund avoided the production of nuclear and military weapons[12]. Impact investing went international in the 1970s. A divestment campaign started in South Africa protesting their system of apartheid. The movement became known as "The Sullivan Principles". Investors required that their money only went to companies that treated all their employees equally regardless of race. If a company did not treat its employees fairly, investors would divest from that business. The Sullivan Principles were applied not only by the individual investor, but government institutions and corporations

[9] Telstad
[10] White
[11]Luc Renneboog
[12] IMPAX

began implementing these ethical considerations too. The divestment campaign is credited as the starting point that pressured the South African government to begin the negotiations that ultimately led to the dismantling of the apartheid system[13].

The United Nations (UN) entered the scene in 1983 and called on businesses to weigh eco-friendly practices into their equation. The UN appointed delegates known as the "World Commission on Environment and Development". The commission stated that businesses have a responsibility to ensure that their methods do not cause harm to the environment[14]. The term "ESG" was coined in a letter that called businesses to action. In 2004, UN secretary Kofi Annan wrote *Who Cares Wins.* Annan wrote to CEOs of significant financial institutions encouraging them to join an initiative that would integrate ESG into markets. *Who Cares Wins* argued that integrating ESG bolsters participating companies, leads to more sustainable markets, and benefits society[15]. Echoing Annan's call for better business practices, the *Freshfields Report* was published within the same year. Produced by the UN Environment Programme Finance Initiative (UNEP FI), *Freshfields* showed how ESG issues are relevant for financial valuation. They argue that ESG criteria is encompassed in fiduciary duty[16]. These two reports are the backbone for Principles for Responsible Investment (PRI).

From the eighteenth century to modern times, ESG assets have increased as more clients are requiring their investor to implement ESG in financial valuations. The Global Sustainable Investment Alliance (GSIA) reported that at the start of 2018, ESG assets reached $30.7 trillion

[13] Raspberry
[14] WCED
[15] Annan
[16] Pirovska

in the five major markets. The major markets include the United States, Europe, Japan, Canada, and Australia/ New Zealand. GSIA reported the following table[17]:

FIGURE 2: GROWTH OF SUSTAINABLE INVESTING ASSETS BY REGION IN LOCAL CURRENCY 2014–2018

	2014	2016	2018	Growth Per Period		Compound Annual Growth Rate (CAGR) 2014–2018
				Growth 2014–2016	Growth 2016–2018	
Europe	€ 9,885	€ 11,045	€ 12,306	12%	11%	6%
United States	$ 6,572	$ 8,723	$ 11,995	33%	38%	16%
Canada (in CAD)	$ 1,011	$ 1,505	$ 2,132	49%	42%	21%
Australia/New Zealand (in AUD)	$ 203	$ 707	$ 1,033	248%	46%	50%
Japan	¥ 840	¥57,056	¥231,952	6692%	307%	308%

Note: Asset values are expressed in billions. All 2018 assets in this report are as of 12/31/17, except for Japan, whose assets are as of 3/31/18.

GSIA explains that Europe has historically led the pack with their overall percentage of sustainable-related investments. Japan has demonstrated growth with their percentage quadrupling since 2016. The US, Australia/ New Zealand, and Canada have maintained the same level of sustainable investments over the past few years. In GSIA's latest 2021 report, the US, Canada, and Japan have grown their overall percentage of ESG investments relative to the whole investment market[18].

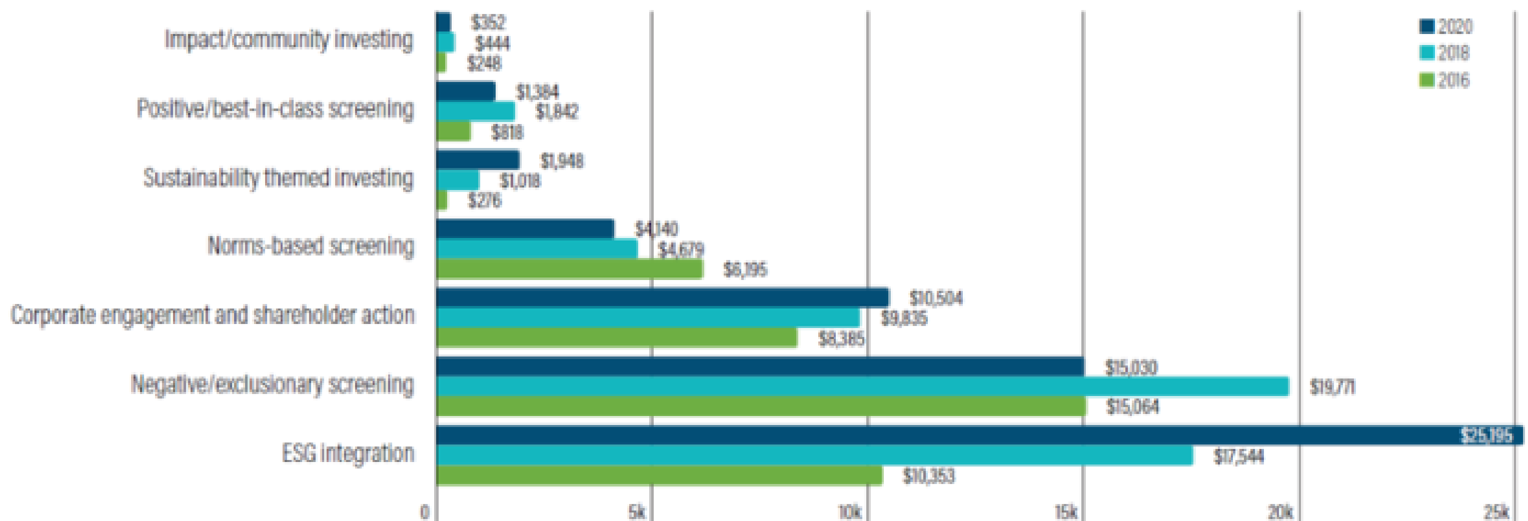
[17] 2018 Global Sustainable Investment Alliance
[18] Dominique

Figure 3. Proportion of sustainable investing assets relative to total

Source: GSIR 2020

As shown by the next diagram, the largest portion of sustainable investments are in ESG.

Figure 4. Global growth of sustainable investing strategies 2016-2020 (USD billions)



ESG Investing has grown larger due to its quantitative assessment. The majority of the other sustainable investment strategies screen or avoid certain sectors or specific companies. ESG differs since it assigns a numerical number through a scoring system. A company with a higher ESG score is considered less risky and better for people and the environment. Since finance is an industry that is always evolving, advisors have a lot of pressure to maintain a productive portfolio. As ESG increases and becomes a larger presence in the investment realm at the demand of the investors, it is essential to understand how committing to the laws governing fiduciary duty interplays with ESG.

Fiduciary Duty

Fiduciary duty is defined as "a person or organization that acts on behalf of another person, putting their clients' interests ahead of their own"[19]. Their duty preserves good faith and trust. A person in the role of a fiduciary is bound legally and ethically to serve in the best interest of their client.

Of the many elements encompassed in Fiduciary Duty, the following three are particularly relevant to this Thesis' analysis:

1) Recognition that every investor is different, with their own set of goals, values, and desired outcomes. Investment should be done in concert with the client's goals, not in spite of them.
2) Investment should be done in good faith with the hope that the businesses or industries invested in will be on-going concerns in one year, five years, ten years, and fifty years. If this is not factored into the investment decision, it puts into question the abilities of the

[19] Kagan

businesses' management and their ability to think long-term for the good of the company and its shareholders.

3) It is critical to use the most accurate data for investment decision. Once the goals of the client are understood, the most accurate data for investment decision should be utilized. If the data does not include a full cost accounting of doing business, it over-inflates all Net Revenue and Equity calculations thereby falsely raising an investment's return.

Leading the financial investment world is the Chartered Financial Analyst (CFA) Institute. The CFA Institute is a globally recognized society of investment professionals that sets the standards for the investor-client relationship. The CFA is the most highly respected designation in the field. To receive the designation, CFA charter holders pass a series of three rigorous tests. CFA Investors are expected to understand fiduciary duty and implement it in every client relationship. Standard III.A. of the CFA Institute *Code of Ethics* requires that "Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests"[20]. Albeit broad, the CFA Institute alludes to three US laws that investors are legally obliged to follow. These laws include the Investment Advisers Act of 1940, the Employee Retirement Income Security Act of 1974 (ERISA), and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Investment Advisers Act of 1940 defined who an investor is and their required standard of conduct. The impetus of the Investment Advisers Act of 1940 was the aftermath of the Great Depression. The stock market had crashed due to misinformation regarding asset management. These calamities inspired many financial regulations aimed to increase financial

[20] Fiduciary Duty- CFA

transparency and heighten regulation. The Investment Advisers Act of 1940 sought to bandage these financial breakdowns by classifying who an investment adviser is, their role with their client, and allocated regulatory power to the Securities Exchange Commission (SEC). The SEC acts as a "police force" of the United States' financial world. Under the act, "'Investment adviser'' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities"[21]. The Investment Advisers Act elaborates the role of an adviser by defining the Standard of Conduct. "The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice"[22]. The act further specifies that client consent is needed on all financial transactions. The Investment Advisers Act defines an investment adviser as one who manages the assets of their client. Their role is to provide the best level of care possible. The client must be made aware of all actions within their portfolio.

The second law that the CFA refers to is the Employee Retirement Income Security Act (ERISA) of 1974. Housed under the Department of Labor (DOL), ERISA aims to protect retirement assets by setting standards for persons or entities who exercise discretionary control over investment portfolios. The DOL serves to protect the workforce for the U.S. Economy.

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[21] Investment Advisers Act
[22] Investment Advisers Act

Specific to ERISA, the DOL ensures that investors are properly managing employee retirement funds. The DOL, like the Investment Adviser Act of 1940, defines a fiduciary as one who runs the plan solely in the interest of the client. Under ERISA, a fiduciary investor must "act prudently and must diversify the plan's investments in order to minimize the risk of large losses"[23]. The DOL proceeds to state that fiduciaries that do not follow these principles of conduct are personally liable to recover any of the clients' losses. A breach of fiduciary duty can also result in court charges. Under ERISA, investors must plan into the future for a successful portfolio while simultaneously diversifying the portfolio and mitigating risks.

Another law created in the wake of a financial crisis is the Dodd-Frank Wall Street Reform and Consumer Protection Act. Enacted in 2010, Dodd-Frank aims to prevent another 2008 Financial Crisis. The act seeks to ensure the financial safety of Americans by increasing the financial stability of major firms, establishing the Consumer Financial Protection Bureau, and integrating credit ratings. The Obama Administration's White House archives describe the 2008 Financial Crisis a result of "irresponsible lenders using hidden fees and fine print to take advantage of consumers"[24]. Dodd-Frank built upon the Investment Advisers Act by making more stringent requirements on financial disclosures. While Dodd-Frank radically changed the financial sector, the subcategory "Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers" is under review. In this section, Dodd-Frank states "Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities"[25]. The CFA rebuts that this ruling is unworkable, and that the SEC would revise the

[23] Fiduciary Responsibilities- Department of Labor
[24] Wall Street Reform
[25] Dodd-Frank

extent of fiduciary duty in the summer of 2017. Since the summer of 2017, advocates for "full-term" fiduciary duty have been met with persistent opposition. Debates about the role of a fiduciary after the initial transaction is still ongoing. The CFA states that they had hoped the situation would have been resolved but support the underlying objective of the DOL which is to serve the client in their best interest[26].

Following the CFA Institute and the US Laws Investment Advisers Act of 1940, ERISA, and the Dodd-Frank Act, the investor must act in the best interest of their client. The Investment Advisers Act specifies that the investor is anyone who manages the assets of their client. Investors cannot place anyone else's interests above their clients. Clients need to be made fully aware of actions in their portfolio and must give the adviser their consent. As specified by ERISA, investors are required to mitigate risk and diversify the portfolio to the best of their ability. Investors must act prudently and think well into the future for their client's portfolio to be successful. While Dodd-Frank revisions have not been made official, this paper will prove that a client's best interest requires an investor providing full-time fiduciary services for both the present and the future.

Legal Implication of ESG

The Nineteen fail the Investment Advisers Act of 1940 and ERISA if investors are no longer allowed to implement ESG. Under the Advisers Act, a client must be made aware of all actions in the portfolio and must give their consent to investment advisers to make any decisions in the portfolio. Investment advisers are therefore required to disclose if ESG is part of their valuation. Clients, with their own money, should have the right to decide whether their portfolio

[26] Fiduciary Duty- CFA

should include ESG. ESG is a choice that should be allowed in a free market. By taking away that choice, the Nineteen are grossly overreaching their governmental authority. It is not the investment adviser who makes the final decision in absence of their client but rather it should be a joint decision made in concert with the clients' goals and values.

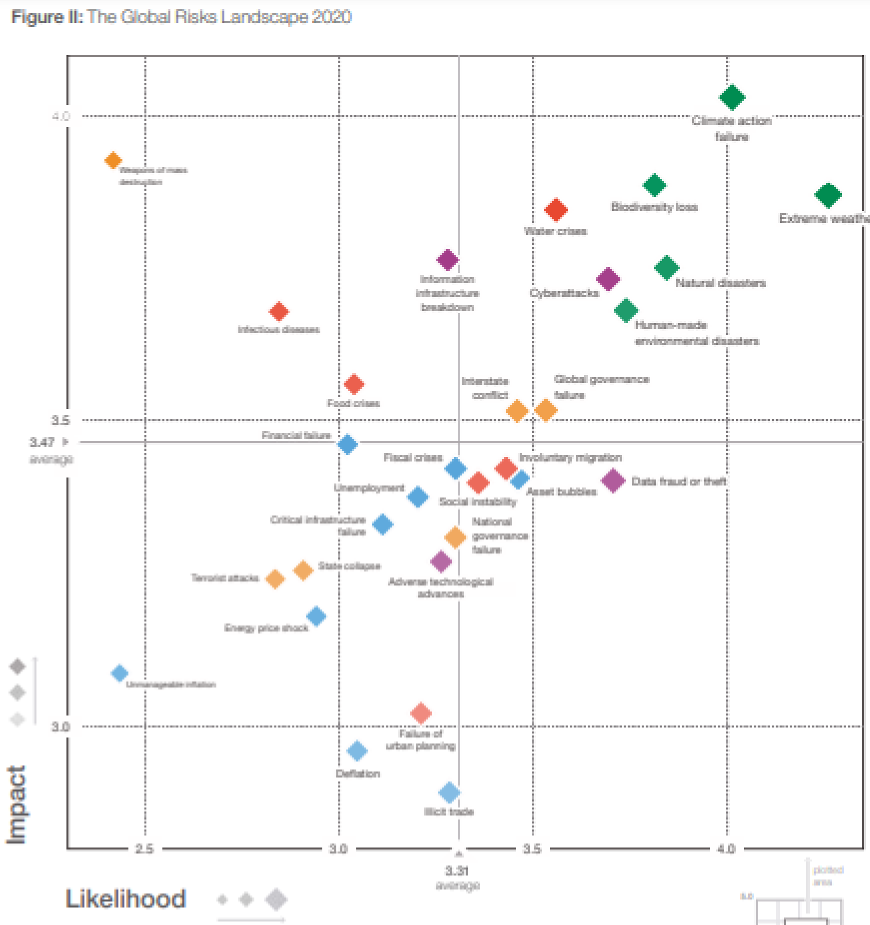
ERISA states that an investor must act prudently and diversify their client's portfolio. To act prudently means to show thought for the future. To diversify a portfolio means to mitigate risk and protect the assets in the portfolio. ESG measures a company by their risk potential. Companies with a lower ESG score have higher risk for the client's assets. By investing in ESG companies, investors are mitigating the risks their clients could encounter if they do not include ESG considerations. The financial institutions that adopted the UN standards did so out of business sense with a long game in mind. The institutions were not mandated to join. Avoidance of these risks diminish the likelihood of various crises from happening to the client.

ESG Mitigation Efforts and Long-Term Success

The laws that define fiduciary duty were the result of financial crises. These events changed the behavior of clients and how they invested their money. Without a sharp change in current business operations, the exploitation of natural resources is predicted to be the largest crisis with unpredictable consequences[27]. Although the Dodd-Frank Act does not require investors to continue fiduciary duty past the initial transaction, ERISA states that investors must mitigate risks. In their 2020 report, the World Economic Forum produced an evolving risks landscape from 2007 to 2020. Listed under the Top 5 Global Risks in Terms of Likelihood, environmental risks have persisted for the past 10 years. In 2020, the Top 5 risks in terms of likelihood included

[27] Global Risk Report

extreme weather, climate action failure, natural disasters, biodiversity loss, and human-made environmental disasters. In 2020, the Top 5 Global Risks in Terms of Impact were climate action failure (1), biodiversity loss (3), and extreme weather (4). The other two were weapons of mass destruction (2) and water crises (5). Considering all risks, the World Economic Forum created a grid comparing impact and likelihood. Environmental risks are the only category to have all risks



in the second quadrant indicating high risk and high impact[28]. The highest risk is climate action failure. Climate change is a side effect of human activity. In 2008, the top three thousand publicly traded companies were responsible for $2.15 trillion worth of environmental damage. The damage is estimated to cost $28 trillion by 2050[29]. According to the Stockholm Resilience

[28] Global Risk Report
[29] S&P Global Trucost

Centre, most of climate change derives from crossing four of the nine planetary boundaries. These boundaries are thresholds for human survival and for successful development into the future. If these boundaries are crossed, the risk of large-scale abrupt or irreversible environmental harm greatly increases. Attributed to human activity, climate change, loss of biodiversity, land-system change, and altered biogeochemical cycles have been crossed[30]. Climate change is expected to make drastic, irreversible changes causing immense harm. In the energy sector alone, an upfront investment to mitigate climate change is estimated to be $1 trillion to $4 trillion[31]. The International Chamber of Commerce (ICC) who produced the estimate elaborates that these estimates could be larger because the chamber is uncertain how climate change costs will evolve with the degradation of other planetary boundaries. In late February 2022, Russia invaded Ukraine causing fuel prices to skyrocket. Many countries boycotted Russian fuel to protest the Ukraine invasion. In the United States, WTI Crude Oil sold for a record $119 a barrel in March[32]. Since Russia is the third largest exporter of oil, the boycott lessened the availability of oil sources. Countries in Europe scrambled to find ways to heat their homes and maintain their lifestyle. As climate change impacts the world, the melting of permafrost is expected to cause severe damage to infrastructure in the Russian arctic[33]. The supply of oil would diminish. With limited supply, the price of oil could easily skyrocket past prices seen in 2022. Another planetary boundary that has already been crossed is the loss of biodiversity. Biodiversity is an invaluable service that underpins human health, well-being, and economic growth. Providing food, clean water, genetic resources, flood protection, and nutrient cycling amongst many others, it is estimated that biodiversity's ecosystem services have a

[30] Planetary Boundaries
[31] Special Report
[32] Oil Price Charts
[33] Russian Artic Oil

monetary value of $125 trillion to $140 trillion. This is more than one and a half times the global GDP[34].

Attempting to capture the true cost of climate change, economist Nicholas Stern discounted future climate change damages. When discounting future value, a lower discount rate yields a higher number into the future. Stern argued a low discount rate because of the moral considerations of future generations[35]. In his evaluation he articulates that the higher weight on the lives and welfare of future generations, the lower the discount rate. Climate change is a looming cost that has yet to be paid. Since the cost is not currently financially incurred, climate change is an externality. An externality can be a positive or negative side effect that is not accounted in the costs of business. Professor William Nordhaus created a model that measures the level of environmental degradation on economic growth. His Nobel Peace Prize model created a price for carbon pollution[36]. The price of these business externalities is expensive. Several governments and corporations have taken steps to not only protect the environment but also mitigate the risks to their wallet. For example, the exploitation of natural resources is caused by extracting too many virgin resources at a pace that is faster than the resources can be replenished. In a linear economy, the resource is extracted, used, and then discarded. A circular economy differs because it "keeps materials, products, and services in circulation for as long as possible"[37]. Compared to a linear economy, circular economies involve reusing, repairing, refurbishing, recycling, and redesigning- all meant to reduce extraction and exploitation of natural resources. Through technological innovation, the UK government decoupled economic activities from resource usage. The UK experienced a GDP rise of 18% while their carbon

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[34] Biodiversity
[35] Stern
[36] Gleckman
[37] What is a Circular Economy?

emissions fell 30% [38]. Studying business operations, McKinsey sought to evaluate resource efficiency. Higher resource efficiency can benefit a business' operating profits up to 60%. In addition, McKinsey discovered that across the different sectors, resource efficiency is significantly correlated to better financial performance[39]. The Climate Disclosure Project (CDP) also conducted a study about strategic use of resources. They found that on average, companies experience a 27% to 80% internal rate of return on their low-carbon investments[40].

These success stories are often from pioneer organizations that intrinsically strive to improve environmental issues. However, as environmental risks become more prevalent, laws and regulations are amplifying. In 1997, there were seventy climate and policy laws. In 2018, climate laws rose to over 1500 laws. Since the Kyoto protocol, the number of climate change laws have increased twentyfold[41] .With the threat of rising costs for natural resources and the increasing levels of regulation, investors must consider ESG to set their clients up for future success and to ensure they are staying updated in an ever-changing industry.

Environmental risks interrelate closely with social issues. These costs are a major consequence of environmental degradation. These costs must be and will eventually be fronted by someone. Alongside McKinsey Global Institute, the Woods Hole Research Centre calculated the socioeconomic impacts of climate change. Affecting human livability and workability, the 2003 European Heat Wave cost $15 billion. If changes are not made, the likelihood of another extreme heat wave has been doubled. The 2010 Russian heat wave attributed to 55,000 deaths. In 2013-2014, the Australian heat wave amounted to $6 billion in productivity loss. For food

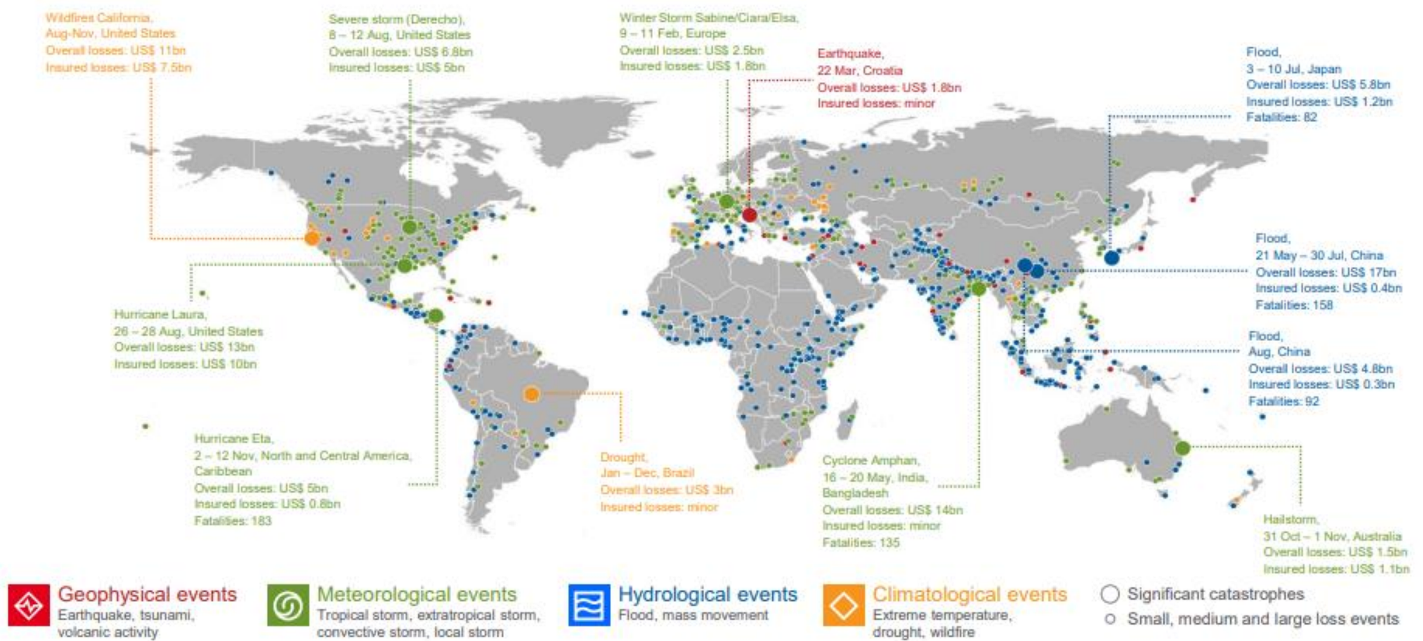
[38] Evans
[39] Henisz
[40] The Climate Has Changed
[41] Global Trends

systems, the 2015 Southern African drought resulted in a 15% decrease in agricultural outputs. The ocean warming is anticipated to have a 35% decline in Atlantic Fish yields. Physical assets are not exempt and add to the cost levels. In the US, hurricane Sandy hit in 2012. Sandy caused $62 billion in repair damages. 2017's hurricane Harvey totaled to a whopping $125 billion in damage. Just North of the US, Canada suffered through the Fort McMurray Fire in 2016. At $10 billion in damage, Canada lost 1.5 million acres of forest to the fire[42]. In 2020 alone, natural disasters cost people $210 billion[43].

NatCatSERVICE

Natural disasters caused overall losses of US$ 210bn

Relevant natural catastrophe loss events worldwide 2020



Source: Munich Re, NatCatSERVICE, 2021

These are costs and risks that affect every socioeconomic class. However, low socioeconomic classes and minorities are disproportionately burdened by environmental risks. Minorities and populations of low income are exposed to higher levels of dangerous fine

[42] Woetzel

[43] Record Hurricane

particulate air pollution. Even more unsettling, pollution is the largest cause of premature death in the world today. The Lancet Commission on Pollution and Health estimated that pollution killed nine million in 2015. The nine million represent 16% of worldwide deaths that year[44]. The journal *Environmental Research* published data showing that the burning of fossil fuels (coal, petrol, and diesel) is a major source of airborne fine particulate matter (PM2.5). China, India, Europe, and the northeastern United States are amongst the hardest hit areas and are predicted to suffer a disproportionate premature death rate[45]. Clean air is a basic need that should not be contaminated for profits.

Another basic need is food. 75% of global crops are pollinated by animals. In 2008, $217 billion was produced from insect-pollinated plants[46]. Despite this staggering dependence on insects, biodiversity loss remains an extreme risk. The Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES) published a report showing that over one million animal and plant species are threatened with extinction[47]. US farmers spent $300 million on artificial pollination to combat this issue. An ecological service that was once free, farmers now must pay. Species are going extinct at a faster rate than ever before, and local communities are forced to spend more money to accommodate the effects of businesses focused only on short-term profit goals from short-term thinking. Two consequences occur as artificial simulation replaces the no-cost ecological services. The supply of food decreases and/or the cost of food increases. If supply plummets, the price per product increases. As food becomes more expensive, this basic need becomes more expensive for low socioeconomic classes. They are priced out of survival. If the cost of food increases, producers must sell at a higher price to

[44] Landrigan
[45] Green
[46] Wojcik
[47] Intergovernmental Science-Policy Platform

maintain a similar profit margin. Once again, increasing prices disproportionately affect low-income communities. Additional costs incurred are climate-migration expenses. By 2050, 150 to 200 million people will have migrated from their homes[48]. Their homes will have become uninhabitable due to biodiversity loss and climate change. Without considering how a business impacts local communities, the discrepancies of fresh air and food security will continue. People will be forced to leave their homes. These negative externalities do not just harm minorities or low socioeconomic communities. They will impact everyone. This includes an investor's client. If an investor has the best interest for their client, these risks need to be mitigated.

Just as injustices exist outside of a firm, maltreatment can occur internally. Businesses rely on their stakeholders to profit. Stakeholders are people who have a vested interest in the company. These people can range from a company CEO to an overseas worker embedded deep in the supply chain. Stakeholders often try to maximize profits. To increase profits, businesses will buy resources at the lowest price possible. Often these low prices are the result of human rights violations deep in the supply chain. Even with international laws aimed at protecting people, instances of poor working conditions, child labor, sexual harassment, and exposure to hazardous substances persist. Globally there are an estimated 21 million people affected by forced labor. 168 million people are involved in child labor. Over half of the 168 million are engaged in hazardous work that puts their health and/or safety at risk. Approximately 15% of the world's gold market originates in artisan mines. Through global supply chains, these business risks contribute to 12 million deaths every year[49]. *Charter for Compassion* explains that the victims of human right crimes lack access to help such as complaint mechanisms or legal

[48] Brito
[49] Human Rights in Supply Chain

recourse. Materials sourced from these unethical businesses are most likely sold at lower prices than ethically sourced materials. While these injustices often do not occur under a company's "roof", by purchasing the unethical product of businesses that do commit human rights violations, the CEOs of the company, the employees of the company, and the customers of the company perpetuate these problems. A corporation's code of ethics for employees "under their roof" should apply to any stakeholder within the company's supply chain.

Even though far fewer instances of human right violations occur under a company's "roof", tragic incidents still occur. On December 10, 2021, an EF-3 tornado struck an Amazon warehouse killing six people[50]. Surviving employees reported that the retail giant ignored severe weather warnings and insisted warehouse workers work until minutes before the tornado caused the building to collapse. Alice and Randy McEwen filed a lawsuit on behalf of their son, one of the victims. Alice McEwen states "(the company) placed profits first instead of the safety of our son and the other families who lost loved ones". The attorney representing the McEwen family comments "Amazon was more concerned with its peak delivery season… workers could have been directed home and the next morning, only losing perhaps 12 hours, could have resumed the work, and a lot of lives and injuries would have been avoided"[51]. This tragic event is the aftermath of negligence in the pursuit of profits. A London School of Economics study found that Amazon's tactics are counterintuitive to higher profits. Over a twenty-five-year period companies that made Fortune's 100 Best Companies to Work For generated 2.3% to 3.8% higher stock returns[52].

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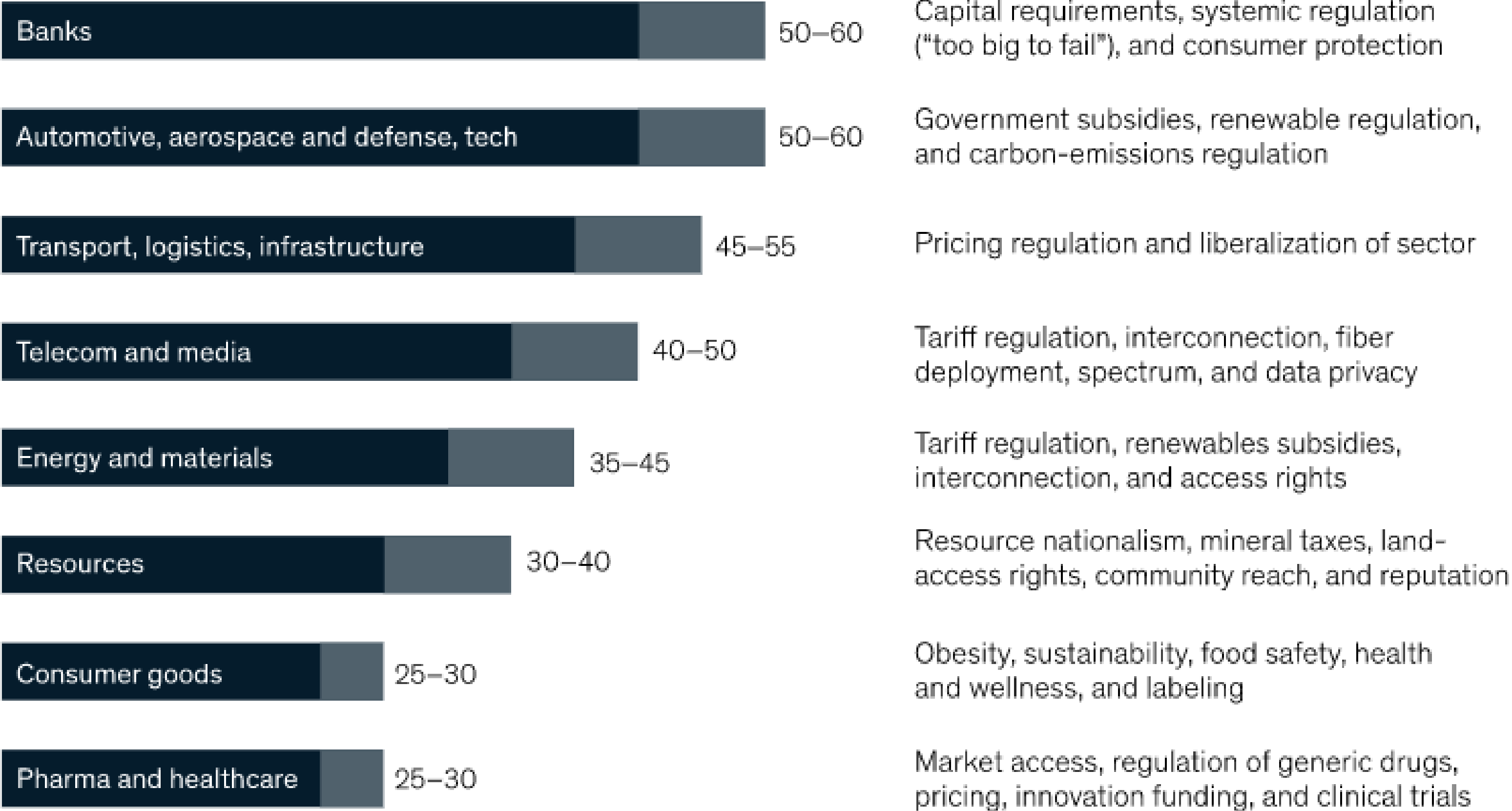
[50] Hassan
[51] Fentem
[52] Edmans

Governance scores encompass environmental and social aspects of a business. Governance evaluates how well a company follows laws and how beneficial a company is to their shareholders. A McKinsey study found that "typically one-third of corporate profits are at risk from state intervention"[53]. Researchers explain that when a company has a stronger external value proposition, they can achieve more strategic freedom because of eased regulatory pressure. Broken down by sector, McKinsey shows the estimated EBITDA at risk.



[53] Henisz

Companies can also be rewarded for surpassing regulatory standards. Referring to Nordhaus' externality model, he discovered a method to price carbon. Nordhaus proposed a "Global Climate Club" that would require participating companies to unilaterally agree to carbon emission levels[54]. Using a cap-and-trade system, businesses would be allocated a certain number of permits. Each permit allots a limited amount of pollution. If a company can adapt and does not need the allotted permits, that company can benefit by selling their credit to another business. Businesses that require higher levels of pollution for their product would have to buy additional permits or suffer fines. The benefit of the cap-and-trade system is that corporations set the price of the permit. If the permit is too expensive, companies are financially driven to find new methods of production. The regulatory power of carbon credits benefits companies that are more eco-friendly and requires adaptation from companies that lag industry standards. These incentives benefit shareholders.

ESG Implementation not only promotes the interest of clients by mitigating risks and minimizing costs, but it also benefits the environment and people. ESG encourages better resource efficiency bolstering a company's profit. This sustainable investment method evaluates natural resource costs into the future and through conservation efforts, attempts to stabilize the price for future generations. Under social valuations, ESG promotes human rights. ESG mitigates socioeconomic costs and shelters targeted victims of work abuse. ESG aids corporations through complex regulatory environments that ultimately benefit shareholders.

ESG Mitigation of Risk

[54] Gleckman

ESG Implementation aims to mitigate these risks and protect shareholders, CEOs, employees, and investor's clients from the negative repercussions of ignoring the building blocks of sustainable and viable businesses. The Nineteens' claims are built on false premises. First, the Nineteen assume that investors only have one goal with their portfolios- to make money. However, by investing in ESG companies, clients can reduce environmental risks and lessen human rights violations, while still making money. By planning into the future, investors help shield their client's portfolios from negative downturns and unstable short-term spikes and flails. If an investor has their clients' best interest in mind, they are planning for an industry that, all things the same, should be successful in one year, five years, ten years, fifty years, and one hundred years. By failing to plan into the future, it puts into question the abilities of a company's managers, general stock management, and the ability to think long-term for the good of their shareholders and investment clients. Finally, the Nineteens' position fails to understand fiduciary duty. They believe that fiduciary duty is solely satisfied by higher returns. But if those higher returns are based on incomplete data and not fully accounting of the costs for doing business, then the ratios used are inaccurate. Fiduciary duty should consider the full costs of doing business. Once those externality costs are included, then an investor can see the true return for their client. ESG is in the best interest of the client, the investor, and even the Nineteen.

ESG Returns

It has been established that ESG is in the best interest of a client. The second point of contingency made by the Nineteen is that ESG companies have a lower return than a portfolio that does not implement ESG. When comparing Bloomberg ESG Scores to Return on Equity (ROE), ESG companies have higher returns than a normal portfolio based on data from the S&P 500 between 2009 to 2021. The S&P 500 was analyzed because it is the most watched index.

ROE was selected because this ratio calculates how profitable a company is and gauges how efficiently the company makes those profits. ROE essentially measures the profits made from each dollar of a shareholder's stock. ROE uses DuPont Analysis. DuPont Analysis considers tax burden, interest burden, operating margin, asset turnover, and leverage ratio. This forms the following formula:

$$ROE = \frac{EBIT}{Revenue} \times \frac{Revenue}{Average\ Assets} \times \frac{Average\ Assets}{Average\ Equity} \times (1 - Tax\ Rate)$$

Some companies within the S&P 500 did not have reportable ROE scores. McDonalds is an example. 2016 was the first year McDonalds did not have a reportable ROE. Looking over their balance statement, their 2016 shareholder's equity is a negative number[55].

6-Year Summary	Years ended December 31,					
In millions, except per share and unit amounts	***2016***	*2015*	*2014*	*2013*	*2012*	*2011*
Consolidated Statement of Income Data						
Revenues						
Sales by Company-operated restaurants	**$ 15,295**	$ 16,488	$ 18,169	$ 18,875	$ 18,603	$ 18,293
Revenues from franchised restaurants	**9,327**	8,925	9,272	9,231	8,964	8,713
Total revenues	**24,622**	25,413	27,441	28,106	27,567	27,006
Operating income	**7,745**	7,146	7,949	8,764	8,605	8,530
Net income	**4,687**	4,529	4,758	5,586	5,465	5,503
Consolidated Statement of Cash Flows Data						
Cash provided by operations	**$ 6,060**	$ 6,539	$ 6,730	$ 7,121	$ 6,966	$ 7,150
Cash used for investing activities	**982**	1,420	2,305	2,674	3,167	2,571
Capital expenditures	**1,821**	1,814	2,583	2,825	3,049	2,730
Cash used for (provided by) financing activities	**11,262**	(735)	4,618	4,043	3,850	4,533
Treasury stock purchases[1]	**11,142**	6,182	3,175	1,810	2,605	3,373
Common stock dividends	**3,058**	3,230	3,216	3,115	2,897	2,610
Financial Position						
Total assets	**$ 31,024**	$ 37,939	$ 34,227	$ 36,626	$ 35,386	$ 32,990
Total debt	**25,956**	24,122	14,936	14,130	13,633	12,500
Total shareholders' equity (deficit)	**(2,204)**	7,088	12,853	16,010	15,294	14,390
Shares outstanding	**819**	907	963	990	1,003	1,021
Per Common Share Data						
Earnings-diluted	**$ 5.44**	$ 4.80	$ 4.82	$ 5.55	$ 5.36	$ 5.27
Dividends declared	**3.61**	3.44	3.28	3.12	2.87	2.53
Market price at year end	**121.72**	118.44	93.70	97.03	88.21	100.33
Restaurant Information and Other Data						
Restaurants at year end						
Company-operated restaurants	**5,669**	6,444	6,714	6,738	6,598	6,435
Franchised restaurants	**31,230**	30,081	29,544	28,691	27,882	27,075
Total Systemwide restaurants	**36,899**	36,525	36,258	35,429	34,480	33,510
Franchised sales[2]	**$ 69,707**	$ 66,226	$ 69,617	$ 70,251	$ 69,687	$ 67,648

[55] McDonald's 2016 10K Report

McDonald's bought back their own shares of the company. For accounting purposes, the value becomes negative. Since average equity is included in ROE, the ROE ratio for McDonald's could be negative even if the ratio would otherwise be positive. As a result, they do not have a reportable ROE. Companies with a negative shareholder equity value were not included because they would not represent the data correctly. A company was also eliminated from the data set if they did not have a reportable Bloomberg ESG Disclosure Score. If the company does not have enough data available for Bloomberg to make a competent report, then the company does not have a usable score. After excluding companies without an ROE ratio or a Bloomberg ESG Disclosure Score, 5,968 points of data were analyzed. Next, the S&P 500 was subdivided into sectors to avoid irregular returns. Following MSCI's Global Industry Classification System (GICS), GICS has the following eleven sectors: Communication Services, Consumer Discretionary, Consumer Staples, Energy, Financials, Industrials, Info Tech, Health Care, Materials, Real Estate, and Utilities. As seen in the S&P 500 Performance Quilt Chart, the Energy sector had abnormal returns in 2021[56].

[56] Annual S&P 500 Performance

S&P 500 Sector Performance

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD
ENRS 34.4%	CONS -15.4%	INFT 61.7%	REAL 32.3%	UTIL 19.9%	FINL 28.8%	COND 43.1%	REAL 30.2%	COND 10.1%	ENRS 27.4%	INFT 38.8%	HLTH 6.5%	INFT 50.3%	INFT 43.9%	ENRS 54.6%	ENRS 31.8%
MATR 22.5%	HLTH -22.8%	MATR 48.6%	COND 27.7%	CONS 14.0%	COND 23.9%	HLTH 41.5%	UTIL 29.0%	HLTH 6.9%	TELS 23.5%	MATR 23.8%	UTIL 4.1%	TELS 32.7%	COND 33.3%	REAL 46.2%	UTIL -0.6%
UTIL 19.4%	UTIL -29.0%	COND 41.3%	INDU 26.7%	HLTH 12.7%	REAL 19.7%	INDU 40.7%	HLTH 25.3%	CONS 6.6%	FINL 22.8%	COND 23.0%	COND 0.8%	FINL 32.1%	TELS 23.6%	FINL 35.0%	CONS -5.6%
INFT 16.3%	TELS -30.5%	REAL 27.1%	MATR 22.2%	REAL 11.4%	TELS 18.3%	FINL 35.6%	INFT 20.1%	INFT 5.9%	INDU 18.9%	FINL 22.2%	INFT -0.3%	S&P 31.5%	MATR 20.7%	INFT 34.5%	HLTH -8.3%
CONS 14.2%	COND -33.5%	S&P 26.5%	ENRS 20.5%	TELS 6.3%	HLTH 17.9%	S&P 32.4%	CONS 16.0%	REAL 4.7%	MATR 16.7%	HLTH 22.1%	REAL -2.2%	INDU 29.4%	S&P 18.4%	S&P 28.7%	INDU -16.8%
INDU 12.0%	ENRS -34.9%	INDU 20.9%	TELS 19.0%	COND 6.1%	S&P 16.0%	INFT 28.4%	FINL 15.2%	TELS 3.4%	UTIL 16.3%	S&P 21.8%	S&P -4.4%	REAL 29.0%	HLTH 13.5%	MATR 27.3%	MATR -17.9%
TELS 11.9%	S&P -37.0%	HLTH 19.7%	S&P 15.1%	ENRS 4.7%	INDU 15.4%	CONS 26.1%	S&P 13.7%	S&P 1.4%	INFT 13.9%	INDU 21.0%	CONS -8.4%	COND 27.9%	INDU 11.1%	HLTH 26.1%	FINL -18.7%
HLTH 7.2%	INDU -39.9%	FINL 17.2%	CONS 14.1%	INFT 2.4%	MATR 15.0%	MATR 25.6%	INDU 9.8%	FINL -1.5%	S&P 12.0%	CONS 13.5%	TELS -12.5%	CONS 27.6%	CONS 10.8%	COND 24.4%	S&P -20.0
S&P 5.5%	REAL -42.3%	CONS 14.9%	FINL 12.1%	S&P 2.1%	INFT 14.8%	ENRS 25.1%	COND 9.7%	INDU -2.5%	COND 6.0%	UTIL 12.1%	FINL -13.0%	UTIL 26.4%	UTIL 0.5%	TELS 21.6%	REAL -20.0
COND -13.2%	INFT -43.1%	ENRS 13.8%	INFT 10.2%	INDU -0.6%	CONS 10.8%	UTIL 13.2%	MATR 6.9%	UTIL -4.8%	CONS 5.4%	REAL 10.9%	INDU -13.3%	MATR 24.6%	FINL -1.7%	INDU 21.1%	INFT -26.9%
REAL -17.9%	MATR -45.7%	UTIL 11.9%	UTIL 5.5%	MATR -9.6%	ENRS 4.6%	TELS 11.5%	TELS 3.0%	MATR -8.4%	REAL 3.4%	ENRS -1.0%	MATR -14.7%	HLTH 20.8%	REAL -2.2%	CONS 18.6%	TELS -30.2%
FINL -18.6%	FINL -55.3%	TELS 8.9%	HLTH 2.9%	FINL -17.1%	UTIL 1.3%	REAL 1.6%	ENRS -7.8%	ENRS -21.1%	HLTH -2.7%	TELS -1.3%	ENRS -18.1%	ENRS 11.8%	ENRS -33.7%	UTIL 17.7%	COND -32.8%

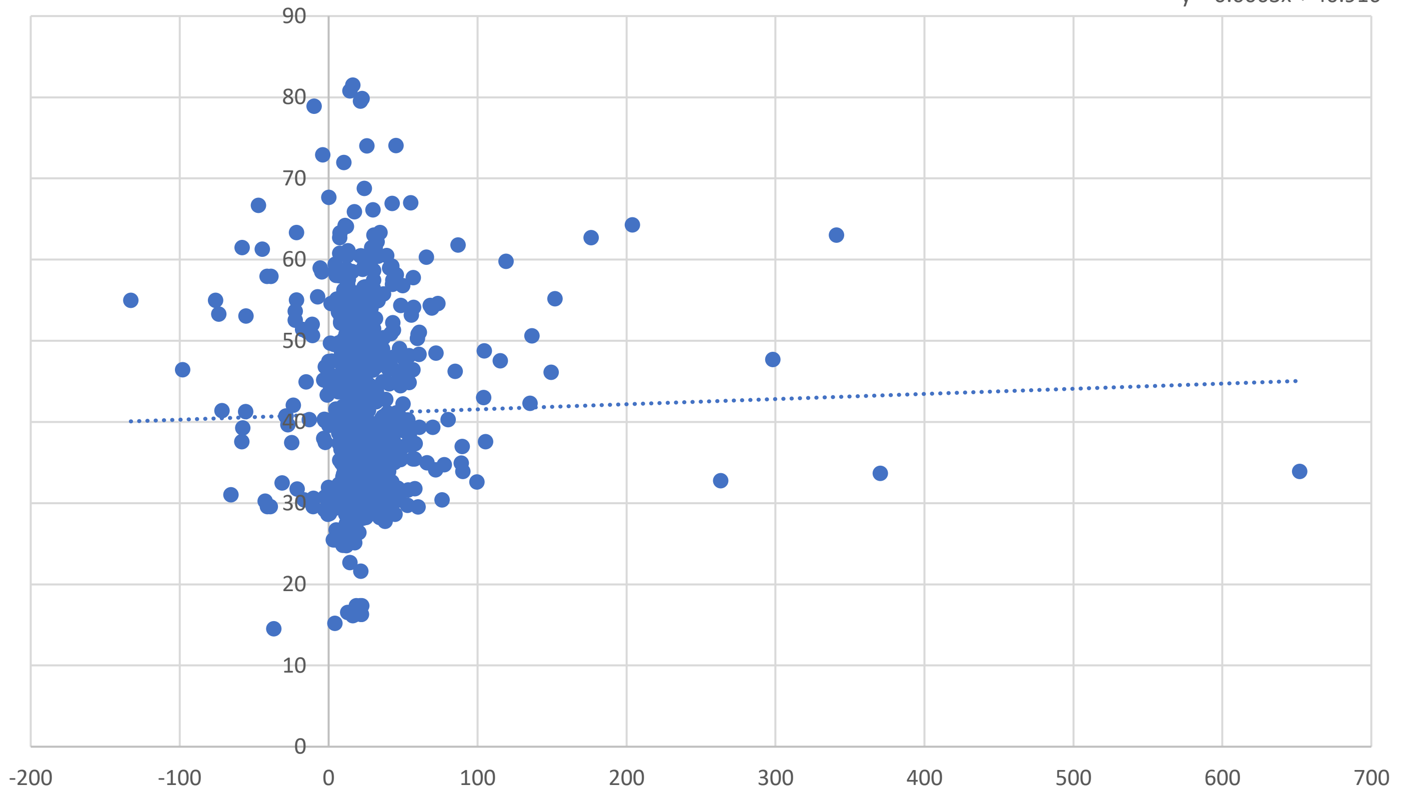
After matching each company's ROE to their ESG score within their sector, the companies were sorted by ROEs above the median or below it. A scatterplot was then created with the top 50% of ROEs versus the whole sector over the years 2009 to 2021. Essentially, the graph displayed the top performing companies against the sector without any constraints. Below is the consumer discretionary sector. Some of the top performing companies in 2021 were Lowe's, eBay, Etsy, Ford, and Whirlpool.

Consumer Discretionary- Top 50

y = 0.0202x + 40.363

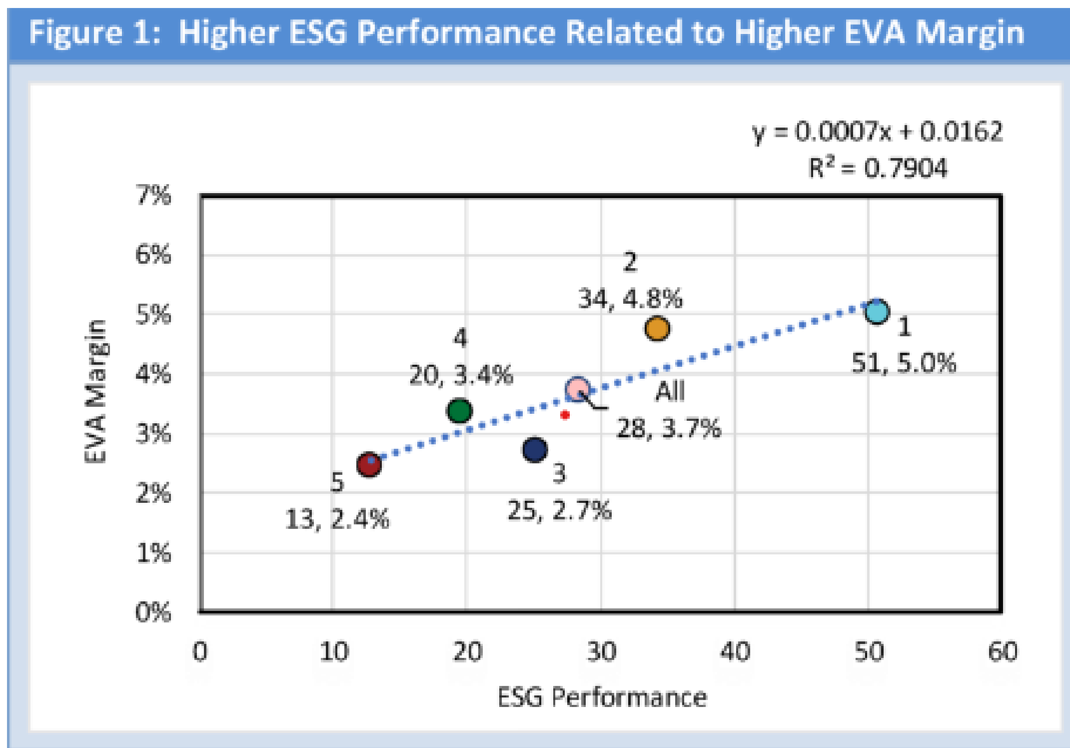
90
80
70
60
50
40
30
20
10
0

0
100
200
300
400
500
600
700



The data found that six of the eleven sectors outperformed with ESG portfolios. The outperforming sectors include Consumer Discretionary, Financials, Industrials, Info Tech, Real Estate, and Utilities. The other sectors had ESG performance lower than a normal portfolio of Communication Services (.0993), Consumer Staples (.0163), Energy (.0877), Health Care (.0021), and Materials (.033).

In 2020, Harvard Law School Forum on Corporate Governance published "ESG Matters" by Anthony Campagna. Campagna used Institutional Shareholder Services (ISS) ESG scores. ISS is an independent company that scores on a scale of 0-100 (100 being better). He pulled data from the end of 2013 through May 2019 comparing ISS ESG Scores to Return on Invested Capital (ROIC). Campagna used companies that had a market capitalization greater than $250 million. He found that higher ESG scores equate to higher profitability and lower volatility[57].



[57] Campagna

In the article he speculates the positive correlation between ESG and ROIC is due to profitable firms having more resources to devote in areas that positively impact ESG. He also hypothesized that profitability rises because a company manages ESG risks better than its competitors. There have been a wide variety of results whether ESG is associated with better financial results. Depending on time frames, which ESG score to use, and which financial performance indicator to compare to, there are mixed results. In part of the CFA study materials for the ESG certificate, they allude to a Global Research Institute study. The report is called "Digging Deeper into the ESG-Corporate Financial Performance-Relationship". The study analyzed over 2,000 academic studies on how ESG factors affect corporate financial performance. They found overwhelmingly positive results with nine out of ten studies showing a positive relationship[58].

Conclusion

The Nineteen's position that ESG is against the fiduciary duties of an investment advisor is built on false premises. It makes several key assumptions that fly in the face of fiduciary duties and sound advice. First, it assumes that all investors are the same and that it is the advisor's money to invest, not the investor's money. Second, if they are successful in making it illegal to invest in ESG companies, it is a gross over-reach of government interfering with what should be a free-market system that would allow choice. Third, if their definition of fiduciary duty is simply to get the highest return for the client, their calculations are based on incomplete information since the financial ratios do not consider a full accounting of the costs of doing business. ESG plans for long-term success, mitigates risk, and outperforms portfolios without ESG considerations. For an investor to fulfill fiduciary duty, an investor must consider ESG.

[58] Digging Deeper

ESG guidelines are in the best interest of a client and therefore should play an active role in fiduciary duty. ESG benefits the environment, stakeholders within supply chains, employees, the client and even the Nineteen.

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