ESG: Hyperboles and Reality

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Abstract

ESG has rapidly become a household name leading to both confusion about what it means and creating unrealistic expectations about its effects. In this paper, I draw on more than a decade of research to dispel several myths about ESG and provide answers to important questions around theories of influence, the relation between ESG and corporate value, and the usefulness of ESG assessments and ratings.

ESG has risen from an obscure and niche concept to a widely used term around the world. When I started working in this area, most (if not all) of my students at Harvard Business School had no idea what ESG meant. Nowadays, they use the term ESG in the classroom taking as a given that everyone understands what they are referring to. The same experience I have had as board member, advisor, and investor. ESG has become a common term heard in investment committee, corporate management, and board director meetings. This is a remarkable development for a concept that barely existed a decade ago.

Companies now implement ESG strategies, investors develop ESG products, and regulators design ESG policies. This activity has been fueled by a significant increase in the number of ESG data that has in turn fueled ESG evaluations. These evaluations span corporates,[1] investors,[2] countries,[3] products,[4] and even universities,[5] using a wealth of ESG metrics. Everything can be evaluated nowadays from an ESG perspective. Perhaps unsurprisingly, negative evaluations are coming with increased scrutiny for those evaluated. A frequent response is a call to distance from those with negative evaluations, through boycotts, exclusions, and divestments.

This explosion of activity has led to several hyperboles about the role of ESG in society, organizations, and markets. For some, ESG has enormous influence on corporate and investor behavior, while for others it has none. Similar levels of extreme polarized views can be found about the performance implications from ESG and about the usefulness of ESG evaluations and assessments. In the rest of this article, I seek to provide insights into three areas that are of great interest to ESG practitioners and scholars. First, I discuss several mechanisms through which the

[1] For example: https://www.corporateknights.com/rankings/global-100-rankings/2021-global-100-rankings/2021-global-100-ranking/
[2] For example: https://www.morningstar.com/articles/1050334/8-top-funds-for-sustainable-investing
[3] For example: https://dashboards.sdgindex.org/rankings
[4] For example: https://howgood.com/
[5] For example: https://www.princetonreview.com/business-school-rankings?rankings=best-green-mba

ESG field could influence corporate behavior. Second, I discuss about the connection between ESG and corporate value. Third, I discuss issues around ESG assessments and ratings.

THEORIES OF INFLUENCE

Divestment

Perhaps one of the most debated issues in ESG is whether to divest from certain assets or not. This is one of the most frequently asked questions when I speak at events. In 2014, Mark Fulton and I wrote an article "*Divestment Alone Won't Beat Climate Change*."[6] We argued that the divestment "approach is limited." We also warned that it could have unintended consequences leading to *worse* societal outcomes. We went on to explain:

> Divestment also runs the risk of unintended consequences which could thwart environmentalists' objectives. Markets have a fundamental correction mechanism for when a company's valuation falls significantly below its cash flow generating capacity: at some point a buyer steps in, often from private markets. Private equity funds do this best, buying up cash rich companies that are undervalued by public markets. Were divestment ever to succeed in lowering the valuations of fossil fuel companies, an unintended consequence could be a shift from public markets to private markets, if carbon tax regulations are not enforced fast enough. Such a shift could hurt transparency; companies that go private have minimal reporting obligations and they typically become very opaque. This could limit everyone's ability to engage the management of these companies in a discussion around climate change. In this case, divestment would clearly backfire.

In other words, if divestment forces companies to go private you lose both *transparency* and *voice*. There are also two other issues here that are important. The first one relates to whether

[6] Serafeim, George, and Mark Fulton. "Divestment Alone Won't Beat Climate Change." Harvard Business Review (November 4, 2014).

there is a transfer of wealth from public to private investors. If public companies are trying to divest under pressure from poor ESG assets, private buyers might purchase those for very low multiples. For example, a private investor buying a highly polluting coal or oil asset at three- or four-times earnings could get the investment back in three to four years and then hold an option for any remaining cash flows after that.[7] The second one relates to the ability to implement change. Think about the following: how could Engine No. 1 had ever succeeded in gaining three board seats at the Exxon board if every investor that thought climate change is an important financial risk for Exxon had divested? They would not.

This last point brings us to the heart of the debate: divestment vs engagement. The criticism of engagement is that many times it has 'no teeth.' Investors can engage for a long time without any tangible progress. This is a valid criticism and in fact one could argue that engagement has been used sometimes as a greenwashing mechanism. A combination of the two is likely to be a better alternative. This is what the decarbonization advisory panel for the New York Common Retirement Fund suggested in 2019 as the most productive way forward.[8] Setting minimum standards, transparently communicating those to investees, providing an ambitious but realistic time horizon to meet the standards, and existing the investment if the investee does not meet the standards. This is similar to our proposal back in 2014 with Mark Fulton, emphasizing the important role that divestment has played in raising awareness and serving an enforcement function:

> None of this is to say divestment has no value. Right now, divestment is causing companies and investors alike to pay attention to the risks of climate change. In other words, if targeted engagement is the carrot, targeted divestment is the stick as

[7] This seems to be happening: https://www.nytimes.com/2021/10/13/climate/private-equity-funds-oil-gas-fossil-fuels.html

[8] Disclosure: I was an unpaid member of the panel.

the enforcement mechanism for those companies unwilling to engage. This mutually reinforcing process stands a better chance of reducing high cost new fossil fuel development than either approach on its own.

Is there a case for immediate divestment without use of minimum standards? I think it exists when we are talking about companies that provide product and services and rely on business models with overwhelming negative impacts that cannot be improved because of their inherent characteristics and any positive impacts from those products are trivial in comparison.

Reporting

A great deal of attention has been paid to ESG reporting as a mechanism to influence behavior. The mechanism is basic: transparency allows for stakeholders, employees, customers, investors, policymakers to match with the companies that they fit their ESG criteria. As more stakeholders make choices based on ESG criteria the stronger are the incentives for companies to change behavior and improve their ESG outcomes. A great deal of research shows that indeed reporting and transparency can be effective at changing behavior and outcomes in general (Leuz and Wysocki 2016) and as it relates to ESG in particular (She 2020; Downar et al. 2021).[9] There are also areas where this has not been the case. For example, disclosure of executive compensation does not seem to have had much effect at curbing the level of executive compensation.

There are at least two important points to make here. The first is that reporting activities is different than reporting outcomes. Most of what has been historically measured and emphasized

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[9] Leuz, C. and Wysocki, P.D., 2016. The economics of disclosure and financial reporting regulation: Evidence and suggestions for future research. *Journal of accounting research*, 54(2), pp.525-622; She, G., 2020. The Real Effects of Mandatory Nonfinancial Disclosure: Evidence from Supply Chain Transparency. *The Accounting Review*; Downar, B., Ernstberger, J., Reichelstein, S., Schwenen, S. and Zaklan, A., 2021. The impact of carbon disclosure mandates on emissions and financial operating performance. *Review of Accounting Studies*, 26(3), pp.1137-1175.

in ESG has been activities and not outcomes. In a paper with Dane Christensen and Siko Sikochi we document that only a small portion of ESG metrics entering the evaluation of ESG raters is outcomes.[10] Most of them are activities (or inputs as we call them meaning policies, principles, management systems, targets, and disclosures). Measuring activities will likely generate many activities but not necessarily different outcomes. Most consumer goods company now have a deforestation policy, but that does not mean the forest is in better shape. Most companies now have a diversity target and systems, but this does not mean that they have become more diverse or inclusive.

The second is that reporting, while it is likely a necessary condition, it is unlikely to be sufficient in generating significantly different outcomes. Changing incentives needs to complement this transparency. Ethan Rouen and I wrote:[11]

> The third decade represents an opportunity to create the guardrails and accountability mechanisms to make this a reality. Transparent, scalable, and comparable measurement of environmental and social impacts will be a necessary condition. In turn, the incorporation of those measures into outcome-based financing, compensation, and policies could well turn out to be a sufficient condition altering our behavior in an unprecedented way.

In other words, measuring and reporting ESG outcome metrics can change behavior if there are strong incentives tied to those metrics. When customers change their purchasing based on ESG metrics, suppliers will change behavior. Many suppliers of Walmart have experienced this over the years as the firm integrated environmental criteria in procurement. The same is the case for

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[10] Christensen, Dane, George Serafeim, and Anywhere Sikochi. "Why Is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings." *Accounting Review* (forthcoming).
[11] Rouen, Ethan, and George Serafeim. "Impact-Weighted Financial Accounts: A Paradigm Shift." *CESifo Forum* 22, no. 3 (May 2021): 20–25.

executives that find incentive plans tied to ESG metrics. Similarly, for companies when investors tie financing rates to ESG metrics.

Payoffs

If ESG creates value for companies why wouldn't all companies produce better ESG outcomes thereby leading to a better world? This is a standard "good for you" argument. I would leave aside the fact that an enormous amount of research shows that even good management practices are not adopted by many organizations because of cognitive, knowledge, incentive, and capability barriers (Henderson 2021).[12] I will focus on the fact that this will never happen because while sometimes for some issues ESG pays it often does not. In 2018, in an article titled "Investors as Stewards of the Commons" I elaborated on this idea:[13]

> While these studies suggest that positive social impact and financial returns could be complementary it is not clear that one can conclude from these studies that over time firms will act in a way that will provide solutions to many of the problems we face. This is primarily for three reasons. First, while in a relative sense a firm that improves its ESG performance could be better off financially in the future, compared to other firms, it does not mean that the observed action of this firm is enough to make a meaningful contribution to the problem. For example, an electric utility company might find that it can improve its profitability or lower its risk profile and increase its valuation, by increasing production of renewable energy to 10 percent of generation but not necessarily if it increases production to 20 percent over a five-year period. However, 10 percent of generation production from renewables is clearly not enough to significantly curb carbon emissions and mitigate climate change. Similarly, a firm might be better off by lifting wages for

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[12] Henderson, R., 2021. Innovation in the 21st century: architectural change, purpose, and the challenges of our time. *Management Science*, 67(9), pp.5479-5488.

[13] Serafeim, George. "Investors as Stewards of the Commons?" *Journal of Applied Corporate Finance* 30, no. 2 (Spring 2018): 8–17.

lower level employees by $1 per hour but it might not be economically viable to lift wages by $2 per hour. However, increasing wages by $1 could still leave these people with below living wages. Second, there are cases where improving a firm's social impact does not pay. For example, in some cases consumers are not willing to pay more for "green" products, and in most cases only subsets of the customer base for specific products are willing to choose greener products (Hainmueller and Hiscox 2015). As a result, firms that take costly actions to source products in a sustainable way could find themselves with a higher cost structure, lower profitability margins and as a result at a competitive disadvantage. Similarly, sourcing from suppliers that respect labor rights might be more expensive in some cases. Third, while in some cases increasing wages or selecting suppliers with better environmental practices might bring a financial benefit in the long-term, short-term pressures on the business might make business leaders averse to making such investments. The market for corporate control, the design of executive compensation packages and the board of directors' evaluation horizons could be barriers to such decisions (Brochet, Loumioti and Serafeim 2015).

The discussion above illustrates why we should not expect the "ESG pays" argument to lead all the way to the desired societal outcomes. Sometimes, it pays up to a certain point and sometimes it does not pay at all. In those cases the efforts that firms will make will be minimal. In general, I tend to think about ESG issues decomposed to financially material or immaterial for a firm. Spending resources on immaterial issues is like philanthropy. Absent any side effects from customers, employees and other stakeholders giving back to the firm because the firm is behaving in a pro-social way they will have a return of -100%. Obviously, there are limits to how much a firm could do so in a competitive context. If something is not profitable it is unlikely to be either scalable (doing more of it) or sustainable (doing it even in bad times). Within financially material ESG issues there are issues where a firm could act on its own as it would be value enhancing if it would improve its ESG outcomes (think about energy efficiency or reducing injury rates at the workplace). There are issues where if the whole industry could act together it would be value enhancing but a firm acting on its own puts it at a competitive disadvantage (competing with integrity in high corruption risk environments). This is where the role of large institutional investors that own the market and have very long term horizons could be particularly helpful as an enforcement mechanism against free riding.[14] And then there are issues that even if the whole industry would act it would be negative financially for the whole industry (adopting a very expensive technology in steel making to produce lower carbon steel given the very high cost of low carbon steel in the marginal abatement cost curve). As we go down from the first to the second and the third set of issues, the importance of regulation and policies to support ESG outcomes increases.

Regulation

Given all these limitations some argue that businesses have no role to play in producing better societal outcomes and that only regulation is relevant. Rebecca Henderson and I have written why we believe this is misguided in an article titled "Tackling Climate Change Requires Organizational Purpose."[15]

> Here we argue that while putting in place an effective regime for pricing GHG emissions is more essential than ever, it is unlikely to be sufficient… A price on carbon is enormously important and would certainly act as an important spur to innovation and diffusion, but reworking the world's energy sector, transportation system, and agricultural practices is going to be a massive undertaking even with

[14] Serafeim, George. "How Index Funds Can Be a Positive Force for Change." *Barron's* (October 12, 2018); Serafeim, George. "Can Index Funds Be a Force for Sustainable Capitalism?" *Harvard Business Review* (December 7, 2017).
[15] Henderson, Rebecca, and George Serafeim. "Tackling Climate Change Requires Organizational Purpose." *AEA Papers and Proceedings* 110 (May 2020): 177–180.

> appropriate public policy in place… Even when prices are aligned and consumers are receptive, technological development and diffusion takes time and is greatly assisted by the presence of firms willing to take the risks necessary to introduce new products and services. The cell phone was probably the most rapidly diffused technology ever launched, but ten years after its introduction it had yet to reach 10 percent of the population… Authentically purpose-driven firms that have embraced making a difference in the face of climate change are ideally positioned to take the risks and spearhead the innovations that will be required to build a carbon-neutral economy… Purpose-driven firms are much more likely to drive the kind of transformative innovation that is essential if we are to tackle climate change. They are also ideally positioned to lead the cooperative efforts that are also crucial to making progress.

The point is that regulation is likely to be a necessary condition but unlikely to be a sufficient condition. Intentions matter and firms that have the intentionality to improve ESG outcomes are more likely to both make more aggressive investments thereby experimenting, innovating, and collaborating in the pursuit of achieving their ESG-related purpose. Plant based protein did not come out from incumbent food companies nor electric vehicles from legacy automobile manufacturers. This is why the whole movement around ESG could go from incremental to transformational. Because it has the potential to open the question about different measures of performance and how we define business success in society.

VALUE

Market Reactions

As a significant number of investors committed to ESG principles by participating in non-profit organizations, such as UN PRI, and as their own investors included ESG-related questions in their due diligence documents, there seems to be an implicit assumption that all investors now consider ESG issues. This is exacerbated by the very large numbers, sometimes in the hundred trillion range, that are classified as ESG. Therefore, there is an emerging underlying assumption that markets are reflecting ESG news and that ESG news are really impacting markets.

In a paper with Aaron Yoon, we examine market reactions around ESG corporate news and find that most generate insignificant price reactions.[16] Investors seem to react only to news that are likely to be financially material for an organization and receive more attention from the media and stakeholders. Moreover, decomposing further the news by type we find that the strongest reaction is generated by news that relate to customer and product related news within the social capital category of ESG. We document small positive responses to positive human capital related news and negative responses to negative natural capital related news.

The lack of significant reactions to the vast majority of ESG news shows that capital markets do not seem to regard many of those news as relevant for assessing the value of companies. Therefore, we should be careful about assuming that ESG information is a strong force in moving markets and the extent to which most investors use ESG information.

Investment Performance

Whenever someone discusses ESG the discussion also comes to the debate about whether ESG portfolios will outperform or not. This is a very difficult question to answer given the complexity of even measuring ESG in the first place in the context of an investment fund. There are many labelled funds that do very little of ESG analysis and research. Therefore, labels are unlikely to be helpful, although the recent SFDR regulation in the EU, could prove useful.

[16] Serafeim, George, and Aaron Yoon. "Which Corporate ESG News Does the Market React To?" *Financial Analysts Journal*, Forthcoming.

Unhelpful are also efforts in designating ESG funds based on portfolio composition. Some funds tend to hold high ESG rated stocks or bonds but there has been no intention behind that and that can be an unintended consequence of some other intended outcome. Moreover, such identification relies on the validity of a specific ESG rating.

Setting aside those concerns the question of outperformance relates to a question about financially materiality of ESG issues and the pricing of those in the market. One robust way to justify expectations of outperformance is to a) invest in companies that are improving their performance on financially material issues, b) management invests to improve on a scale and time that pays off and c) expectations about any improvements in future financial performance or valuation multiples are not already reflected in prices. This seems to be much easier to do in a private equity setting, rather than in public markets, given that the investor had direct control over the company and can catalyze a and b after investing in the company.

These three components all deserve attention. The first one is fairly standard by now. Many investors now construct their own proprietary materiality maps trying to weight different ESG issues based on their importance. The same is the case for ESG rating providers. The second one is very difficult to assess and requires much more in-depth analysis. I have not seen many serious efforts to assess this second component. Being able to provide robust assessments of that component will likely yield even stronger evidence of a link between ESG and financial performance. Aaron Yoon and Kyle Welch research comes the closest to assessing this second component.[17] They use employee surveys that assess managerial capabilities to show that

[17] Welch, Kyle and Yoon, Aaron, Do High Ability Managers Choose ESG Projects that Create Shareholder Value? Evidence from Employee Opinions (June 2, 2020). Available at SSRN: https://ssrn.com/abstract=3616486 or http://dx.doi.org/10.2139/ssrn.3616486

managers who receive higher ratings from employees are more likely to allocate resources to ESG efforts in a way that enhances financial performance.

The third component is something that I explored in a paper. I showed that many firms with higher ESG assessed performance were increasingly more highly valued in capital markets.[18] The way that I think about that is that investments in material ESG issues create intangible assets (or reduce liabilities) for a firm thereby creating future economic benefits (or reducing future economic obligations) from them. But higher pricing could mean lower returns, especially if prices get too high and overestimate the magnitude of those intangible assets. Consistent with this idea firms with strong ESG assessed performance and negative societal sentiment around them exhibited lower valuation and higher returns in the future than firms with strong ESG assessed performance and positive societal sentiment. One way of thinking about the former is firms where the ESG fundamentals are disconnected from the market's view while for the latter they are aligned. Therefore, one cannot ask only the question about what the value of ESG investments is but also ask what is the price that an investor is paying to buy into those investments. Not understanding both the value and price of ESG investments can lead to underperformance.

Another robust way of thinking about outperformance through ESG is more thematic in nature. Allocating capital in growth areas of the economy, if that growth is not priced yet in markets can be a fruitful area. A prime example here would be 'climate solutions' companies. These are companies that are providing the necessary products and services to decarbonize energy, transportation, food and agriculture, industrial processes, and real estate. But again, the same caveat applies: investing in companies that might experience fast growth in the future does not

[18] Serafeim, George. "Public Sentiment and the Price of Corporate Sustainability." *Financial Analysts Journal* 76, no. 2 (2020): 26–46.

mean that one might outperform if those growth expectations are already priced in the market. In fact, some of those companies can become overvalued leading to negative returns in the future.

The analysis above illustrates also why one cannot have much confidence on the performance outcomes of most ESG investment products. Most of these products are quasi-index funds designed to minimize tracking error and to change weights on holdings to optimize certain ESG metrics or ratings. By construction, those products will deliver very close performance to the benchmark. A great number of products are only doing some basic form of negative screening. Again, this has little to do with the two basic ways that outperformance could be justified. In private markets, an increasing number of private equity funds are integrating ESG issues into due diligence, management during ownership, and exit valuation. Because of the opacity of those markets, we still have little data on how private market investors are precisely using ESG.

ESG as a preference

A common characterization of ESG is that it represents a preference or taste among some companies or investors. In that framework, there is no inherent value in ESG activities other than expressing a preference. For example, there is no value from identifying new markets, serving customers better, becoming a more attractive employer, or improving operating efficiency. I find this view unlikely to be a good depiction of reality given that the whole business and investor universe is increasingly adopting (in label or in practice) ESG practices. This is something that we have documented with Ioannis Ioannou at a paper "Corporate Sustainability" A Strategy?"[19] In most industries we are observing a widespread convergence of practices by imitating across competitors:

[19] Ioannou, Ioannis, and George Serafeim. "Corporate Sustainability: A Strategy?" Harvard Business School Working Paper, No. 19-065, January 2019. (Revised April 2021.)

> Our findings reveal that globally, within most industries, companies undertook an increasingly similar set of sustainability actions over the past decade. Moreover, we find that the interindustry variation in the degree of imitation of sustainability actions is explained, to an extent, by the variation in the materiality of environmental and social issues and variation in the level and tone of stakeholder attention that industries face. By considering variation at the industry-action level, we find that actions are more likely to be imitated when they are characterized by low regulatory uncertainty and that practices with a high degree of novelty are less likely to be imitated.

This finding opens the possibility to think about ESG, not as a preference, but as a set of common versus differentiated practices. This allows us then to connect ESG to strategy. The reason is that strategy, as my colleagues Michael Porter and Mark Kramer have explained in their work on shared value, is about what makes you different. It is about the unique competitive positioning that an organization occupies within an industry. Therefore, we can think about ESG as a strategy if it allows an organization to differentiate itself. ESG practices that are diffusing and becoming common among all companies are more likely to be practices that have to be adopted as they are becoming 'a standard of doing business' and part of an organization's operational effectiveness.

EVALUTIONS

Disagreement

One of the most hotly debated issues in ESG is the disagreement among rating providers when they assess the ESG profile of a company. An important paper by Berg, Koelbel and Rigobon (2020) has decomposed that disagreement to what is being measured (scope), how it is being measured (measurement) and what is prioritized (weight).[20] They document that rating disagreement is primarily driven by the first two components.

It is not clear whether this disagreement is a good or a bad thing. Certainly, disagreement can create confusion among market participants and create confusion among companies about market expectations. It can also contribute to a lack of accountability as companies can always find one rating provider where they score well. But at the same time, multiple viewpoints and opinions can be helpful especially in new contexts where prematurely converging in one point of view might lead to inferior evaluations and can dampen competition for new ideas and new evaluations.

For those worried about disagreement, a natural place to look for a solution is in transparency, as this is something that has worked in creating more agreement among credit rating agencies or in analyst earnings forecasts. If we had more disclosure, we would be more likely to agree on ESG assessments the argument goes. That seems to be wrong historically according to our research with Dane Christensen and Siko Sikochi in a paper titled "Why is Corporate Virtue in the Eye of the Beholder?":

> Contrary to evidence in these settings that disclosure mitigates disagreement, in our setting, disagreement is larger when firms have higher levels of disclosure. In our view, this highlights the importance of developing a shared understanding of a) what constitutes good or bad ESG performance, and b) what metrics to use to capture ESG performance, as preconditions for ESG disclosure to decrease disagreement.

[20] Berg, F., Koelbel, J.F. and Rigobon, R., 2020. Aggregate confusion: The divergence of ESG ratings. MIT Sloan School of Management.

This is an interesting finding because it highlights the importance of building the rules and norms upon which we assess a firm's activities or outcomes as "good" or "bad." An injury rate or water intensity can be acceptable for one analyst and unacceptable for another. In the absence of developing a consensus on how we evaluate these metrics it is very likely that we will be getting a very wide set of outcomes from these assessments. Moreover, in the presence of more information the analysts have even more information to disagree about. In our research we found that analysts tend to disagree more on ESG outcomes rather than ESG activities. This in turn could be problematic:

> In the presence of information asymmetry and incomplete information about a firm's ESG performance, ESG ratings can perform a significant information intermediary function, mitigating the adverse selection problem and thereby helping investors and other stakeholders to choose companies that exhibit their preferred ESG outcomes (Chatterji and Toffel 2010). In particular, having rating agencies focus on ESG outcomes might be desirable to mitigate 'cheap talk' by companies, as a company would need to show real effects (e.g., reductions in carbon emissions, improvements in lost time injury rates) instead of disclosing the adoption of a policy or initiative that might generate no real effects (Grewal and Serafeim 2020). However, our results suggest that ESG rating agencies have a more difficult time agreeing when evaluating a company on outcomes rather than input metrics, and that disclosure exacerbates disagreement on outcomes even more than it does on inputs. This lack of consensus about how to interpret outcomes might be an obstacle that encourages raters to focus more on inputs and thereby causes potential damage to the corporate accountability function that ratings could perform. In this context, we regard disagreement as inhibiting the accountability process. Moreover, while disclosure may have many positive effects, it likely needs to be placed in a framework that allows analysts to evaluate those outcomes with clear benchmarks. Overall, given concerns over ESG rating disagreement, our

> findings suggest a lot of work still needs to be done to develop rules and norms to determine what characterizes good ESG performance.

What could be a positive sign? In my mind, a positive sign could be observing that the result of this study changes over time. As analysts develop a consensus both on the metrics to use to assess a firm's performance on a specific ESG issue and how to interpret the information reflected in each metric, the relation between disclosure and disagreement might diminish or even become negative. In other words, if it proves that the study is reflective of the early stages of institutional innovation around ESG disclosures and that over time we develop robust evaluation processes.

Usefulness

Partly because of the issue of disagreement and partly because sometimes highly rated ESG companies have proven not to deserve their assessment, some have completely dismissed such assessments as useless. Certainly, as in the case of any assessment, they can be improved. But saying that they are useless is not something that is supported by research. In a paper with Aaron Yoon we find that these ratings are helpful in predicting future ESG related news.[21] This is important as it provides evidence of a connection between ESG assessments and one measure of realization:

> Proper allocation of resources in an economy requires institutions that provide information intermediation (Healy and Palepu 2001). As a result, a large amount of resources is spent in producing performance evaluations, such as sell-side analyst forecasts, recommendation ratings and credit ratings. A central feature of these ratings is that there is an eventual realization that disciplines those evaluations, such

[21] Serafeim, George, and Aaron Yoon. "Stock Price Reactions to ESG News: The Role of ESG Ratings and Disagreement." *Review of Accounting Studies* (forthcoming).

> as future stock returns in the case of investment recommendations (Barber, Lehavy, McNichols, and Trueman 2001; Clement and Tse 2003; Gleason and Lee 2003), realized earnings in the case of analyst forecasts (Mikhail, Walther, and Willis 1999; Bradshaw, Drake, Myers, and Myers 2012; Hong and Kubik 2003), and default on debt in the case of credit ratings (Becker and Milbourn 2011)… we focus on a relatively newer set of performance evaluations: environmental, social and governance (ESG) ratings. These ratings now are sourced by investment managers with trillions of dollars in assets under management influencing portfolio construction and trading. However, due to their multidimensionality and the difficulty in clearly observing the outcomes associated with ESG performance, it is much less clear how one can or should judge their quality. As a result, an emerging stream of literature has focused on the fact that different raters give the same company very different ratings, raising questions about their usefulness.

The important point here is that there is a big distinction between something can be 'improved' and something is 'useless.' While assessments could be improved and their connection to future realizations could improve this does not mean that already they do not perform an important function.

REALITY

The rise of ESG within business will not solve all of society's problems. But it is also not irrelevant and in fact could be a force for accountability and progress. Both views are hyperboles. Whether the full potential will be achieved remains to be seen and in fact its potential will be shaped by both market forces and public policy. Contrary to the opinions of some, neither is likely to be sufficient in making progress and both are necessary.

Another hyperbole comes from estimates on how many investors consider ESG information when they make decisions. While an increasing number of investors seem to have

ESG policies and other such intentions, this does not necessarily mean that they would react to ESG news by changing capital allocations. Similarly, adoption of ESG practices will not raise universally performance in organizations. It is not realistic to expect that every organization that invests in ESG efforts will experience positive results. As with every aspect of business activity, new product development, recruitment, procurement, talent development, operations optimization, robust management and governance processes that ensure strong ESG strategy implementation will be key (Serafeim 2022).[22]

In my experience, most organizations have now developed commitment among their leaders to take ESG seriously, again a significant difference from even five or seven years ago. But they have not developed robust management tools and frameworks to embed disciplined capital and talent allocation into budgeting, management control systems, incentives, and corporate culture to drive ESG outcomes forward.

[22] George Serafeim. 2022. Purpose and Profit: How Business Can Lift Up the World. Harper Collins Leadership.