Community Finance Brief

Ignore ESG to Build a Sustainable Future

CSG

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"Drill, baby, drill" was a campaign slogan in 2008 first used by former Republican National Committee chair Michael Steel. Popularized by former vice president nominee Sarah Palin and still part of former president Donald Trump's current stump speech, it remains a central component to a political stance of many across the country. What began as a position on energy independence is now a largely a piece of political theater used to underscore conservative credentials.

It reached a crescendo last year when President Biden used the first veto of his presidency to reject a Republican Senate proposal to prevent pension fund managers from basing investment decision on factors like climate change. While this issue died in D.C. as a result of the veto, it has taken on a new life at the state and local level. The success of the anti-Environment, Social, Governance (ESG) and/or anti-woke movement has a grassroots appeal (and real legs).

Financial institutions are not known for taking strong stances on divisive issues and rightly or wrongly shield themselves from this stage behind the wall of fiduciary duty. When environmental and/or social implications of action is under a microscope, this stance has become increasingly difficult in the last decade.

States like Florida and Texas have blacklisted ESG-friendly companies and rating agencies while Citigroup closed its public finance business. Websites that emphasized ESG work just two years ago on behalf of various institutions now avoid the term. Philanthropic enterprises in many cases water down the terminology. For anyone watching this industry, the ramifications of this movement are clear.

Quick Takes

In 2023, there were 83 bills introduced in state legislatures that are considered 'anti-ESG' and 19 that became law
- *S&P Global*

A 2022 poll found that 69% of Americans favored the U.S. taking steps to become carbon neutral by 2050
– Pew Charitable Trusts

48% of Republicans in the 18- to 39-year range see government regulations as necessary to encourage reliance on renewable energy
- *Pew Charitable Trusts*

DRLL ETF has a 1-year trailing return of negative-5.09%, just outperforming the 'energy equity' category (negative-5.76%) as of Feb. 28th. Exxon, Chevron, ConocoPhillips stock are the three largest fund holdings accounting for roughly 43% of the entire portfolio
– *Morningstar*

For the purposes of this *Brief,* we focus on public finance.
These issues may take a larger stage in the private sector (a great read from Harvard Law can be found here) but the intersection of ESG and governing entities has larger ramifications

because governments create the landscape where these decisions are being made. Seeing as government does not operate on a strictly fiduciary duty to shareholders but rather on an ethical and moral compact with fellow humans and the environment we all live in, the terms of the discussion take on a different tone.

Politics will eventually win out on any ethical considerations and the questions get boiled down to whether or not governments will support non-financial implications more heavily when it comes to policy making. It is here where ESG, which is essentially government efficacy, has strong identification with conventional conservative ideals. Government accountability and transparency are concepts that for some reason have been muddied by the debate around ESG.

"I want to know what the long-term impacts are of climate on a company. I want to incorporate that in my investment decision. That's not political. That's just good business," says **Witold Henisz**, the director of the ESG initiative at the University of Pennsylvania's Wharton School of Business. "I'm not saying this is the morally right thing to do. I'm saying let's look at the impact on revenues, on costs, on productivity."

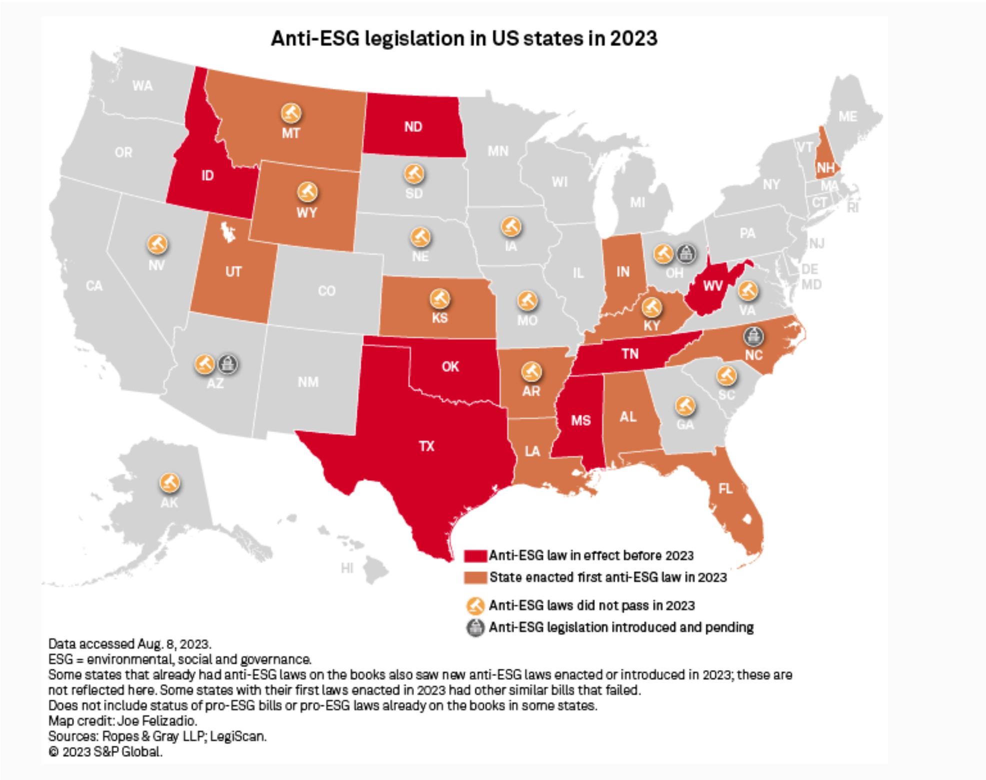
HOW WE GOT HERE

In early February, South Carolina became the 16th state in the union to ratify anti-ESG language in some form. Specifically, the bill directs all investment decisions for the public pension system be based on financial return and not on factors such as environmental, social and governance.

Much of so-called anti-ESG movement began with the tobacco lobby after the landmark 1998 Master Settlement Agreement was signed between big tobacco and all U.S. fifty State and territories. The Free Enterprise Education Institute (started by Philip Morris alum, among others) targeted corporate social responsibility initiatives, which form the foundation of ESG principles. Despite efforts to discredit the concept of considering social and environmental factors alongside financial ones, these early criticisms did not gain much public attention.

This changed dramatically at the federal level during the Trump Administration. In response to progressive environmental stances of the Obama Administration and, to some, a latent racial backlash to the man himself, the 45th president's administration was marked by increased support for deregulation. While the Black Lives Matter movement was born in the summer of 2013, the political rift to the movement was magnified during this same tenure.

Perhaps due to the inability for cohesive action at the time, it was not until *after* the Trump presidency that the anti-ESG movement really took hold. This is in part due to the work of Vivek Ramaswamy who was able to combine the political rhetoric behind the anti-ESG/woke movement and monetize it through exchange-traded funds and other investment approaches. The ability of the State Finance Officers Association (funded in part by Ramaswamy) to create a grassroots approach to anti-ESG has been very effective.



Not only do 9 more states have pending anti-ESG legislation, but several more are committing to not doing business with entities that work in the so-called 'ESG' space (see: Citigroup). The evidence is amply demonstrated in the private sector as shareholder votes supporting ESG issues have been declining since 2021 (see figure , **page 4**). From the big picture though, 2023 saw at least 29 states adopt some sort of anti-ESG legislation (see map of the country, **above**).

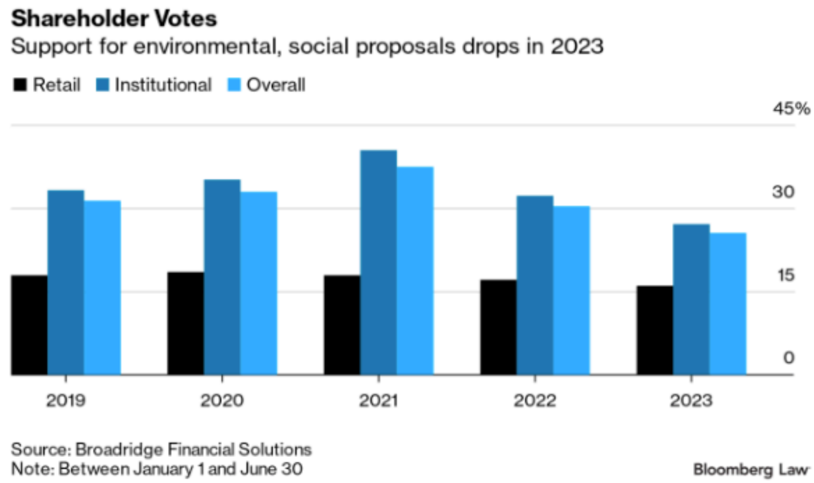
How this impacts community life, the environment and the economy is unclear. There are early signs that it is not helping the state of Texas as it has banned several underwriters of its municipal bonds, but broadly speaking, it is too soon to tell. Complicating matters is that there are leaders in various industries that are ignoring these state-level roadblocks and operating with environmental and social considerations at the forefront as well as unprecedented climate-focused federal dollars in the process of being allocated.

PROGRAM TRANSPARENCY AND SUSTAINABILITY

It would behoove policy makers to consider the long-term efficacy of governments, their investments and how they engage with the private sector. The environment, social issues and internal transparency align quite well with broadly accepted viewpoints across political spectrums:

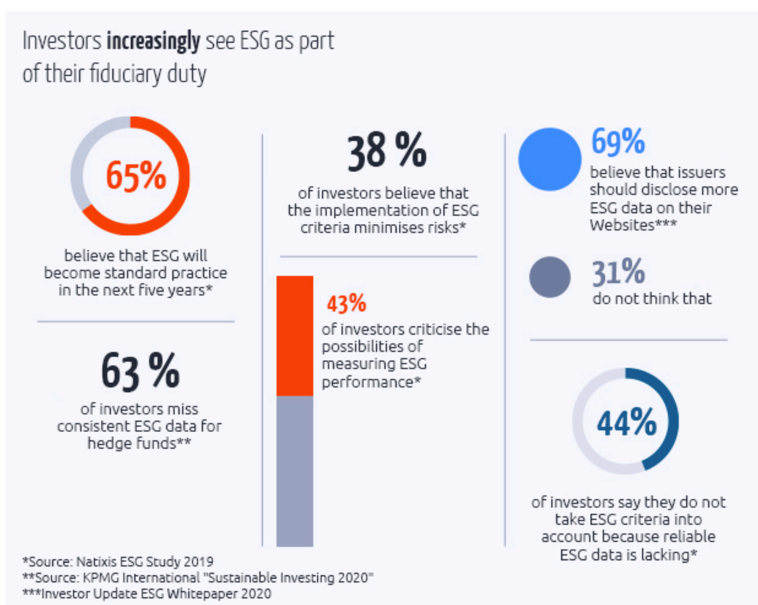
- **Prudent Stewardship:** The focus on long-term sustainability and risk management within ESG dovetails with the conservative ideals of preserving resources, responsible planning, and future-oriented thinking. Environmental stewardship, for instance, can secure access to critical resources and mitigate long-term economic risk.
- **Individual Responsibility and Limited Government Intervention:** Proactive ESG practices by companies can preempt the need for extensive government

regulations. Companies that effectively manage their environmental impact, social responsibility, and governance structures operate with a strong sense of autonomy and require less corrective intervention.



- **Market-Based Solutions:** ESG principles rely on market forces and investor choices to drive positive change rather than heavy-handed mandates or top-down regulation. This approach resonates with the conservative emphasis on free markets as solutions.
- **Community and Stability:** The "S" in ESG, with its focus on social factors like workplace safety, human rights, and community impact aligns with conservative values of strong communities and a thriving workforce. Healthy, flourishing communities are the bedrock of a stable society.
- **National Security:** Aspects of ESG, particularly those related to environmental resources and supply chain management, are important considerations for national security. Reducing dependence on foreign suppliers or ensuring the responsible use of critical resources bolsters American resilience.

In considering these alignments, the focus is more about outcomes over any sort or label. The tangible benefits of community stability and longer term financial returns along with equal footing for all people are not political in nature and lend themselves to traditional conservative orthodoxy.



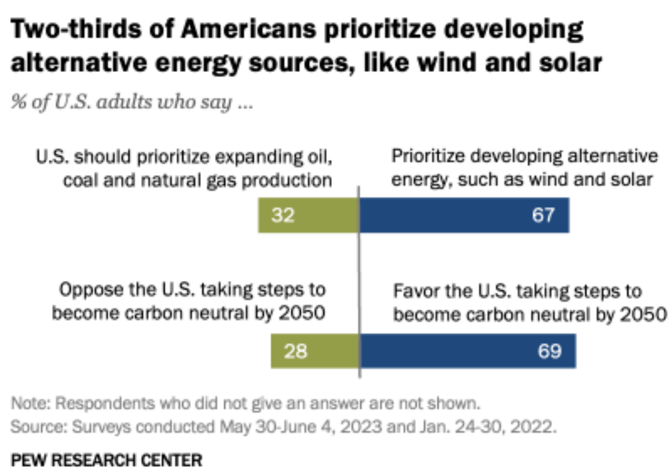
The Short-sightedness of Banning ESG

The surge of state legislation aimed at banning the consideration ESG factors is a misguided and potentially destructive policy direction. This push, largely driven by political ideology, disregards the fiduciary responsibility of pension funds to prioritize long-term financial returns for beneficiaries.

ESG is fundamentally about smart risk management and long-term value creation – principles that have long been cornerstones of conservative financial thinking. Ignoring these factors is akin to driving a car without a speedometer or a fuel gauge – you're increasing the chances of running into trouble.

Numerous studies demonstrate a positive correlation between ESG integration and financial performance. A 2021 meta-analysis by NYU Stern found that sustainable investment funds often outperform traditional ones. This is hardly surprising – companies that manage their environmental impact, treat their employees fairly, and operate with integrity are more likely to thrive in the long run.

Unfortunately, ESG has become needlessly politicized. Critics often wrongly label it as a "woke" agenda, despite evidence showing that ESG investing can be a force for good across the political spectrum. The reality is that ESG is simply about prudent investing, a concept conservatives have traditionally championed.



The implications of banning ESG factors are alarming. Pension funds, with their responsibility to retirees' financial security, could be forced to invest in companies with higher long-term risks, potentially jeopardizing returns. It's worth noting that many investors are increasingly demanding ESG considerations, and excluding them could make these pension funds less competitive.

Moving Forward: Responsible Investing

Instead of banning ESG, the focus should be on depoliticizing the issue and emphasizing principles that all sides can agree on. Here's how:

- **Focus on Fiduciary Duty:** The primary responsibility of an investment manager is to maximize returns for beneficiaries. ESG factors should be considered only insofar as they have a material impact on financial performance.
- **Promote Transparency and Accountability:** Clear reporting and disclosure about how ESG factors are integrated into investment decision-making are essential. This builds trust and ensures that investors and governments aren't pursuing ideological agendas.

- **Embrace a Broader Framework:** Moving beyond the politically-charged "ESG" label, governments can focus on metrics of responsibility, sustainability, and long-term risk management.

The politicization of ESG investing is a disservice to taxpayers and the beneficiaries of public pension funds. By recognizing the inherent conservatism of ESG, and focusing on a broader framework of responsible investing, policymakers can ensure that investments and government programs are managed in a way that safeguards their beneficiaries' futures, avoids unnecessary risk, and remains consistent with sound financial principles.

Those pointing to polling data on climate change or on generational shifts as a reason for why anti-ESG or anti-Woke isn't sustainable underestimate the power of the constituency. People vote against their own interests regularly in this country not because they are uneducated but because they are being pandered too. Americana. Environmental justice. Who we think we are and who we really are different things. This is exaggerated in voting trends. A union member voting for Trump. Polls on divisive issues that pertain to race, gender, solar energy and sexual orientation aren't about the issue, they are about the tribe we belong too.

This upends a long-term goal and is replaced by an election cycle. Instead, taking the issues and linking them to where it is least expected is what will change this debate over time. It is efficacy - measuring the result of an action - not ESG.