Corporate Cancel Culture

Policy Exchange

How ESG came to rule our investments

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About the Author

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Foreword

By Baroness Cash, former Chair, Mind Gym plc, Commissioner at the Equality and Human Rights Commission and barrister.

It is a good thing for businesses to act responsibly, socially, and environmentally. Big corporations have immense reach, so it is right that their actions across the world be carried out with respect for the environment and their impact on the societies in which they operate. It is in this context that ESG has grown, its original intentions laudable. However, we have seen a mission creep which means that investors freely interpret nebulous parameters of ESG without due regard to the repercussions of decisions made. In addition to the burdensome costs of this regime, this groupthink has had unintended consequences. and in turn there has been an understandable rise in the political backlash against ESG.

If we are to avoid throwing out the good along with the bad alike, we need to have a serious, informed conversation about ESG. This paper by Policy Exchange provides a compelling starting point. As a society, we need to balance good governance of businesses against the danger of stifling regulation. Similarly, whilst corporations should not carry out their activities with a complete disregard for the environment, the way that these effects are measured should not be based on unreliable and patchy data. The only way to achieve a satisfactory middle-way in these cases is by having a transparent debate about the advantages and disadvantages of ESG in its current form.

Most concerningly of all is the way the use of ESG to drive investment decisions is driving finance away from the defence companies that are providing essential arms for Ukraine. With a major land war raging in Europe, we cannot indulge the lazy belief that looking to our defence – and those of our allies – is somehow unethical, or that defence manufacturers are not a vital part of that endeavour. Pacifism is rightly a fringe view in our society – and yet it has unthinkingly been entrenched within the heart of our financial ecosystem.

Worryingly, the author cites a reluctance by business leaders to speak openly about their concerns. As the former Chair of a listed business, I have experienced this first hand. But without a frank conversation, issues go unaddressed and businesses are crippled. Those who are most critical monopolise the conversation, and what follows is the danger of overcorrection, with the positive aims of ESG being set aside completely. Insufficient thought is given to the way in which worthy objectives are best served.

As a country we need to answer urgent questions: why is economic growth stagnant, why do we struggle with productivity, what factors are driving our economic strategy. As part of that an honest conversation about the role ESG has played, the shortfalls of it and what changes are needed is vital. Policy Exchange has now provided a clear and welcome guide for that conversation. It is one that all who care about the success of our economy should consider closely.

Introduction

ESG – Environmental, Social, Governance – investing is one of those ideas which has crept up on us without a government or single organisation appearing to be driving it. It is a product, perhaps, of what Marx would have called the impersonal forces of history. It has never been properly debated. Its perverse consequences have never been rationally addressed. It has been advanced through numerous initiatives to which have been pushed through as if they were inevitable. Corporations and financial institutions have jumped on board because everyone else has been doing so, and so it seems unavoidable. Few in positions of influence have been brave enough to stand back and question the merits of what they are doing.

That is why we have ended up in a situation where the defence industries of western democracies have come to be treated as pariahs which deserve to be starved of capital, where oil and gas assets have been passed from western corporations to much less-regulated offshore private equity vehicles. We have investment being transferred from small companies to large ones, from developing countries to developed ones – all supposedly in the name of ethical advance.

But where did ESG come from and is it really inevitable that it should continue to govern investment decisions? To answer these questions is it necessary to acknowledge that ESG is not wholly bad. We all surely want companies which are responsibly governed and which go about their business with a sense of responsibility towards society; we wouldn't want the economy – and thus our lives – in the hands of rapacious corporations who care for nothing other than the personal enrichment of their shareholders. But as we shall see the laudable aim of improving corporate responsibility is not always best served by trying to reduce ethical behaviour to simple, numerical scores or through trying to employ the consciences of individual investors who might have a limited grasp of the environmental, social and governance issues on which they are trying to base their investment decisions. Too often, ESG ends up operating like the heavy-handed cancel culture practiced by student activists and others, in which the investment world attempts to shame businesses of which it disapproves. Moreover, while there may be fundamental issues on which almost everyone might be agreed – such that mining companies should not kill their workers or people who live close to their operations through cavalier practices – many environmental, social and governance issue are not clear cut. There is a range of quite reasonable – and yet opposed – views on many of these issues which cannot be classified as 'good' or 'bad'.

As we shall see, ESG has suffered a backlash in recent years, not least with the re-election of Donald Trump in the US. But it should not be assumed to be dead on its feet; it is very likely to rebound. It requires urgent and comprehensive debate. What follows is an attempt to start that off.

ESG: the origins

When I was a child a classmate once asked me a hypothetical moral question: would I accept a gift of £1 million if it meant that somewhere, on the other side of the world, a random person, whom I did not know and whose demise could never be traced to me, would drop dead as a result? I can't remember how I replied, only thinking that it seemed an impossible scenario and therefore did not require an answer. But perhaps it is not quite as hypothetical as it sounds. When we invest in the shares of a business we don't really know everything that it gets up to. For all we know, our capital gains and dividends (should they arise) could be coming at the cost of causing others harm. Sometimes it is obvious that this is the case – for example when we read that a mining company whose shares we own, and which might have helped boost our wealth, has suffered a disaster that has killed workers and poisoned the local environment.

To a greater or lesser extent we would all surely recoil from an investment which blatantly offended our moral principles. Even if you get it past the regulators I think – indeed hope – there would be few takers for the IPO of a latterday Royal African Company. We would not want to grow rich at any cost to others in society. We do have the law to help guard us from having our money used to invest in unethical purposes – there are certain practices in which we cannot invest because they are illegal. We also have the moral values of people who run businesses – companies are not run by amoral bots (at least not yet) but by people like us. We can at least hope that they will make business decisions which do not cause great harm.

But this might not always seem enough. Most of us have some kind of vision of the world as we would like it to be. There are things we would like to see happen more, other things we would like to happen less. It is natural that we should want our money invested in such a way that chimes with our sense of what is good and what is bad. For charitable organisations whose very purpose is to advance a cause it would be bizarre if they did not take care to ensure that their investments did not help to undermine it.

But should we trust our own judgement, or should we leave it to others to choose investments which – we hope – will chime with our own values? That is the crux of ESG: it is an effort to formalize and quantify the concept of using investments to achieve good in the world. It promises to make tricky ethical calls for us, so that we don't have to be bothered. It can be traced to the formation of a British organisation called Ethical Investment Research Services – EIRIS – set up by churches and charities in 1983 to advise on which investments to avoid. At the time, South Africa was the subject of various boycotts over its apartheid policy. Many western companies responded to a campaign to persuade them to withdraw operations from the country. They did so, perhaps, partly out of ethical considerations by their owners, and partly for fear that they might themselves be boycotted by their customers should they continue to do business in the country.

Later in the 1980s came the first 'ethical' investment funds. But the beginning of a global effort to promote good corporate behaviour, and penalise the bad, really began with the Global Compact launched by UN Secretary-General Kofi Annan in 2000, and which sought to lay down ten principles for corporations to follow. Six of them might be described as falling under the definition of 'social' concerns, three were environmental in nature and one was more to do with governance. The first demanded that businesses support and respect internationally-proclaimed human rights, the second insisted that they make efforts to make sure they are not complicit in human rights abuses. The third declared that businesses should uphold freedom of association and the right to collective bargaining, the fourth demanded the elimination of all forms of forced and compulsory labour, the fifth the abolition of child labour and the sixth the elimination of discrimination in the workplace. Moving on to environmental concerns, the seventh demanded that businesses "support a precautionary approach to environmental challenges", the eighth that they "promote greater environmental responsibility" and the ninth "to encourage the development and diffusion of environmentally friendly technologies". Finally, the tenth demanded that businesses "should work against corruption in all its forms, including extortion and bribery".

With the exception perhaps of the right to collective bargaining, which implies the recognition of trade unions in the workplace – something which some large corporations continue to reject – these were all pretty universal, broad-brush, non-controversial principles to which few businesses would have a problem signing up to. They did not propose that whole areas of business, such as fossil fuels or weapons manufacture, be put beyond the pale; only that companies should operate within the bounds of human rights treaties to which almost all governments had signed up to half a century earlier. Within four years, 1500 companies globally had signed up to the compact.

The Global Compact led to a UN report published in June 2004 entitled *Who Cares Wins*, which first introduced the acronym ESG – Environmental, Social, Governance. It made the case that investing in accordance with ESG principles would not only be good for society; it would be good for investment returns, too[1]. But this is where something odd happened. In order to oversee the writing of its report the UN appointed a working party of 22 corporations – every single one of which was a financial institution, and a western financial institution at that. They included Goldman Sachs, Morgan Stanley, Axa, BNP, Citigroup, Credit Suisse, Deutsche Bank, HSBC and ABM Amro – yet not a single manufacturer, mining company or any

1. *Who Cares Wins: Connecting Financial Markets to a Changing World* United Nations June 2004

other kind of business. A code of behaviour which was supposed to cover businesses of all kinds was being laid down entirely by the financial sector.

Nobody knew at the time that four years later the financial sector would be at the centre of a storm, with many banks facing collapse as a result of contagion traced back to US mortgage securities and other bad debts, and the whole industry accused of reckless behaviour. Even so, it was hardly healthy that the UN was trying to delegate the whole subject of corporate responsibility to banks and investment houses, effectively trying to establish them as the moral police force which would oversee the entire world of business.

Goldman Sachs seems to have been especially influential in the report, which contained a long section on the embryonic Goldman Sachs Energy, Environmental and Social Index (GSEES). This sought to "identify specific environmental and social issues likely to be material for company competitiveness and reputation". It sought to mark the oil majors on eight topics: climate change, pollution, human rights, management diversity and incentives, investment in the future, workforce, safety and transparency and vision – and then compared their scores with their financial performance. There was no mention of reducing carbon emissions to net zero, phasing out fossil fuels or any of the standards to which many people now try to hold oil and gas companies. Rather, Goldman Sachs asserted that "the world is moving from the age of oil to the age of gas, and potentially to an even lower carbon world" – and marked the companies on the basis of that.

There was a clear winner from the exercise. BP came out on top, leading on climate change, human rights and on transparency and vision, and coming second on management diversity, workforce and safety. But was a good mark on ESG issues associated with superior share price? "A strong performance on social and environmental issues is no guarantee of stock market performance," concluded Goldman Sachs. But in future, it suggested, the picture might be different. Alas, BP's good score did not translate to good performance or a rising share price. Six years after the company came top of the class in the GSEES, on 20 April 2010, the Deepwater Horizon, an offshore drilling rig employed by BP in the Gulf of Mexico, exploded, killing 11 oil workers and unleashing the worst oil spill in history. BP's share price collapsed as the costs became clear. For a while it seemed questionable whether the company would survive at all.

That, then, was the inauspicious start to the practice of trying to assess a set of companies on ESG principles. The first company to win plaudits in this way turned out to be very far from exemplary on at least two of the categories on which it had scored highly – safety and pollution – and had suffered huge financial losses as a result. It was government regulators, not the ESG police, which eventually brought BP to account.

Goldman Sachs' thesis can be put as thus: ESG concerns will, if they have not already, eventually impact on a company's fortunes and share price performance, because a company's bad behaviour will one day get it into trouble with the law, lead to consumer boycotts or some other fate. Therefore, there is no conflict between investing on ESG principles and investing in order to maximise financial returns. The two go hand-in-hand – what is good for the investor's conscience will be good for profit – eventually, even if not immediately.

The concept of ESG soon developed, however, to a subtly different assertion: that it was right to take ESG factors into account when making investment decisions, regardless of whether that was the right thing to do from a financial perspective. In 2005, the Asset Management Working Group of the United Nations' Environment Programme Finance Initiative (UNEP FI) commissioned the UK law firm Freshfields Bruckhaus Deringer to solve a bit of a legal problem. Many institutional investors, it realised, were under a fiduciary duty to maximise financial returns on their clients' money; so might they fall foul of the law if they started taking investment decisions based on anything other than financial returns, say on ethical considerations?

Freshfields argued not. In the nine countries which it studied it concluded that while it might not be strictly legal for an asset manager to make investment decisions based purely on his own personal ethical views, that did not preclude taking ESG matters into consideration when building up a diverse portfolio. If this wasn't clear in law, then it could always be put right: the report cited a recent law in the Canadian province of Manitoba which expressly permitted trustees to look to non-financial criteria when making investment decisions without falling foul of their fiduciary duties. Freshfields went on to make a broader philosophical point, saying "many people wonder what good an extra percent or three of patrimony are worth if the society in which they are to enjoy retirement and in which their descendants will live deteriorates"[2]. In other words, asset managers are entitled to believe that their clients want to do the world some good, and to make investment decisions accordingly – even if it does not maximise returns.

UNEP followed this up in 2006 by publishing its Principles for Responsible Investment, put together by 20 institutional investors from 12 countries backed up by a "70 person multi stakeholder group of experts from the investment industry, intergovernmental organisations, civil society and academia" – but apparently excluding anyone from any business other than a financial one. These principles demanded that investors incorporate ESG principles into their investment decisions, demand disclosure from the businesses in which they are investing and engage with those companies. The document didn't demand the "exclusion or screening out of particular companies or sectors" – rather it suggested engaging with badly-behaving businesses instead. It did, however, add that exclusion "may be an appropriate approach for some investors"[3].

The stage, then, was set: the UN was preparing the world for a future in which asset managers, pension fund managers and other institutional investors would be encouraged to use their financial might in order to nudge the corporate world into more ethical behaviour. If you won't live by our standards, investors were being asked to say, then we will not

2. *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* UNEP Finance Initiative, October 2005
3. *Principles for Responsible Investment* UNEP 2006

invest in your shares or bonds and your company will suffer. Henceforth, asset managers were to become the corporate world's moral police.

Who makes the rules?

But there remained a very large question: what were going to be the rules by which corporations would have to live to avoid censure by the financial world? There quickly grew up a vast industry concerned with rating and ranking companies for their ESG performance, using various different metrics. A bewildering number of classifications became available, which as we shall see often conflict with each other. Ratings agencies, which had grown up selling advice on the security of corporate bonds, got in on the act – very profitably, too; just how much so we will deal with later. There is the S&P Corporate Sustainability Assessment (CSA) which assesses 3,500 companies, scoring them on a scale of 0 to 100. There are Moody's ESG Credit Impact Scores, which rate companies on a scale of 1 to 5 for each of the E, S and G elements. There is Sustainalytics, an offshoot of investor data company Morningstar, which offers companies a 'rated by Sustainalytics' badge. There are the ISS ESG ratings, which assess 8,100 companies and 28,000 investment funds. There are MSCI's ESG ratings, which assess each of 2800 companies as either a 'laggard', 'average' or a 'leader' on each of the elements of ESG. To qualify as a 'leader', for example, at least 30.7 percent of your directors must be female, you must have a tax gap of no more than 1.5 percent (that is the difference between the corporate tax rate you actually pay and the official tax rate in the jurisdiction where you are based), and your greenhouse gas emissions must be consistent with a global temperature rise of no more than 2.4 percent – which seems to ask rather a lot of climate science, let alone a company's accountants. Laggards, by contrast, have fewer than 13.5 percent female directors, have a tax gap of more than 4.9 percent and their emissions, it is somehow calculated, would lead to a global temperature rise of more than 3.0 Celsius.

Companies are also enticed with the chance to earn 'B Corp' status, awarded by a charity, B Lab, set up in 2006 with a declared, and somewhat ambitious, purpose of "transforming the global economy to benefit all people, communities and the planet". As well as answering a questionnaire on their business practices, companies are obliged to insert into their constitutions a legally-binding clause "to consider the impact of decisions on your company's stakeholders now and in the future". What does this mean in practice? B Lab UK offers an example from one of its accredited companies which "places two spare chairs around the boardroom table, one for the environment and one for 'society' so they always have a seat at the table".

Then there is CDP Global – the Carbon Disclosure Project – a not-for-profit company which is funded in part by the Bezos Earth Fund, the Bank of America and the World Health Organisation. It also raises £9.6 million in subscriptions from the companies which it assesses. It publishes an A list of companies which have scored the highest marks for their impact on each of 'climate', 'forests' and 'water'. As of 2023 there were 362 global companies on the list[4].

In 2001, the London Stock Exchange Group started to publish a FTSE4Good index, made up of companies which were deemed to be benefitting the planet and human societies – a purely binary selection, where a company is either 'good' or, presumably, 'bad'. There are now numerous indices, one for developed countries which included 1,119 companies in 2024, 84 of which are in the UK, and one for emerging countries, which has 702 companies. There is also an FTSE4Good All-World Index. What makes a company 'good' or 'bad' isn't immediately clear: the publicly-available bumf says merely that "criteria are developed using an extensive market consultation process and are approved by an independent committee of experts". Nor are the constituents of the index easily available: the factsheet on the London Stock Exchange's website only lists the top 10 companies by weighting, the largest three of which are Apple, Microsoft and Nvidia.[5].

While inclusion in ESG indices and accreditation schemes is voluntary – at least notionally – they come with an implied threat: live by our standards or we will try to starve you of capital. However, governments and supra-national bodies have started to take inspiration from them. And their demands are anything but voluntary. The EU institutionalised ESG reporting with its Non-Financial Reporting Directive which from 1 January 2017 placed a legal obligation on all 11,700 EU-listed companies with more than 500 employees to collect and publish ESG data in a pre-determined way. In 2023, this was replaced by the Corporate Sustainability Reporting Directive (CSRD) which extended the duty to all listed companies in the EU, plus all private companies with more than 250 employees, and added complexity to how the data has to be collected. Also falling into its orbit are non-EU listed companies which generate more than 150 million Euros worth of business in the EU. Data collected under the CCSRD will be presented for the first time in 2025 company reports. As we will see later, the costs of compliance promise to be fantastically high.

ESG has been slipped quietly, too, into the Listing Rules which corporations must observe if they are to list their shares on UK markets, made up by the Financial Conduct Authority (FCA). In 2022, the FCA tweaked them to demand that company reports include a statement explaining why they have failed to meet a target of having 40 percent of their company boards made up of women, including either the Chair, the CEO, Chief Financial Officer or some other senior position. They must do the same if at least one of their board members is not from an ethnic minority. The targets have simply been imposed by the FCA without any justification as to why they should exist. From being a mechanism to help ensure proper corporate behaviour and to protect investors, the Listing Rules have evolved into a subtle tool for social change, imposed by a government agency which is not directly accountable to the public. It is a textbook example of how public bodies can use their powers to create pseudo-laws without the consequences ever having to be properly debated.

4. *The A List 2023* www.cdp.net
5. *FTSE4Good Index Series* FTSE Russel fact-sheet

The FCA has proved a miserable failure in what is supposed to be its main job: protecting investors against fraudulent and reckless practices. It failed to foresee the collapse of mini-bond issuer London Capital and Finance in 2019, in which 11,000 investors lost £236 million[6]. In 2024, it was forced to apologise to victims of a fraudulent peer-to-peer lending firm, Collateral[7]. Yet instead of concentrating on putting right its failures over regulation it seems to be doubling down in its self-appointed role of policing diversity in listed companies. In December 2024, it drew up proposals to force financial firms to publish yet more diversity and inclusion data. In March 2025, it decided not to enact them, but it exposed an attitude at the FCA: it believes that it will be more acceptable for investors to bear losses so longer as those losses are split fairly between genders and ethnic groups. The FCA also wants to force investment firms to recognise a lack of diversity as a 'non-financial risk'. It asserts: "We consider that greater levels of diversity and inclusion can improve outcomes for markets and consumers. In particular, by helping reduce groupthink, supporting healthy work cultures, improving understanding of and provision for diverse consumer needs and unlocking diverse talent, supporting to competitiveness of the UK's financial services sector. We have been clear that diversity and inclusion are regulatory concerns."[8] I asked the FCA whether it had any evidence that meeting diversity targets actually did improve a company's performance, and that lack of diversity is some kind of risk to a business, and it was unable to produce any – instead sending me a statement which merely reiterated the claim. As we shall see later the limited evidence which has been claimed to link diversity with company performance has turned out to be somewhat shaky.

What is certain is that diversity reporting requirements have serious consequences for businesses, not least in terms of costs. The FCA estimated that its abandoned diversity reporting rules would have cost firms £561 million in one-off costs plus an additional £317 million per year[9]. The rules are turning some institutional investors into activists seemingly more interested in creating an ideal society than in encouraging good financial performance in the firms in which they invest. In December 2024, a group of institutional investors in the retail chain Card Factory brought a motion demanding that the company sack its chairman, Paul Moody, in order to help it hit the target of having a 40 percent female board. At the time, two members of its six-strong board were female[10]. The motion failed, but it raises the question: are companies going to be allowed to pick the best people for the job – or are they going to be forced to select senior staff who tick the right boxes? If the latter, it doesn't promise to do much for the fortunes of UK businesses, and nor does it help female executives, who will begin to look like diversity hires even when they have attained their positions on merit. As it happens, Card Factory did use to have a female CEO, Karen Hubbard, who was at one stage the only female head of a FTSE-listed retailer; so the company can hardly be claimed to be a corporate dinosaur. At the time of her leadership, between 2016 and 2020, the company could claim all the plaudits for diversity,

6. Financial Times 1 February 2021
7. FinancialReporter.com 19 December 2024
8. *Diversity and Inclusion in the Financial Sector – working together to drive change* www.fca.org.uk 25 September 2023
9. Sunday Telegraph 22 December 2024
10. Daily Telegraph 20 December 2024

though sadly it turned out to be a calamitous time for its fortunes, with its share price crashing from over 300 pence to less than 50 pence during her four years in charge. If we want companies to thrive it is imperative that they are allowed to choose the right person to lead them, not the person who is going to look best on an ESG form.

Unsurprisingly, pressure groups for various causes also spotted the opportunity to become involved in ESG, and for many of them their aim was very different from the original UN concept of ESG, which was to nudge companies into better behaviour. The pressure groups' aim was to try to starve certain businesses, including whole sectors of the economy, of investment – a kind of corporate cancel culture. The idea of divestment – making a big show of selling investments in things you don't like, and which had originated in the 1980s involving investments in apartheid-era South Africa – was reborn with a vengeance, with campaigners lobbying universities, churches, pension funds, city authorities and many others to divest from companies whose activities they disapproved of.

Some of this involved the 'S' and 'G' elements of ESG. The state of California, for example, started to divest from tobacco companies in 2000, the year the UN published *Who Cares Wins*. In 2017 New York City decided that it didn't want to invest in private prisons. In 2005, Stanford University, which had been one of the first to divest from South Africa, withdrew investments in Sudan, whose government had recently been accused of genocide in a US federal law.

Environmentalists seize control

But once campaigning groups started to get involved it was the 'E' in ESG which came to the fore, and one aspect in particular: ESG spawned a boycott of fossil fuel businesses. In 2012, the Board of Trustees at Unity College – now Unity Environmental University – in New Gloucester, Maine, announced that they were to divest its $13.5 million endowment fund almost entirely of fossil fuels. The fund had already reduced its holdings in fossil fuels, from 10 percent in 2008 to 3 percent in 2012, and now intended to reduce that to less than one percent. This was the first such initiative, and set off a copycat reaction by other higher education establishments, including Syracuse University, New York, in 2015, which similarly divested its much larger $1.8 billion fund of companies involved in fossil fuels. It soon became an international phenomenon; by 2015 funds worth $2.6 trillion had announced an intention to divest from fossil fuels. In the same year 26 British MPs signed a motion calling for their £600 million pension fund to do the same. According to Green MP Caroline Lucas, not previously known for her investment advice, "Divestment makes sense from a financial and moral point."[11] MPs had been egged on by claims made by Bank of England Governor Mark Carney in September 2015 that investors faced "potentially huge" losses from the assets of oil companies becoming stranded as the world abandoned fossil fuels for clean energy[12]. By 2017 the number of MPs calling for divestment reached 100 and by 2019 it was 300 – approaching a majority

11. Financial Times 13 December 2015
12. Financial Times 29 September 2015

of the House of Commons.[13] UK Universities joined in, with Oxford, Cambridge, Edinburgh and Manchester all announcing their intention to divest from fossil fuels – although that did not stop them continuing to use and benefit from them. They carried on heating and lighting their premises, while academics, like MPs, continued flying around the world on fossil-fuelled planes.

At the same time the financial industry began to launch vast numbers of ESG funds – or 'sustainable funds' as they were often called – to retail investors. Many such funds either reduced or eliminated altogether investments in fossil fuels, weapons manufacturers, tobacco companies, and selected investments on the grounds of overall ESG scores. By the beginning of 2020, reported investment data company Morningstar, there were 2400 ESG funds in Europe alone, 360 of which had been launched in 2019. Others, such as 28 funds run by Scandinavian investment group Storebrand, had been converted from existing funds by ditching coal, oil and gas shares. Retail investors lapped them up. In Europe in 2019, 120 billion Euros was ploughed into such funds, more than double the 49 billion Euros invested in 2018[14]. By the end of 2019 there was $960 bn invested in sustainable or ESG funds globally. While much of the early activity had been in the US, it was European investors who were now showing by far the most enthusiasm: European funds held $684 billion, a little over two thirds of total assets. Investors continued to back ESG funds in the early months of the pandemic, adding $45 billion globally in the first quarter of 2020 – while non-ESG funds saw a net outflow of $384 billion[15].

In his annual letter written to CEOs in January 2020, Larry Fink, CEO of Blackrock, which manages $9 trillion worth funds, declared: "Climate change has become a defining factor in companies' long term prospects." He added: "I believe we are on the edge of a fundamental reshaping of finance…. We will see changes in capital allocation much more quickly than we will see changes in the climate itself." While he did not commit Blackrock to a complete divestment in fossil fuels, he did inform investors that it was exiting companies which derived more than 25 percent of their revenues from thermal coal[16].

Fink may run one of the largest investment houses in the world, but he wasn't able to see what was coming. The world was indeed on the cusp of a sharp change in capital allocation, but not from fossil fuel investments to renewable energy. It was the other way around. The world of ESG investing was to enjoy another 18 months of explosive growth before suffering a sharp reversal.

Initially, ESG investing paid good rewards. In June 2020, a Morningstar analysis of 745 European funds advertised as 'sustainable' or ESG found that 60 percent of them had outperformed their non-ESG equivalents over a 10 year period. Over one, three and five years, too, a majority of ESG funds had outperformed. "These findings debunk the myth that there is a performance penalty associated with ESG investing," said Hortense Bioy, Morningstar's Director of Passive Strategies and Sustainability research[17].

13. The Ecologist 25 October 2019
14. Financial Times 30 January 2020
15. *Investors Back ESG in the Crisis* www.morningstar.co.uk 12 May 2020
16. *Blackrock's 2020 Letter to Clients* www.blackrock.com
17. Financial Times 13 June 2020

By 2017, Unity College President Stephen Mulkey was boasting of the success of the institution's ground-breaking investment strategy of shunning fossil fuels, saying it had "had no negative effect on our endowment portfolio". Over five years it had produced an annualised return of 9 percent, more than its 8.2 percent target. Thanks to divestment, he said, the college had avoided a precipitous fall in the value of coal and oil stocks, caused by a 50 percent fall in the price of crude oil since 2014[18]. Oil prices were under pressure thanks to the explosive growth in the US shale gas industry and the decision by OPEC countries not to reduce production, as they would normally do when oil prices fell, but to allow the bottom to fall out of the market in the hope of pushing US producers out of the market.

The idea that ESG investing would be good for returns became a self-fulfilling prophecy – for a while. The more people that argued 'good' companies owned the future, the more money flowed into their shares and the higher those prices were driven. It was classic bubble behaviour. Investors ceased to analyse the underlying prospects for a company and instead piled into it just because it was assessed as doing the world good, and because its price was going up. From the middle of 2020 to the middle of 2021 ESG was the dotcom of its day.

But as with all bubbles the good times could only last so long. Initially, the pandemic led to a crash in oil prices. But in 2021, as the world emerged from the Covid pandemic, oil prices began to reverse their seven year slump; as demand recovered, supply remained suppressed. By November 2021 Bernard Looney, CEO of BP, was calling his company a 'cash machine' – having lost $22 billion in 2020 it went on to notch up a $13.5 billion gain in 2021. In 2022, oil prices surged further after Vladimir Putin invaded Ukraine and European countries boycotted Russian oil and gas. Oil and gas shares had a strong year: between 30 June 2021 and 30 June 2022 shares in Exxon Mobil rose 37 percent from $62.70 to $86.14, while Shell was up 47 percent from 1442 pence to 2123 pence. Even more spectacular was the performance of Thungela Resources, a company created in June 2021 by the spinning out of coal assets from the mining giant Anglo American. On 30 June 2021, the shares traded at 195 pence; a year later they stood at 1245 pence, an increase of 538 percent. So much for the 'stranded assets' of the oil and gas sector putting investors at risk; the concept was exposed as naïve in its belief that fossil fuel assets were doomed – there are evidently good profits to be made in the short term even if coal is eventually replaced by other forms of energy. If that time does come, there is scant sign of it so far. In the decade since divestment from fossil fuels became fashionable, global consumption of oil, gas and coal is up – oil consumption rose by 19 percent in the decade 2013-2023, oil 10 percent and coal 2 percent[19]. Nor are fossil fuels necessarily doomed even if the world does start to advance towards net zero carbon emissions – numerous industries from plastics to fertilizer depend on crude oil as a raw material. Besides, one of the possible paths towards cutting carbon emissions – into which the UK government announced £22 billion of

18. Unity College press release www.unity.edu 22 June 2017

19. *Statistical Review of World Energy 2024* Energy Institute

investment in October 2024 – is carbon capture and storage (CCS), which could allow the continued burning of fossil fuels with minimal carbon emissions. CCS is an expensive technology which is not guaranteed to succeed on a commercial scale. Nevertheless, a blanket boycott of fossil fuel investments is a bold punt on the future of energy markets, which fails to take account of certain possible technological paths.

While fossil fuel prices were rising sharply in 2021 and 2022, the bubble in green energy investments deflated. What advocates of ESG failed to notice as they loaded their portfolios with renewable energy shares is that the rapid expansion in renewable energy during the 2010s was being driven by low commodity prices and low interest rates. Renewable energy, by its nature, tends to have low running costs but high upfront costs: investment relied heavily on borrowed money. During the years of near-zero interest rates – and rates which were often below zero in real terms – renewable energy seemed cheap. But that turned around sharply when interest rates began to rise in 2021. Between mid 2021 and mid 2022, shares in Danish wind turbine-maker Vestas fell 34 percent from 237.7 Krona to 156.1 Krona. Orsted, Denmark's former national oil and gas company which has subsequently reinvented itself as a renewable energy company, fell 18 percent from 906.4 Krona to 740.0 Krona. A year later its shares had crashed to 252 Krona, just a fifth of their value at their peak. Investors who bought into the story that renewables will rapidly displace fossil fuels suffered accordingly. In 2022, 59 percent of ESG funds, globally, were outperformed by their non-ESG equivalent[20]. For some advocates of ESG, investing the experience was far worse. Between the middle of 2021 and the middle of 2022, the value of Unity College's endowment portfolio plunged from $18.6 million to $15.7 million – a salutary lesson for anyone who thought that avoiding fossil fuel stocks was a sure strategy for increasing performance[21].

ESG funds did better in 2022, but still underperformed mainstream stock market indices[22]. By 2023, ESG investing seemed to be in full retreat. In the first nine months of that year, according to the Investment Association, UK investors withdrew £1 billion from 'responsible funds' – yet another moniker for ESG[23]. In the US investors withdrew $13 billion from ESG funds over the course of 2023[24]. In June that year Larry Fink announced that he had stopped using the term ESG on the grounds that it had become "too weaponised". While Blackrock would continue to push oil companies to achieve net zero targets, he said the company would not divest from them entirely as it had from coal companies. Referring to his letter to investors in 2020 he said that he hadn't intended it to become a political statement[25].

The backlash begins

There was by then a growing political backlash against ESG investing. In 2021, the state of Texas passed two laws which banned state pension funds, and other government agencies, from investing in businesses which it claimed were boycotting the oil and gas industry – an important part

20. *How Do ESG Funds Perform?* *www.morningstar.co.uk* June 2023
21. Unity College Financial Statements June 30 2022
22. www.morningstar.com 18 December 2023
23. Financial Times 3 November 2023
24. www.morningstar.com 5 February 2024
25. Reuters 26 June 2023

of the state's economy. A token list of 10 such enterprises was eventually produced, including Blackrock, Credit Suisse, UBS and BNP Paribas[26]. By December 2023, 18 US states had passed legislation ordering state pension funds not to invest on ESG principles[27]. The insurance industry's own ESG initiative, the Net Zero Insurance Alliance, a UN-backed venture by insurance companies to tilt their portfolios towards investments in cleaner technologies, also came under attack. In May 2023, the attorneys general of 23 US states wrote to the 28 members of the pact threatening to sue them for anti-competitive practices. Within weeks, 12 members had withdrawn[28].

But the backlash went on to inspire a backlash of its own. A study by the University of Pennsylvania claimed that the Texas anti-ESG law had harmed the ability of municipalities to raise money as it had narrowed the number of financial institutions which they could use to underwrite bonds[29]. In August 2024, the American Sustainable Business Council announced that it was going to take the state of Texas to court, claiming that the anti-ESG law broke the First Amendment by interfering with its members right to free speech[30]. Inevitably, perhaps, although not foreseen by the UN when it kicked off the whole concept of ESG, the world of investment had descended into political vipers' nest.

At the same time, the concept of ESG came under attack from a different angle: from environmental campaigners who accused the financial industry of 'greenwashing' – making extravagant claims about the environmental-friendliness of their products which are not backed up by evidence. In 2021, the Economist dug down into the world's 20 largest ESG funds and found that they included investments in oil, coal, gambling, alcohol and tobacco[31]. These investments are not actually inconsistent with the original concept of ESG investing – the UN body which came up with it did not wish to preclude any particular industry sectors. Yet it is perhaps not what customers of ESG funds have come to expect of their investments.

For many years, ESG investing was essentially unregulated: anyone could call an investment fund 'sustainable', 'ethical' or anything else – without conforming to any rules. But in recent years, the US Securities and Exchange Commission, the European Securities and Markets Authority and British Financial Conduct Authority have all introduced guidelines.

Britain's investment industry watchdog, the Financial Conduct Authority (FCA), first consulted on a list of proposals to lay down a set of rules regarding the advertisement of ESG funds. The final rules, which were published in November 2023 and came into force on 31 May 2024, consisted of a 'general sustainability rule' which states that ESG claims "are fair, clear and not misleading, and consistent with the sustainability profile of the product or service", and a set of four trademarked labels which investment firms could use to describe their products. These were 'Sustainability Focus', 'Sustainability Improvers', 'Sustainability Impact' and 'Sustainability Mixed Goals'[32].

The rules were especially notable for two reasons: firstly, the FCA, like so many of the financial companies which have jumped on the ESG

26. Financial Times 29 August 2022
27. Financial Times 4 December 2023
28. Reuters 2 June 2023
29. www.knowledge.wharton.upenn.edu 12 July 2022
30. Reuters 29 August 2024
31. Economist 22 May 2021
32. FCA Policy Statement PS23/16 Sustainability Disclosure Requirements (SDR) and Investment Labels November 2023

bandwagon, has fixated on the 'E' while having little to say about the 'S' and the 'G'. Second point is the sheer vagueness of the rules put forward by the FCA. While a general rule to make sure that an investment fund does what it says on the tin might be regarded as a fundamental part of honest trading, the trouble with the labels is that they don't really mean very much. What is 'sustainability', for one thing? Does it refer to an activity which could theoretically be continued ad infinitum without exhausting the world's resources – or does it mean something which is financial sustainable over a period of time? How fast does something have to improve to qualify for the second label, sustainability improvers'? Would an oil company qualify if it was tackling methane emissions and had a carbon capture project – or would it have to have a plan to cease all oil production by a certain date? It makes even less sense when the word 'sustainable' is used to exclude tobacco companies. Smoking might be a lethal habit, but the production of cigarettes and cigars is not inherently less sustainable than other forms of agriculture and manufacture; it isn't going to kill the planet.

The FCA's written guidance doesn't offer a lot of help. For 'Sustainability Focus' it suggests the fund would be "investing mainly in assets that are sustainable for people and/or the planet". Further "at least 70% of the product's assets would need to meet a credible standard of environmental and/or social sustainability, or to align with a specified environmental and or sustainability theme." So does that mean a fund would pass muster if it were 70 percent invested in organic beansprouts and 30 percent invested in coal, cigarettes and cluster bombs?

The FCA's rules are vague for a reason: it is extremely difficult to assess whether an activity is a threat to the environment or not. There are fierce arguments over such things as electricity generated by the burning of biomass, and the rare metals required for the manufacture of electric car batteries. These matters cannot be boiled down into a few simple investment rules.

In the US and the EU investment funds are obliged to hold 80 percent of their investments in shares, bonds and other assets which conform to their self-declared investment principles; in Britain it is 70 percent. The other 20 – 30 percent is allowed to be held in other assets – the idea being that funds need a degree of flexibility. The EU, however, goes further and demands that funds whose titles include certain buzzwords refrain from investing altogether in particular classes of company. Include the words "green", "environment", "climate" or "ESG", and you are forbidden from investing in companies which derive more than 50 percent of their revenues from gas, 10 percent of revenues from oil or 1 percent of revenues from coal. You are also forbidden from investing in companies involved in "controversial weapons" or which are involved in the cultivation or production of tobacco[33]. It is hard to see what the latter two have to do with the climate, although they might have more relevance to the 'S' and 'G' elements of ESG. Then again, what is supposed to constitute a "controversial" weapon? That rather depends on subjective opinion.

33. Guidelines on funds' names using ESG or sustainability-related terms, www.esma.europa.eu May 2024

The new rules certainly had an impact, however. According to investment group Morningstar, 30 funds which previously advertised themselves as ESG had already removed the term from their advertising, and a further 1600 funds would be forced to do so[34].

Yet for all the poor performance of ESG funds, the backlash, the apparent retreat of some financial figures like Larry Fink, it would be foolish to conclude that ESG was going to melt away in a hurry. Just as the dotcom crash didn't signal the end of the internet, and companies like Amazon which survived the rout went on in some cases to make spectacular recoveries, ESG has not gone away. By 2024 ESG funds had staged a recovery, attracting inflows of $4.3 billion during the second quarter of that year[35].

As we shall see later, ESG is a fast-growing global industry which is already worth at least £14 billion a year in revenue to the companies which provide the ratings, the software to comply with ESG reporting rules and consultancy services to help companies manage their ESG scores. Vested interests which hold such a large stake in ESG are going to do everything they possibly can to maintain its existence.

Moreover, the investing public seems still to be keen on ESG. According to a survey by the FCA, 81 percent of adults say they "would like their money to do good as well as earn a financial return"[36]. That is a question without context. A more relevant question would be: how much financial return would you be prepared to sacrifice in return for knowing that your investments are improving the environment? Nevertheless, the public has been told that ESG funds are good for their money and good for the world, and it will take some shifting that notion. Indeed, were the FCA not worried that investors were being hoodwinked by ESG there would presumably have been little need for its new rules.

ESG seems to be deeply engrained, too, in the practices of institutional investors. A survey by Harvard Law School in 2022 reported keen interest among them in using ESG criteria to influence investment decisions. Globally, 26 percent of investors said that it was "central to our investment approach". Most others said that they took ESG scores into consideration, with just 11 percent unmoved – saying either that they were yet to be convinced by the concept of ESG investing or that they did not take it into account. While ESG has a close association with the US, it was European investors who were the keenest, with 31 percent saying it was central to their investment approach; in the US the corresponding figure was 18 percent and in the Asia-Pacific region it was 22 percent. Asked if they thought ESG was a 'passing fad' just 13 percent said they thought it was.[37]

But in a sign of trouble to come, 41 percent globally said that they thought the focus of ESG had tilted too much towards the 'E' element, and that social issues were being pushed out by climate change. Just over half of respondents – 52 percent – feared that 'greenwashing' could trigger a mis-selling scandal – which makes you wonder why so many of them were apparently so keen to fall in with the crowd and invest in companies which they believed might be embellishing their claims to be

34. Understanding the new ESMA guidelines on the use of ESG-related terms in fund names, www.natwest.com 10 September 2024
35. *Global Sustainable Fund Flows Q2 2024* www.morningstar.co.uk 22 July 2024
36. Press release www.fca.org.uk 23 April 2024
37. ESG Global Study, Harvard Law School Forum on Corporate Governance, 2022

environmentally-friendly.

ESG persists in spite of the vagueness of its aims, its cost to business, its perverse incentives and its contradictions. Let's have a look at some of these in closer detail now.

Imposing costs on business, proportionally greater on smaller ones

There is, needless to say, a cost to companies in managing their ESG rankings, not least thanks to the multiplicity of rival indices to please. It takes time and costs money to make applications and assemble data in order to make ESG returns, and in many cases there are fees to pay in order to qualify for ESG rankings and indices. While ESG relies on the disclosure of large quantities of data, the cost of complying with ESG is one form of data which remains somewhat obscured. I asked the organisations which provide the main ESG ratings and accreditation schemes how much they charge, either for companies to list in their indices or to sell data to subscribers. None would disclose fees, except for B Lab, which publishes what it charges companies for the privilege of being able to call themselves a B corp. For a company with a turnover between £1 million and £2.5 million, there is submission fee of £200, a verification fee of £1440 and an annual fee of £2000. For those with a turnover between £100 million and £175 million, the corresponding fees are £800, £7200 and £30,000 – although there is a 40 percent reduction for companies which are more than 50 percent owned by "people of colour and under-represented ethnicities", LGBTQ people or the disabled.

Otherwise, it is a case of trying to tease out the information. An unidentified multi-national has revealed that it has spent $18 million (£13.9 million) over the three years to 2024 collecting data on carbon emissions to comply with its obligations under the EU Corporate Sustainability Reporting Directive (CSRD) and will have to spend a further $50-$60 million (£38.5 million - £46.2 million) over the next five years in order to comply with the coming Corporate Sustainability Due Diligence Directive (CSDDD)[38]. The costs are so high in part due to the difficulties in obtaining data from suppliers in the developing world.

But one business' costs are another's opportunity. ESG is proving extremely profitable for those companies involved in collecting and providing data, consultancy and the materials required in order to obtain and maintain ESG ratings. There are hefty fees on the other side, too; paid by the investment industry. One fund manager told me that his mid-sized company alone was paying £1 million for ESG data. This is a cost which inevitably ends up being passed onto investors.

There are several elements to the ESG industry. First, there are the

38. https://www.ft.com/content/276028dc-a492-44ec-9eee-58d9fb51c159, 16 May 2024

fees for supplying data to investors, either in the form of indices or in bespoke data. All told, according to management consultancy Opimas, the global market for ESG data was worth $2 billion (£1.54 billion) in 2024, having quadrupled in six years[39]. Then there is the market for consultancy: advising businesses how they can improve their ESG scores and conform to various reporting requirements. This, data company Verdantix estimated a value of $14 billion (£10.8 million) in 2023, having grown from $11.5 billion (£8.85 billion) in 2022. It predicts that it could rise to $49 billion by 2028[40]. There is also a growing market for supplying software to help companies submit ESG data. This, according to Global Market Insights, was worth $838.6 million (£644 million) in 2023. It forecasts that it could grow to $2.7 billion (£2.1 billion) by 2032[41]. Conservatively, we can put the size of the global market for ESG data at somewhere in excess of £13 billion and growing fast.

That is the value of ESG services which are being bought and sold. That doesn't give us a figure for the total cost to business of complying with ESG reporting, because there will be other internal costs to businesses – such as employing staff to collate data and submit returns. The US financial regulator, the Securities Exchange Commission (SEC), has put the cost to US businesses of complying with ESG requirements at $8.4 billion (£6.5 billion)[42]. This assumed that consultants are being paid $600 an hour to advise on ESG. Nice work if you can get it.

Nor does it include a new layer of costs being imposed on ESG funds themselves, in the shape of anti-greenwashing rules. In a cost-benefit analysis of its new rules, the FCA estimated that asset managers would face an average one-off cost of £351,000 plus annual costs of £217,000. As for financial advisers – some of whom are one-person bands – they would face a one-off cost of £23,000 plus an annual cost of £2000. There are 1000 asset management companies in Britain[43]; so if all of them were dragged into the net that would mean a one-off cost of £3.5 billion plus an annual cost of £2.2 billion. Needless to say, these costs will be end up being passed onto their retail customers, who will suffer lower returns as a result.

ESG, then, adds an extremely expensive dollop of cost onto business, and onto investors directly and indirectly. But what are we getting for our money?

The assertion that ESG means better returns is not borne out by evidence

If you want to make the case that a good ESG score make for better returns then you can easily find a financial index, and quote it over a carefully-chosen period, to appear to prove your case. Over the five years to 2023, for example, the FTSE4Good Developed World Index produced a total return of 95.1 percent, compared with 87.1 percent for the plain FTSE Developed World Index, which includes 'bad' companies as well as 'good' ones. There have also been years when it has been the other way around.

39. The Market for ESG Data in 2024 www.opimas.com 11 March 2024

40. *Green Quadrant: ESG and Sustainability Consulting 2024* www.assets.ey.com January 2024

41. www.gminsights.com October 2024

42. Speech by Mark T Uyeda, transcript of 2022 Cato Summit on Financial Regulation

43. www.theglobalcity.uk

It shouldn't really be a surprise that the overall five year performance is a little higher given that the 'good' index gives a slightly higher weighting to US technology companies which have enjoyed a boom in their share prices over that period. Whether technology companies deserve to be lumped together as companies which are 'good' for society and the planet is another matter. For one thing, there is the voracious and growing energy consumption of Artificial Intelligence (AI) and cryptocurrency. In 2022, according to the International Energy Agency, these two uses accounted for 2 percent of global energy demand, consuming as much as Japan – and this is likely to double by 2026[44]. There are arguments, too, that social media companies are doing far too little to protect children online, and are therefore failing in their social obligations to society. But it would be a brave fund manager which took the US tech giants out of their portfolios on the basis of their wanton energy consumption or failure to tackle online harm. Somehow, one feels, tech companies are always going to be allowed to score highly on ESG ratings because to leave them out of portfolios would be too extreme of a step for ESG funds.

Take away the distortions created by counting tech companies as 'good' companies and the outperformance of ESG disappears. Let's take another selection, this time the 29 UK-based and UK-listed companies which made it into the S&P Global Sustainability Yearbook published in 2023. This is not distorted by a few massive tech companies because the FTSE has few of them. Had you turned this into your portfolio, how would you have fared over the next 12 months? The 29 shares were down an average of 3.7 percent, compared with a fall of 1.8 percent for the FTSE 100 Index.

Or let's look over a much longer term. Between September 2009 and September 2024, the MSCI World ESG Leaders Index turned a $100 investment into $472.85. An investment in the parent index, the MSCI World Index, by contrast would have grown into $473.68 – essentially no difference[45].

There is, then, very little evidence of an ESG performance bonus. The idea that you can take a bunch of companies which score well on ESG criteria and outperform the market is bunkum. There are plenty of individual cases, indeed, where chasing ESG ratings has seemed to hinder a company's performance. Take the example of food and consumer goods giant Unilever, which in 2019 announced a headlong plunge into trying to do the world some good. Asserting that its "brands taking action for people and the planet grew 69 percent faster than the rest of our business" in the previous 12 months, Chief Executive Alan Jope declared that "in the future, every brand will be a brand with a purpose"[46]. What did that mean? Two years later, for example, Unilever announced that it would stop selling Ben & Jerry's ice cream in Israeli settlements in the West Bank, on the grounds that the settlements "are inconsistent with our values"[47].

Investors, however, seemed far from impressed, and the shares began to drift downwards – in spite of a boom in ESG funds. Profits moved sideways. In his new year letter to investors in 2022, Terry Smith, founder

44. *Electricity 2024* www.iea.org
45. *Index Factsheet* MSCI World ESG Leaders Index 30 September 2024
46. News release www.unilever.com 11 June 2019
47. www.bbc.com 20 July 2021

of Fundsmith, accused Unilever's management of being "obsessed with publicly displaying sustainability credentials at the expense of focusing on the fundamentals of the business". He added: "a company which feels it has to define the purpose of Hellmann's mayonnaise has in our view clearly lost the plot"[48].

In October 2023, Unilever began to change its tune. Its new chief executive, Hein Schumacher, appointed three months earlier, announced that it would no longer try to 'force-fit' brands with a purpose. While he didn't abandon the company's overall ESG efforts, he hinted that the company had gone too far, and that the attempt to create brands with a purpose had "generated more heat than light". Shareholders were delighted, with Unilever's share price surging by 25 percent in 2024.

If ESG was what really drove company value, it would be hard to conceive of a more devastating blow than being dumped from the FTSE4Good index. This is what happened to UK construction company Galliford Try in January 2023. FTSE Russell, which compiles the index, said that it was one of 34 companies which had failed to satisfy criteria set out in its Transition Pathways Initiative, a decarbonisation agenda laid down by a committee of 130 institutional investors chaired by the Chief Responsible Investments Officer at the Church of England Pensions Board. Did it prove to be a powerful 'sell' signal? Hardly. Galliford Try was trading at 164 pence at the time of its ejection in January 2023; by October 2024 it was at 360 pence.

A similar thing happened to Barclays after it was left out of the S&P Global Sustainability Index in 2024. Over the previous 12 months, when it was proudly listed in the 2023 Yearbook, its shares plunged by 21.5 percent. And after being kicked out? Over the following 12 months its shares rallied by 65 percent.

What about further down the corporate chain? As we shall see later, ESG does not favour small companies; rather it helps steer investors' money away from them. But many have tried to play along. Among those who have made a big effort over ESG is Focusrite, a small British company which manufactures music-making equipment, with a turnover of £170 million, and whose performance and share price had done fantastically well up until 2021. Focusrite's annual report that year had a large wodge of pages dedicated to ESG. The company announced that it had just appointed a diversity and inclusion team, which had organised events for National Inclusion Week, Black History Month, International Women's Day, Mental Health Awareness Week and Pride. It was holding online sessions to help staff cope with stress. It had measured its Employee Net Promotion Score (eNPS) – a metric based on a survey of staff and produced by data company Qualtrics – and boasted of a 'good' score of 43. It had started – voluntarily – to publish its gender pay gap. It was sponsoring academies in Malawi, Mozambique, Zimbabwe, and donating to food banks, LGBT health and wellbeing services. It had started holding seminars for staff on transport, food, biodiversity and the road to net zero. It claimed to have offset 660 tonnes of carbon emissions from air freight

48. Annual letter to investors, January 2022 www.fundsmith.co.uk

by buying carbon credits in afforestation, habitat protection and clean water projects. It was also looking into transporting more of its products around the world by ship, in order to save more carbon emissions. It had conducted a Climate Materiality Assessment, aimed at reducing the carbon footprint of its products, tested its resilience against scenarios of future global temperature increases of 2 Celsius and 4 Celsius. It had entered into a contract to buy 100 percent of its electricity from renewable sources.

On paper, this was a company which stood out as top of the class in ESG. And there is much to be said for some of what it was doing – not that philanthropy began with ESG, and nor did the idea of looking after the wellbeing of your staff. The likes of Andrew Carnegie and Robert Owen were doing it in the 19th century. But did putting these things together with climate initiatives and promoting it as ESG help Focusrite's investors? Three years later, the company's shares had collapsed by 85 percent and it was issuing profit warnings, complaining of rising shipping costs and that customers in India had started buying cheaper, previous generation products. The main risks to its business turned out not to be climate change, but more mundane things such as the costs of doing business – and customers losing interest in the product. On top of that, the company's share price had been deeply afflicted by negative sentiment towards smaller companies. ESG is a factor in this as it pushes institutional investors towards the large companies for which data is easily available.

There is a fundamental weakness with ESG: it conflates things like a business donating to, sponsoring and getting involved in good causes – all good for society but which do not really impact on a company's economic fortunes, beyond a bit of positive PR – with matters which really could destabilise a company, such as poor governance. It fixates on risks from climate change, while distracting from the more straightforward issues why companies get into trouble – such as having a poor business model, or some small weakness which leads to disaster. As already mentioned, BP making the right noise over climate change, and thus earning itself a high ESG score, didn't prevent the company from nearly succumbing to the Deepwater Horizon disaster. The real risk to the company turned out to be the cement casing of an oil well – but that is something which is never going to be picked up in a desktop ESG assessment.

No-one should assume that making gestures towards inclusivity and the like is necessarily going to turn to be positive for a company. On the contrary, there is a risk for a business in being seen to be too political. What might be seen as doing social 'good' by company executives might not necessarily be seen in the same way by customers. In 2023, brewing company AB Inbev sent a personalised can of Bud Light beer to transgender actor Dylan Mulvaney, who then featured it in an Instagram post. The idea, according to the company's Vice President for marketing, was to make the beer more 'inclusive' and to distance it from what she saw as its "fratty and out-of-touch" image. Many customers, however, saw it differently – as political posturing. A boycott was organised, sending the company's US sales plummeting by 10 percent, and profits by 28 percent.

It was forced to lay off two percent of its workforce[49].

One of the central pillars of ESG is diversity. Not only, it is asserted, is it good for society to have a company board of balanced gender, to be representative of ethnic groups and sexual orientation; it is positively beneficial to a company's performance. In 2015, consultant McKinsey&Co published a study claiming that companies with greater ethnic and gender diversity on their boards enjoy superior performance. Companies in the top quartile for gender diversity, it claimed, were 15 percent more likely to outperform the median company in their industry, while companies in the top quartile for racial/ethnic diversity were 35 percent more likely to outperform the median. McKinsey went on to publish two other papers making similar claims. But in 2024 a pair of economists, Jeremiah Green of Texas A&M University and John R M Hand of the University of North Carolina, attempted something which is central to scientific method but perhaps a little less common in pamphlets put out by management consultants: they tried to reproduce the results. But they couldn't. McKinsey&Co didn't reveal the names of the 366 American and British companies they used in their analysis, but Green and Hand produced figures for all 500 companies in the US S&P500 Index. They found no significant statistical link between the diversity of a company's board and its economic performance[50]. While there might be an argument for saying a company is better off with people of widely different perspectives on its board, diversity – as defined by ESG structures – is not really achieving that. Take McKinsey & Co's 'Shareholder's Council' (as it calls its board) as of November 2024. It is impeccably balanced on gender – it has 13 men and 13 women. It is diverse from an ethnicity point of view. But how different are its members? Six have engineering degrees, one has a biology degree and one history; all others have studied economics, political science, business. They might look different, but they would appear to have shared a remarkably similar education: they are an MBA elite.

It is hard not to see the out-performance of high-scoring ESG companies in the years up to 2021 as just another investment fad, like the dotcom bubble before it. Share prices were bid upwards because there were several hundred ESG-based funds which were piling into them willy-nilly. Then the music stopped, investors panicked about businesses being over-valued and piled back out again.

It is not even clear what ESG is supposed to be measuring

The conceit of ESG is that is sorts out the 'good' from the 'bad' – the nice businesses which are helping society and the planet from the nasty ones which are exploiting workers and raping the Earth. But what is 'good' and what is 'bad'? Most people might agree in extreme cases – such as that an oil company which is cavalier about safety and pollutes the sea with crude oil, or a business which keeps its staff in slave-like conditions and pays them a dollar a week is pretty bad. But most companies surely fall into a

49. BBC.com 3 August 2023

50. *McKinsey's Diversity Matters/Delivers/Wins Results Revisited* www.econjwatch.org March 2024

large grey area – where different people, according to their political views or other considerations, might reasonably disagree on whether a business, or part of a business, is a positive influence on society or a negative one. At one extreme, an anti-capitalist might well believe that all joint stock companies are an evil, and give each and every one of them an ESG rating of zero.

The ESG industry itself often follows a policy of blanket exclusion. Some indices have decided that certain business activities are so beyond the pale that they shouldn't even be considered for inclusion at all. Dig down into the published methodology of the FTSE4Good Index and you find that it excludes companies which produce tobacco, mine coal or which manufacture weapons – not just cluster bombs and land mines but any kind of gun or vehicle designed to carry arms. The latter, in particular, raises eyebrows: is the defence of free, democratic nations not a 'good' activity? The FTSE4Good Index is effectively promoting pacifism. If these are the values of the people who compile the FTSE4Good indices they are not shared by the British people. A YouGov poll from 2022, for example, found that 66 percent of adults agreed with the statement that "military action is sometimes the right thing to do" against 17 percent who thought it was never right[51].

The FTSE4Good indices do not exclude oil companies. These are, however, excluded from CDP Global's A list. Unlike the FTSE4Good, on the other hand, CDP Global are happy to include tobacco companies on their list of exemplary companies – Phillip Morris International and Japan Tobacco both appear on it. Depending on which ESG index you are looking at, in other words, a company might either be top of the class – or out on the naughty step. This exposes one of the fundamental problems of ESG – what constitutes a 'good' or a 'bad' businesses depends rather on the eye of the beholder; yet how many investors, when sinking their money into an ESG fund, really stop to ask whether the values which a particular ESG rating systems imposes on the companies it assesses? For some people, oil and gas are the greatest evil in the world, for others it might be alcohol and gambling, for others it might be sexism, animal experiments or weapons of war. The assertion that there is one set of moral standards on which the whole world can agree is quite obviously wrong. The CDP list, for example, includes a couple of brewers – whose activities may not be looked at so favourably in the Islamic world. The S&P Global Sustainability Index includes several gambling companies, whose activities are illegal in many Middle Eastern countries as well as Singapore and Pakistan.

If ESG ratings were providing useful information you might expect the ratings given to a company by various ratings agencies vaguely to agree with each other. Yet this is very far from the case. A study by the Massachusetts Institute of Technology and the University of Zurich in 2022 analysed the ratings given to 924 companies by six of the main ratings agencies. They found the scores to have an average correlation of just 0.54 – in other words, they only vaguely aligned. By contrast, credit ratings

51. www.yougov.co.uk 21 September 2022

produced by the two big agencies, Moody's and S&P, had a correlation of 0.99[52]. The disagreement was due to differences in metrics, how they were being measured and in the weightings given to difference metrics. Whether a company is 'good' or 'bad' can depend on small differences in methodology – which rather brings into question the entire foundations of ESG.

Do investors actually study what funds are investing in before they choose which ones to buy, or do they make their decision based merely on the name of the fund, influenced by a vague and general desire to do good? I have struggled to find any detailed research on what information people refer to when making decisions to invest in ESG funds, though a Morgan Stanley survey from 2024 does reveal one or two useful insights. Its headline finding – that 77 percent of investors globally are 'interested' in sustainable investing, and that the proportion steadily increases as you move down the age profile – is the sort of figure frequently batted around by organisations trying to make the case for ESG. Read a little closer, however, and you find that only 14 percent of those surveyed had more than half of their money invested in sustainable funds. While 88 percent apparently believe that investing on the basis of ESG has the 'potential' to achieve higher returns (couldn't it equally be said that shunning ESG has the *potential* to increase returns?), 67 percent reported that they had a 'lack of trust' in reported ESG data. In other words, whatever information investors are acting on when they choose ESG funds, a majority of them don't have much faith in it[53].

The Morgan Stanley report also reveals something interesting about what specific issues investors want to base their investment decisions upon. Climate – which seems to dominate fund managers' own idea of what is important – came pretty high up, with 72 percent of individual investors reporting that it was something on which they were inclined to base investment decisions. But it was trumped by 'water' and 'healthcare'. People don't want to invest in companies which poison the water but they do want to invest in companies which they hope might help cure cancer and the like. As for gender diversity of a company's board – a popular obsession of the ESG industry – it came at the bottom of the list of concerns. What is important to fund managers does not seem entirely to chime with what matters most to the people who invest in their funds. Indeed, in all the reams of bumf I have read from ESG ratings agencies, I have not once come across any suggestion that they are prioritising companies which are involved in medical research – even though this seems to form an important part of what individual investors interpret as a social good. ESG is focused on boycotting companies deemed to be harming the planet; while investors seem more inclined to positively back companies which they think will do society good.

To try to answer the question of what information investors act on when they choose to invest in 'sustainable' funds, I put out a poll on X.com (formerly Twitter) asking people who had invested in ESG or 'sustainable' funds whether they had taken the trouble to look up what

52. *Aggregate Confusion: the Divergence of ESG Ratings*, Berg et al, www.ssrn.com 15 April 2022

53. *Sustainable Signals: Understanding Individual Investors' Interests and Priorities* Morgan Stanley Institute for Sustainable Investing 2024

the funds had actually invested. I wasn't overwhelmed with responses and I can't claim it to be a scientifically-derived sample, but seven out of 10 who replied said no. Is it even easy to find out what ESG funds invest in? I went onto the website of Hargreaves Lansdown – one of the most popular platforms in Britain for retail investors – and shopped around. I typed in the word 'sustainable' and it offered me 231 funds with that word in their title. I then tried to find out what the funds themselves were invested in.

I started with the 'Abrdn Myfolio Sustainable 1' fund and clicked on the 'fund analysis' tab. That listed the fund's 10 largest investments, all of which were other funds (these make up 63 percent of the holdings, I was to learn). That didn't tell me anything at all about the companies whose shares and bonds my money would ultimately be invested in. I then clicked through to 'key features and documents', and so onto Abrdn's annual report on its investment funds. This gave me some data on the fund's performance, warned me that some of my money would be invested in emerging markets and also that the ESG criteria might lead to the exclusion of some investments which were included in the benchmark index used to compare the fund's performance. It added, "The interpretation of ESG and sustainability criteria is subjective meaning that the fund may invest in companies which similar funds do not (and thus perform differently) and which do not align with the personal views of any individual investor". But still there was no information whatsoever as to where my money would ultimately be invested, nor even the criteria on which investment decisions would be made. I was being enticed to invest purely on the assertion that a fund containing the word 'sustainable' would be doing the world some good and therefore I ought to feel good about myself. It is like when I buy petrol and the card machine asks me whether I would like to add an extra 50p 'for charity' without telling me which cause I would be supporting.

I next tried the AXA Framlington Global Sustainable Managed Class Z1. This time, the list of the fund's top 10 investments did provide some insight. Top was Apple, followed by AstraZeneca, Microsoft, a Japanese government bond and Alphabet. Next came a company called Intuitive Surgical, the Progressive Corporation (whose business is motor and home insurance), Freshpet (an intriguingly-named food producer), American Express and a US government bond. This time, clicking through to the fund report did give me a much longer list of the companies in which my money would be invested – which, possibly to some investors' distress, included BP. But as to why these companies had been chosen, and on what general criteria the fund was run, I was still in the dark. All it told me was, "We invest in companies which meet one of three thematic areas that offer exposure to sustainable opportunities, benefitting from secular growth drivers – People, Planet & Progress". As to what that is supposed to mean I have no idea.

That was the typical experience: either the funds carried little or no information of where my money would be invested, or I would get a list of companies but no coherent explanation of why they made the cut and others had been excluded. The report for the Blackrock Developed Markets Sustainable Equity fund told me that "sustainable companies are identified for this purpose as being companies that can lead in a more sustainable world, either through their products and services that are enabling greater sustainability, of their characteristics that make them ESG leaders or improvers." As to what 'sustainability' means there was no guidance. The report told me that the fund screens out some sectors but didn't tell me what they were – I would have to refer to the prospectus for that. The report for the Fidelity Sustainable Consumer Brands funds informed me that 'sustainable' means "sustainable investments with environmental or social objectives". Its largest investments – only the top 10 were listed on the fund factsheet – seemed to be the usual mainstays of any global fund at the moment: Apple, Microsoft, Amazon, Nvidia. Why these companies have superior environmental or social objectives to others it was not explained.

It seems unlikely, in light of this, that investors in ESG funds have much idea of what they are investing in when they take the plunge. ESG is a world of grand principles but one where the details tend to be obscured.

Driving Investment into the services sector at the expense of resources, manufacturing and especially defence

The S&P 500 Sustainability Yearbook, the most prominent of publicly-available data sources on ESG, could be seen as a compendium for the investor who wants to do the world some good. It is supposed to cover almost all sectors of the markets (with one or two exceptions, of which more later), and to cover the whole world. Nevertheless, if you classify those listed in the 2024 Yearbook, they break down as follows:

Banking/finance	142
IT/electronics	96
Pharmaceuticals/healthcare	67
Industrial/manufacturing	62
Food/consumer	53
Leisure/retail	44
Business services and supplies	40
Utilities	39
Real Estate	39
Oil/gas	36
Construction	34
Metals/mining	33
Chemicals	30
Transport (excluding airlines)	18
Airlines	8
Textiles	6
Defence	1

Whether intending to or not, ESG is favouring certain sectors of the economy. Tech companies seem to do remarkably well in spite – as already discussed – of their high energy consumption. Above all, the financial world – which is setting the criteria for ESG – appears to be patting itself on the back. Among the 142 banking and financial companies which S&P Global has seen fit to include in its elite group is itself. Tremendous congratulations. At the other end of the scale, only a single manufacturer of defence equipment – CAE Inc of Canada – makes the list, and that is only partly involved in defence. Its business is in flight simulators, and other simulation equipment rather than weaponry.

Indeed, companies which manufacture weapons are excluded altogether from consideration for inclusion in the S&P Global Yearbook – not just those producing cluster bombs or nuclear weapons but any kind of small arms. Many ESG funds have taken the same approach – divested entirely from defence on the pretext that military activities are 'bad'. In 2021, ASD – the trade body for the European defence industry – was moved to write to the European Commission warning that its efforts to embed ESG into finance were harmful to Europe's security – indeed, they were contradictory to the EU's stated policy of strengthening defence. As French electronic group Thales argued, it was perverse that its cyber security businesses counted in the minds of ESG investors as a social good but that its radars and military communications systems were blackballed[54].

Three months later, the full folly of the ESG world's approach to defence was underlined by Russia's invasion of the Ukraine, and the whole of Europe was reminded how vulnerable it is. Some ESG funds did relent and agree that they would consider investing in defence companies. Yet 18 months after the Ukraine invasion, defence companies – especially smaller ones – were complaining of finding it hard to raise funds. ADS – the UK equivalent of Europe's ASD – said there were "strong anecdotal examples" of companies which had found their banking facilities withdrawn or were finding it hard to obtain loans because of the nature of their business. As the then City Minister Andrew Griffith and defence procurement minister James Cartlidge put it, "It is perverse that as war rages on our continental doorstep there is a parallel universe where the defence sector is being shunned". ESG, they added, was threatening the defence industries of democratic nations in a way that dictatorships did not have to worry about: "there are not too many ESG outfits in Russia or North Korea."[55]

The S&P Yearbook does not exclude companies involved in the extraction or refining of fossil fuels other than thermal coal, but they are nevertheless a little thin on the ground, as are mining and construction companies. It is self-evident that these companies are going to have higher carbon emissions than one whose business is purely clerical. But does that mean that it would be better if investors shied away from them? Take your clean-cut bank, a high-scoring ESG hero on the basis that it has supposedly 'offset' its carbon emissions by buying into a forestry scheme. It has, say, managed to achieve a target of having a board that is 50 percent female, and has donated a sliver of its global profits to charitable causes.

54. www.ft.com 1 December 2021
55. Mail on Sunday 30 July 2023

Nevertheless, it is a certainty that it operates out of buildings which require steel, and that the steel used has been manufactured with the aid of coking coal. Yet the company which mined the coal is held up as an environmental vandal and will struggle to get onto anyone's ESG ranking table (miner Anglo American does appear in the S&P Global Yearbook but then it divested itself of its coal-mining interests by spinning them off in a demerger in 2021). Your high-scoring bank is also ultimately reliant on defence equipment, too. As the world found out on 9/11, it would have been easy to think, standing in the financial district of a western city, that the rich world has moved on from the grubby business of war and that all efforts can now be put into commerce and trade, but sadly it isn't true.

To take a handful of companies which fall foul of funds which apply an exclusion to defence companies, there is BAE, which is deeply involved in the design and manufacture of Typhoon and F-35 fighter jets which between them form the backbone of the air defence of Europe. It also manufactures Astute class submarines, vital to Britain's maritime defence. There is Babcock, which is currently building frigates for the Royal Navy. There is Qinetiq, which is involved in cyber defence among other things, helping to protect Britain against cyber attack. Do ESG investors really think that these are companies which deserve to be shunned, and that by doing so they will help create a better society? A blanket exclusion policy prevents ESG funds from exerting pressure where it might well be justified, such as when defence companies sign contracts to supply equipment to dictatorships.

Some ESG scoring ignores obvious reality. There is, for example, an organisation called Valuable 500 which exists, according to the mission statement on its website, "to end disability discrimination" and boost the numbers of people with disability discrimination in the workplace[56]. All very laudable. Except, that is, that it proceeds to score companies partly according to a simple metric: the percentage of their workforce "which identifies as disabled/living with a disability". The companies it has rated, it says, have come out with figures between 0.07 percent and 62.5 percent – a massive difference. Those at the top end of the range are not just doing society good, they are doing themselves a favour, it asserts. It goes on to quote a report from the accounting firm Accenture which claims that companies which "have led on key disability criteria" enjoy 1.6 times more revenue, 2.6 times more net income and twice as much profit as other participants in its survey[57]. That sounds striking until you ask whether it is simply reflecting that it is easier for larger companies, with dedicated ESG teams, to achieve good scores on these kinds of surveys.

The methodology of the Accenture report is not clear – it doesn't go into details as to what criteria it is measuring, nor which companies it is measuring against others. But it ought to be obvious that a company's ability to absorb disabled employees into its operations depends very much on what those operations are. If you have an office-based business such as finance or technology it is going to be a lot easier than if you are, say, a mining company or an airline. Even with the best intentions towards

56. www.thevaluable500.com

57. The Disability Inclusion Imperative www.accenture.com 27 November 2023

inclusivity, the crew of an airliner need to have the physical ability to command the evacuation of an aeroplane; to employ people who are not would break endless regulations; yet an airline is going to come out with a lowly score if you are simply going to tot up the number of disabled employees. There is something deeply unsatisfactory, too, about Valuable 500's measure of counting people who "identify" as disabled. You have to wonder how a company could possibly end up with 62.5 percent of it employees disabled unless it is using a pretty broadbrush definition of what constitutes a disability. As with other aspects of ESG scoring businesses on the percentage of their employees who identify as living with a disability is inevitably going to favour those in developed countries which have a wider definition of what is meant by disability. A bad back, a tendency towards migraines or mild depression can mean very different things in some societies than in others.

ESG is presenting society with a serious problem if it is going to dissuade investors from backing industries which are vital but which will always struggle to achieve high ESG scores. Fortunately, private equity has so far been able to take up the slack on fossil fuel assets. There are still enough investors prepared to back the defence industry that is hasn't been starved of cash to invest. But take ESG to its logical conclusion, where the entire investment world was led along by the likes of the S&P Global Sustainability Yearbook, that is where we would end up: with no defence forces at all for western countries.

Promoting the interests of large companies over small, first world businesses over developing ones

If a financial organisation is claiming to be doing the world some good with its investment strategy, you might imagine that it would be focused on addressing the disparity in wealth between the developed and developing world, and helping to promote growth in the latter. Yet that is not quite how things are turning out in the sphere of ESG. In January 2023, 34 companies were removed from the FTSE4Good Index for failing to satisfy the FTSE4Good's reporting standards on climate change, having been warned they were in danger of failing two years earlier. They included stockbroker Charle Schwab, gold miner Fresnillo and, as already mentioned, British construction firm Galliford Try. But most of those which were expelled from the Index were from developing countries, with 14 Indian companies culled[58].

In fact, ESG funds have been steadily divesting from emerging markets in recent years. An analysis of the MSCI Emerging Markets ESG Leaders' Index found that the weighting of companies from the poorer, developing countries (defined as EMDEs) fell from 68.2 percent in 2018 to 62.9 percent in 2022. Excluding China and India, the weighting given to companies from EMDE countries fell from 33.2 percent to 21.7 percent over the same period[59]. As for the MSCI World ESG Leaders Index – which you might expect from its name to cover the entire globe – its weighting

58. Financial Times 10 January 2023

59. *Resetting the ESG Investment Paradigm to Support Emerging Markets and Developing Economies* www.mobilistglobal.com April 2023

of companies from developing countries is precisely zero; its members are drawn exclusively from 23 developed markets[60]. It is as if poor countries are not part of the world at all.

Plot companies' ESG scores against the per capita Gross National Income (GNI) of the countries in which they are based and there is a strong positive correlation[61]. There is a very good reason for this: it is much harder for companies in developing countries to produce the required data to gain good ESG scores. For companies in developed countries, supplying data for an ESG assessment is often a case of simply handing over data which has already been collected for some regulatory purpose. For a company in a developing country it might not have that data at hand, or it might not have been gathered in the same standardised way as in developed countries. Some ESG indices obtain data not directly from companies but via third party sources, who are less likely to be able to provide environmental and employment data for developing world companies because there is no publicly-available repository of such data. This is a problem that is getting worse as requirements for reporting on environmental matters are tightened in an effort to combat greenwashing.

ESG takes an especially harsh line against coal – even funds, indices and accreditation schemes which accept oil and gas companies tend to exclude companies which have investments in thermal coal. This is logical from the point of view that generating electricity by burning coal, megawatt-hour for megawatt-hour, releases around twice as much carbon emissions as does burning gas. Together with sulphur emissions from coal, there is a compelling environmental case for switching from coal to gas where possible. Yet that rather ignores that many developing countries with little access to natural gas are heavily reliant upon coal to help power their industries and generate wealth. India, for example, derives 55 percent of its energy needs from coal[62]. Unlike gas, coal is easy to store and transport, and therefore requires less infrastructure than does an energy system based on gas, making it invaluable for many developing countries. There may come a time when developing countries are able to switch to renewables or other clean forms of energy, but that will be some way off. A blanket exclusion on investing in coal fails to recognise any of this; it simply seeks to starve of capital an industry which is helping to improve the lives of billions of people in the developing world.

Many other demands of ESG, too, are very Western-centric, such as requirements for representation of women on boards. It is only in recent years that there has been widespread female representation on company boards; yet ESG demands that the rest of the world follows suit immediately. ESG is a subtle form of western moral imperialism, and one which is making it harder for poor countries to obtain the capital they need in order to develop. As Colin Mayer of Oxford University's Said Business School has put it, ESG "is a mechanism for encouraging investment to flow out of relatively high-risk emerging markets into what are perceived to be less exposed developed markets"[63].

Within the developed world, ESG tends to discriminate against smaller

60. *Index Factsheet* MSCI World ESG leaders Index
61. *Resetting the ESG Investment Paradigm to Support Emerging Markets and Developing Economies* www.mobilistglobal.com April 2023
62. Indian Ministry of Coal, www.coal.nic.in
63. Financial Times 20 October 2022

companies. Of the 32 UK-based and UK-listed companies in the S&P Global's Sustainability Yearbook for 2024, 26 are in the FTSE 100 list of the hundred biggest UK companies. The other six are in the FTSE250. There was not a single representative from the small cap index, nor the alternative investment market (AIM). There is a very good reason for this. It is relatively little trouble for a large company to employ an ESG team to help massage its performance in the right tables; for a small company it is very much more difficult, as the cost of doing so hits far harder. The regulatory cost of being a FTSE company, according to one senior executive, is a minimum of £3 million a year, and while this cost rises with turnover, it is proportionally far higher for small companies than large. The result is that small companies end up getting overlooked. As one fund manager puts it "when taking ESG into consideration you tend to look at what data is available, which draws you again and again to the large companies".

That is not helping to raise capital for small companies which wish to expand – the very companies on which an economy relies in order to grow. Rather it is just helping to channel yet more of investors' money into, and puff up the share prices of, existing large companies – financial and tech ones especially.

Encouraging a switch from public listings to private equity

While the ESG funds which shun fossil fuels were suffering heavy losses in 2022, someone was making money. The fossil fuel assets which had been dumped by listed companies as they chased ESG ratings had been eagerly bought up by private equity firms, who are less exposed to campaigning on the part of climate activists, and who are less easily held to account by the public, the media and by regulators. In June 2024, for example, Carlyle, one of the world's largest private equity groups, bought extensive gas exploration and production assets from the UK-listed firm Energean. The assets – capable of producing the equivalent of 47,000 barrels a day – were placed in a subsidiary of Carlyle chaired by Tony Hayward, who had been CEO of BP at the time of the Deepwater Horizon disaster in 2010, which killed 11 oil workers and released upwards of 500,000 tonnes of crude oil into the Gulf of Mexico. In that guise, he had felt the full pressure of public scrutiny which comes from leading a public company, seeming to struggle with the exposure, becoming what the BBC described as "the most vilified business leader anyone could remember"[64]. In one interview he attracted ridicule by declaring "the Gulf of Mexico is a very big ocean. The amount of volume of oil and dispersant we are outing into it is tiny compared with the total water volume"[65]. On another occasion he said he referred to the pressure the disaster had put on him personally, saying "I want my life back"[66] – before apologising to the families of the oil workers who had been killed. Although Hayward had left BP by then, the company's first AGM following the disaster attracted four hours

64. www.BBC.co.uk 20 April 2011
65. www.BBC.co.uk 14 May 2010
66. Reuters 2 June 2010

of protests from environmental campaigners, including hostile questions from the floor.

To gain entry to the AGM of a public company, and therefore be able to make a very public protest, it is necessary only to own a few shares; not so in the world of private equity. Almost everyone knows the name BP; rather few have ever heard of the Carlyle Group. In private equity there are no public meetings, and a lot less regulatory supervision. There is a lot less media coverage and fewer opportunities to protest: unlike BP, the Carlyle Group does not own a portfolio of branded petrol stations across Britain. Most importantly of all, in private equity your investors are not burdened by the cost of gathering and collating data for inclusion in ESG indices.

Carlyle is not alone among private equity groups in scooping up oil and gas assets from public companies. In 2021 and 2022, private equity firms bought $25 billion worth of fossil fuel assets from public listed companies, with $14.5 billion worth of them bought out by another private equity firm KKR. Among the assets part-owned by the firm is Canada's Coastal GasLink, which has attracted protests from environmentalists and native Americans whose territory it passes through[67]. Several days of protests in November 2021 led to 29 arrests[68]. For a public company this would inevitably lead to calls for divestment, but it is easier for private equity to bear. That public companies are loathe to own assets which cause them PR problems means private equity firms have an opportunity to pick up assets on the cheap. In the words of James West, private equity partner at legal firm Mayer Brown, oil majors "are facing pressure to divest some of their assets as part of the transition to renewables and this is creating an opportunity for specialist private equity funds to pick up assets at valuations they like."[69]

Pressure group Global Energy Monitor, which traces the ownership of fossil fuel assets, reported in 2024 that 21 of the largest private equity groups between them owned 272 companies involved in fossil fuel extraction and burning, including important assets which had previously been in the hands of listed companies such as the General James Gavin coal power plant in Ohio. Built in 2002 by the public company American Electric Power, it was sold in 2016 – at the height of the divestment movement – to private equity groups Blackstone and ArcLight. The financial industry was put in charge of policing corporate ethics by the United Nations, but this particular corner of the financial industry – private equity – has ended up enjoying the profits from coal itself.

It is a good job, from the point of the divestors, that private equity funds are prepared to do this; were there no private equity firms to buy the troublesome assets, listed companies would be suffering massive losses as they tried to dump their investments. But what ESG is doing is to shift controversial activities from the well-regulated, relatively transparent world of public listed-companies and into the darker, less accountable world of private equity. This is surely not what the proponents of ESG intended.

67. www.pestakeholder.org 17 January 2023
68. www.cbc.ca 30 November 2023
69. www.mayerbrown.com 24 January 2022

Giving undue power to the financial sector

ESG relies on the conceit that the financial sector, and fund managers in particular, are fit and proper people to take on the role of moral policemen for the entire corporate world. The weakness here is exemplified by the case of the Royal Bank of Scotland (RBS), a once-booming financial institution which seemed to be on its way to becoming Britain's largest and most successful bank. Then came the financial crash of 2008/09. As Warren Buffett has put it, it is only when the tide goes out that you find out who has been swimming with no trunks. On 7 October 2008, hours after CEO Sir Fred Goodwin had been making a bold speech about the opportunities which lie ahead, the bank had to approach the government for an emergency bailout to stay afloat, its rapid expansion having exposed to bad debts arising from the growing scandal of subprime mortgages. The government responded by recapitalising RBS with £20 billion of fresh equity. By the end of 2009 the UK taxpayer had put in £46 billion and owned 82 percent of the bank. Barring a miracle, the 'investment' will never be repaid: the government has since reduced its stake to less than 50 percent by selling shares at a thumping loss. However, while losing taxpayers large sums, senior executives were earning fat bonuses; in 2010 the bank paid out £950 million in bonuses – nearly matching the £1.1 billion it lost that year. Goodwin, to much anger, was allowed to keep his full pension rights, and by 2023 was reported to be enjoying retirement income of over £500,000 a year[70] – something he would not have been able to do had the government not intervened and RBS been allowed to go under. He did at least lose his knighthood.

The problems with RBS didn't end there, however. In trying to save itself, the bank was accused of driving other businesses to ruin through it Global Restructuring Group (GRG) – an arm of the bank which was supposedly trying to help businesses in financial trouble to get back on their feet again. However, many business owners accused the bank of driving viable businesses to the wall in order to feast on their assets. In 2013, a report by Lawrence Tomlinson, entrepreneur in residence at the Department for Business, Innovation and Skills, concluded that RBS and other banks had resorted to "heavy handed, profiteering abhorrent behaviour", concluding that "it is undeniable that some of the banks, RBS in particular, are harming their customers through their decisions and causing their financial downfall."[71] The FCA later conducted its own investigation which concluded that there was "clearly evidence of poor behaviour within GRG", but that the activities of GRG were mostly unregulated and therefore it had no power to impose fines or impose other sanctions[72].

Yet none of this stopped RBS jumping aboard the ESG bandwagon. In 2021, the NatWest Group (the new name of the former RBS Group) proudly announced that its private banking arm, Coutts, had achieved B Corp status. "B Corps are businesses that balance both purpose and profit," it declared. "They are legally responsible for benefitting customers, workers, communities and the planet while delivering profit. Their long-

70. Mail on Sunday 4 November 2023
71. Banks' Lending Practices: Treatment of Businesses in distress www.tomlinsonreport.com
72. Report on the Financial Conduct Authority's further investigative steps in relation to RBS GRG June 2019 www.fca.org.uk

term aim is to build a more inclusive and sustainable economy."[73] In 2020, it announced that it was going to cut off financing for large oil and gas companies unless they could show they had a credible plan to reach net zero; it followed up the threat a year later by reducing lending to the sector by 21 percent[74]. The bank's Environmental, Social and Governance Disclosures Report for 2023 declares all manner of achievements to do with 'financial inclusion', saying it had opened basic bank accounts for the financially excluded and made £5.7 million of funding available for charities to help people cope with the cost of living. It also boasted that 40 percent of its board members were now women, and 13 percent of its senior staff from an ethnic minority.

Yet in that same year another side of NatWest's commitment to 'financial inclusion' emerged. Nigel Farage, then honorary president of the political party Reform UK, complained that Coutts, a subsidiary of NatWest, had written to him telling him that it was closing his accounts – or 'debanking' him. NatWest's then CEO Alison Rose at first claimed to a BBC reporter that the bank's decision had been for purely financial reasons – his deposits with the bank had fallen below the level required to be a customer of Coutts[75]. Yet Farage then obtained, under freedom of information laws, a 40 page dossier revealing the truth: that he had been debanked because Coutts' Reputational Risk Committee had taken exception to his political views. Citing his friendship with and support with Donald Trump, a comment he had made comparing the campaign group Black Lives Matter to the Taliban and his opposition to the government's net zero policies, the committee declared that Farage's views "do not align with our values" and, in Orwellian tones, recommended that the bank set itself on a "glide path to exiting" Farage as a customer once his mortgage had expired[76]. When the truth emerged, Rose was forced to resign.

There are some good things in NatWest's ESG disclosures – such as setting up basic bank accounts for customers who were otherwise unable to open bank accounts. Yet the debanking scandal exposed a dark alleyway down which ESG inexorably leads when taken to its logical conclusion, with a large and powerful corporation using its muscle to impose the political views of its management, to the point of excluding customers whose own views are at odds with them. NatWest's use of the term 'our views' was itself objectionable – what it meant was the views of its senior executives. It is improbable that among NatWest's 61,000 staff there are not many who agree with Farage on many issues, given that his political party Reform UK won 14 percent of the vote in the 2024 UK general election.

ESG hands huge power to banks, fund managers and others who are involved in the scoring of companies and in their selection for investment funds. It is far from clear what they have done to deserve this power nor why they are being trusted to wield it wisely.

73. News release www.natwestgroup.com 28 July 2021
74. www.euronews.com 21 February 2022
75. www.bbc.co.uk 21 July 2023
76. Document accessed via www.telegraph.co.uk, 19 July 2023

Delivering few measurable gains for society or the planet

If ESG was worth the billions that are being spent on it, we might expect that by now to be showing up in improved environmental and social conditions around the world. We might expect there to be fewer people working in poor employment conditions, for carbon emissions to be falling, rivers to be less polluted – and for these things to have undergone a sharp improvement over the past two decades in which ESG has been with us. Is it possible to observe an ESG effect on any of these things?

Let's take a look at some pointers – a few of the things which ESG is trying to eradicate. An important marker for the success or otherwise of ESG is global coal consumption. There are many other environmental metrics, of course, but none which have been targeted so strongly by ESG. A prohibition on investing in thermal coal is one thing which unites almost all ESG funds – even those which are happy to maintain some investments in oil and gas. So if ESG were effective we might expect it at least to have achieved some progress in cutting global coal consumption. Yet global consumption rose 4 percent in 2022 to hit a new high of 8.42 billion tonnes[77]. Coal use had levelled off in the decade between 2010 and 2020 but has surged since 2020, partly in response to the global energy crisis precipitated by the Ukraine invasion. It is perhaps just as well that ESG has not succeeded in snuffing out the global coal industry. Germany, among several European countries, was driven to reopen mines in order to keep the lights on as Russian gas was no longer available. But the steepest rises were in Asia, with consumption rising in 2023 in China by 4.9 percent, in India by 8 percent and Indonesia by 11 percent, all to fuel industrial growth – a fair amount of it to manufacture goods for western consumers. Rising use of coal has contributed to overall energy-related carbon emissions also rising to a new high of 37.4 giga-tonnes in 2023[78]. If the world is going to wean itself off coal, it is not going to happen as a result of investors in the West shunning the sector. All ESG has achieved is to persuade western corporations to exit the coal business. Anglo American, for example, has earned itself a place in the S&P Sustainability Yearbook partly thanks to offloading its coal interests in 2021. But they were simply transferred to a demerged, South African-listed company Thungela Resources. Filthy though coal might be, the company rewarded investors with a 15-fold capital return in its first 18 months of existence.

Neither, by the way, has ESG succeeded in reversing growth in consumption of other fossil fuels – gas and oil are also at record highs. On the other hand, Britain has succeeded in removing thermal coal from its energy mix, the last coal plant closing in the autumn of 2024. But it is hard to argue that ESG played any role in this – it was simply a result of government policy. Long before coal was wound down as a source of electrical energy in the UK, its polluting effects were mitigated by way of the clean air acts, which placed legal obligations on those who burned the fuel – either banning it from being burned in hearths in urban areas

77. *Coal 2023* International Energy Agency www.iea.org

78. www.iea.org

or forcing operators of coal-fired power stations to fit scrubbers to their chimneys to lessen the emissions of acid rain-forming sulphur dioxide. These measures succeeded because they used the law to achieve a specific outcome. The effectiveness of the clean air acts, which led to a very rapid improvement in air quality in Britain and a cessation of the London smogs, contrasts with the far less effective attempts by ESG to achieve environmental gains through people power.

Another feature of many ESG funds is a prohibition on investing in the manufacture of any kind of weapon. So has that helped to reduce armed conflict? Until around 2010 it seemed as if the world was becoming a steadily more peaceful place. Since the mid-1980s the number of people being killed on the battlefield had plummeted by around 90 percent to around 20,000 a year. That was in spite of the war in Iraq. And since then? The trend has been sharply reversed. In 2022, 204,000 people died on battlefields around the world – the highest figure since 1984[79]. Efforts by ESG to divest from arms companies may make it a little harder for defence companies to raise capital in order to develop the sophisticated systems which keep rich countries safe from invasion, but they are having no effect on the rates of global violence; the guns and other weapons are still coming from somewhere. As for the nastiest weapons, the cluster bombs, land mines and so on, we do have laws to try to prevent them falling into the wrong hands; UK companies have been prosecuted for breaching those rules. Laws directed at preventing arms falling into the hands of malign dictatorships or terror groups are not always perfect, but they are better than an indiscriminate, self-imposed ban on ESG funds investing in all weapons manufacturers. The latter are actively harmful to the defence of democracies.

Tobacco? Here there is some good news. The global prevalence of tobacco use fell from 32.7 percent of the global population in 2000 to 22.3 percent in 2020[80]. Whether that has anything to do with ESG or is a result of government health campaigns or simply societal change is quite another matter – in Britain, at least, smoking began to decline sharply from the 1960s, long before anyone dreamt up ESG. Rather, it was government health warnings that proved to wean people off the habit.

Obviously, there are numerous factors involved in all of the above trends; you couldn't expect ESG to resolve all the world's problems. But it is hard to produce any evidence that it has made any positive impact on the world – even if it has made some investors feel better about themselves.

79. *Conflict Trends: a Global Overview 1946-2022* Peace Research Institute Oslo

80. *WHO global report on trends in prevalence of tobacco use 2000 - 2025*

Conclusion

Few would want to see public corporations buy goods produced by slave labour or pollute the atmosphere with abandon. The idea that businesses should act with responsibility, socially and environmentally, is surely a good thing. It goes without saying that they must also be run by people who are honest. It will always be the principal ambition of a company to make money – without doing which it will not survive – but that doesn't mean that it is acceptable for it to behave in a way which is harmful to society.

But in trying to formalise good corporate behaviour, to quantify it and reduce it to an easily-digestible score, the concept of ESG has produced many perverse outcomes. It has gathered a momentum which was not necessarily intended by those who conceived it a quarter of a century ago. It is distorting markets, steering capital into parts of the economy at the expense of others, driving some business activities into the hands of private equity where they will be much less regulated than they were before, concentrating investment in a small number of large companies and strangling smaller ones.

All these issues are widely acknowledged – in private – in the corporate world. Yet few seem brave enough to make a stand. Among those I spoke to there was a notable reluctance to go on the record, even though they shared negative views about aspects of ESG. "It feels totemic," in the words of one FTSE executive. Yet they felt there would be too great a price to rock the boat.

How did we get here? To one senior figure in the world of venture capital, chief executives tend to be drawn from the world of sales. They are brilliant at persuading others to buy a product, yet also rather given to jumping on bandwagons driven by others; not least their own human resources and public relations teams. PR people have to justify their existence, and diving into ESG provides one means of doing so.

ESG has itself mushroomed into a multi-billion pound industry. It has created richly-rewarded work for the companies which produce the ratings and the scores, and for those who offer services to companies wanting to show off their ESG credentials. But none of this would be possible were it not for a lack of curiosity on the part of investors who have been enticed into putting their money into 'good' ventures. There is a remarkable opacity to ESG investing. How ratings agencies arrive at their scores is a little-prodded mystery, at least by the investing public. Their methodologies do not tend to be shared with investors, and neither do their results find much agreement with each other. ESG is an exercise in trying to quantify the unquantifiable. Where it can easily be understood is when it is a purely binary operation: excluding certain sectors of the economy on the assertion that all companies who work within them are somehow 'bad'. But this is naïve, and dangerous to society. Investment funds can do without oil or defence companies, but societies cannot – at least not yet. To try to starve such businesses of capital is tokenism at best, but also potentially damaging.

If we want corporations to behave, there really is no better device than the law. This is worth emphasising, as a positive message to take away from what may otherwise seem – necessarily, alas – an essay with a negative conclusion. Nothing I have written here should be taken to imply that companies should be allowed to act with impunity. Business is, for the good of society, quite properly regulated through many channels. Sometimes, regulation may be excessive and may need to be cut back, rationalised in order to avoid excessive costs being imposed on business for disproportionately small benefits. Few would argue, however, that we should not have regulations on business at all. Measures such as the Clean Air Acts and laws to prevent the pollution of waterways have near-universal support. They are vital to protect the environment and society even if they do impose some costs on business. Examples of such laws are all around us. Companies are legally obliged to consider the effects of their actions on the environment by a whole panoply of legislation, from the Control of Pollution Act 1974 to the Environment Act 2021. The latter, in particular, covers a wide range of issues, including water quality, air quality, biodiversity and the treatment of plastic waste. Of course there may be continuing debates about the merits of particular provisions in these laws. But the key point is that the laws are there, for all to see: if people disagree with them strongly enough, they can campaign for amendment; those who think they are not extensive enough can campaign for them to be strengthened and augmented.

Whether we need ESG is another matter. There is a big difference between laws which are properly debated, which are passed with a democratic mandate, which are enforced through due process, which are clearly worded, which are transparent, which are targeted specifically at the problem they are trying to solve – whether it be to clean up the air, prevent exploitation of workers or avoid corruption on the part of company executives – and the system of peer pressure which ESG scores seek to exert. The latter, by contrast, is opaque. It works on the basis of rules which are imposed by a small oligarchy of people who run financial institutions, who have no democratic mandate and who in many cases are reluctant even to share the methodology by which they come up with their ESG scores. Investors are expected to nod along with their assessments without asking too many questions. As we have seen, ESG scores are often arbitrary, contradictory and inconsistent.

There is an argument that we need ESG in order to impose good behaviour in corporations which operate around the globe. The UK Parliament can regulate to try to prevent British rivers being polluted and

British workers being exploited. But how does UK law try to achieve the same, say, in Cambodia? ESG scores are proffered as a solution: theoretically they provide a way of punishing western corporations for bad behaviour overseas. But as we have seen, ESG often fails in this task because the data required to feed its algorithm-based scores simply doesn't exist in the case of developing countries. Companies in the developing world are discriminated against, and starved of capital as a result. It is not impossible, in any case, to draw up laws which demand that home-based corporations behave well when they do business abroad. The Modern Slavery Act, for example, demands that companies act to ensure their supply chains are free of forced labour.

If businesses behave badly, it is not unreasonable that potential customers should seek to boycott them. There are many corporations which have fallen foul in this way, such as those who sought to do business in apartheid South Africa. But to refuse to invest in a company on the basis that it falls below a threshold achieved on an arcane ESG scoring system? That makes little sense. The world is waiting for businesses to speak openly about the inadequacies of ESG – and to rebel against the whole charade.

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