

# Making ESG Real:

A Return to Values-Driven Investing

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# Executive Summary

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**The conceptual error at the heart of current ESG frameworks is that they measure how environmental and social risks may harm shareholders, rather than how business may harm the world.**  
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Investing based on environmental, social, and governance factors—ESG investing—faces criticism from two main sources. Conservative U.S. politicians have tried to stir ill-informed hysteria over what they deride as “woke capitalism.” Separately, a very different group of skeptics that includes academics and journalists have relied on serious research and arguments to raise questions about whether current forms of ESG investing can deliver on their promises.

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Informed by these legitimate scholarly and journalistic critiques, we offer a dramatically different approach that can revive the original goal of ESG investing—namely, using investment decisions to create incentives for companies to conduct themselves in a more responsible fashion.

The conceptual error at the heart of current ESG frameworks is that they measure how environmental and social risks may harm shareholders, rather than how business may harm the world. We show how this misconception developed historically and unpack the three reasons that it’s misguided. First, firms often take actions that harm society without shareholders suffering consequences. Second, enlightened ESG policies often add costs that investors are unwilling to tolerate because they reduce shareholder returns, although many E policies and some S policies may be cost-justified in the long-run. Third, centering ESG on financial returns misleads many investors who assume that a fund labeled “ESG” is values-driven. Instead they are fed exaggerated marketing claims by funds that are failing to achieve the traditional objective of protecting society.

Much of the legitimate critical literature dwells on the incoherence of current ESG ratings. Scholars agree that the scores given to the same company by different ESG raters are deeply uncorrelated. ESG funds use any number of semi-secret rating frameworks, applying different weights to countless different metrics and criteria. Some of the most crucial data—for instance, on global value chains—is chronically missing or goes unmeasured. Firms that excel in one facet of ESG may lag in another, and the component factors often work at cross-purposes, yet the frameworks typically assign companies a single composite “ESG” score. With so much noise around the ESG signal, no one can quite tell what values investors are expressing or what conduct they’re encouraging.



To improve the current ESG investing system, regulators need to require financial services firms to be more transparent about their ESG methodologies and force companies to report more extensive ESG data. The Securities and Exchange Commission is already cracking down on misleading ESG labeling (sometimes known as greenwashing), and is poised to propose a new rule on “human capital” reporting. To build on its campaign against greenwashing, we urge the SEC to compel financial service providers to be transparent on every dimension of every ESG ratings system they design or employ. To make its human capital rule more meaningful, we urge the SEC to fill the void in basic data on the composition and compensation of the indirect workforce—including all forms of outsourced or contingent labor in both the global supply chain and domestic markets.

At the same time, investment managers need to install broader exclusions, narrower targets, and customized goals. Because ESG funds are rife with holdings that offend ESG values, fund managers should apply more aggressive negative screens. Because composite “ESG” funds, as currently structured, are a bundle of contradictions, portfolio managers should disassemble the bundle, and design funds that target specific objectives within the E or the S. Because ethical priorities are highly personal, asset managers should customize ESG portfolios to fit each of their client’s values.

Of course, none of this would alter the subordination of stakeholder protection to shareholder return. To address the field’s most elemental conceptual error demands a wholly new approach. We propose that motivated ESG investors expressly authorize their advisers to prioritize specified ethical objectives over financial return. Although fiduciary law would foreclose this path to pension investors, other investors are free to choose their own investment strategies, and to loosen their advisers’ fiduciary duties by agreement.

With these clients, the way is clear for innovative asset managers and wealth managers to offer investment products that incorporate all of the lessons learned from good-faith ESG critiques. We envision the creation of targeted E and S funds, giving interested investors the option of expressly stating that they prioritize values over value, and are ready to sacrifice return in the pursuit of specific environmental or social objectives. Call it ESG Values investing.

# 1. Introduction

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We propose the creation of ESG funds that expressly prioritize the protection of people and the planet over the maximization of investor wealth, while still aiming for strong returns.  
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The idea of investing based on environmental, social, and governance considerations—better known as ESG investing—grew out of older forms of ethical investment. Its traditional goals were to express investors’ values, and to protect society from corporate misconduct by rewarding socially responsible corporate behavior.

In recent years, conservative politicians have caricatured ESG investing as the motor of “woke capitalism.” This partisan rhetoric has drowned out a more meaningful critique of how ESG funds actually operate. Independent of the culture-war attacks, the responsible critics who know the field best doubt the adequacy of ESG frameworks in assessing or curbing corporate harm to society. Indeed, most ESG frameworks no longer even *try* to assess how firms might harm people or the planet. The most fundamental flaw of today’s ESG funds is that they focus on the risk of harm to *companies*, because the main aim of the funds’ managers is to maximize shareholder return. Partly as a result, many ESG funds scarcely differ from non-ESG funds. The largest asset managers, like BlackRock and Vanguard Investments, have taken what could be a powerful instrument of change, and used it to promote rebranded index funds.

Most ESG funds are preoccupied with shareholder return because they cater

to pension advisers, who (properly) owe a strict duty to advance the financial interest of pensioners. Regrettably, the preoccupation with return limits ESG investing as an ethical tool, because there’s a tradeoff between ethical purpose and profit. This predicament ought to inspire ESG asset managers to reexamine to whom they cater. Instead, they typically deny there is a tradeoff between purpose and profit.

ESG advocates pretend that ESG best practices always benefit shareholders. The inconvenient truth is that it requires additional resources to pay workers fairly or to ensure workplace safety throughout a company’s global supply chain. In the long run, some S spending may be cost-justified—but we should not pretend that is generally true. In the short run, meaningful steps to improve workers’ lives rarely boost bottom lines or stock prices, and most investors, sadly, focus on the short run. Return-maximizing ESG funds are based on a fiction, and therefore do little to protect the environment or society.

In this report, we offer a deliberately different approach, with a primary focus on the market for public equities. We propose the creation of ESG funds that expressly prioritize the protection of people and the planet over the maximization of investor wealth, while still aiming for strong returns. To be sure, such funds would be unsuitable for pension advisers. But the rules of the ESG game need not be set by the market segment with the most rigid legal constraints. Most investors are free to loosen fiduciary duties by agreement—and to select an investment strategy that prioritizes their ethical objectives. The new-model ESG Values Funds that we envision would cater mainly to individuals, family offices, and perhaps some charitable foundations that are drawn to this approach.

If ESG investing is to become more credible and meaningful, leading asset managers and data providers will need to be more candid about their methods, and more candid in their marketing. We envisage a new category of more ambitious investment funds that do not necessarily promise comparable financial returns but do base their decisions on meaningful data in specific domains of social or environmental concern. These funds would invest in companies based on their actual performance in meeting clear standards and metrics. For this approach to succeed, asset managers will need to target narrower objectives—and exclude broader swathes of the market from their portfolios. Ultimately, these portfolios could be customized to fit each client's values. Far-sighted asset managers and other market players should explore the creation of funds within the E or S that truly incentivize ethical business conduct, and genuinely reflect the values of ethical investors. In our view, an important

group of potential investors are ready for a return to ESG values. They are ready for ethical investing that honors the intuitive meaning of the phrase and aims to safeguard society from corporate excesses and to reward corporate leaders.

This idea presents a commercial opportunity for a large and complex market. ESG is a huge investment class, albeit not as huge as generally reported. Until recently, the standard estimate for the size of the ESG investing domain was [\\$35 trillion globally, with \\$17 trillion in the U.S.](#)<sup>1</sup> On closer inspection, much of that was merely “ESG-integrated”—a crude branding exercise by which an investment manager “considers” ESG factors in its usual analysis. A more current calculation by the [US SIF trade group](#) (formerly the U.S. Social Investment Forum), excluded assets that are ESG-integrated. That instantly chopped the estimate for U.S. ESG assets in half, to \$8.4 trillion.<sup>2</sup> Although ESG funds in the U.S. suffered a minor net outflow of capital in the last quarter of 2022 and the first half of 2023, ESG funds globally have resumed growth.<sup>3</sup>

Selling ESG data to large investors is itself a rapidly growing \$1 billion business.<sup>4</sup> The market is splintered among some 160 ESG data vendors, but it is concentrated at the top.<sup>5</sup> Among the key players: [ISS](#), [S&P](#), [Morningstar Sustainalytics](#), [LSE Refinitiv](#), [Moody's](#), [Bloomberg](#), and the industry-leading [MSCI](#). Typically, these data vendors take corporate ESG disclosures and transform them into ESG ratings, which enable asset management firms like BlackRock to assess individual securities for inclusion or exclusion in ESG funds.<sup>6</sup> The asset managers then sell their ESG investment products to all manner of institutional investors, as well as to retail investors.

Here is what “ESG” is not, at least for purposes of this report. First, ESG is not a catch-all for any public-spirited activity of which a company is proud. However praiseworthy, charity and volunteer work have nothing to do with sustainable reporting, rating, or investing. Second, ESG is not code for CEOs taking stands on hot-button issues. In reality, no firm earns ESG ratings points when its CEO sounds off on a social or environmental controversy.

We support the idea of ESG investing, and oppose those who would extinguish it. But at the same time, we believe that it needs to be thoroughly reimaged to advance its traditional goals. To reclaim its place as a viable ethical tool, ESG investing needs to reward more sustainable corporate conduct—and especially, in our view, a heightened respect for vulnerable workers.

## The Landscape of ESG Reporting, Rating, and Investing



## 2. How ESG Took A Wrong Turn

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The absence of a mechanism to hold a firm accountable for the ills it generates in the outside world does not make that harm any less real or important.

On the contrary, the need for ESG investing arises precisely when firms are not disciplined by existing legal or market pressures.

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The conceptual error at the heart of ESG investing, in the form that now predominates, is to frame ESG analysis in terms of shareholder *value* (the worth of the portfolio), rather than shareholder *values* (the principles held by investors).

### Scoring “corporate goodness”

The leading ESG rater for investors, MSCI, is commendably open about the singular goal of its ratings. They “are not a general measure of corporate goodness,” the firm states on its website. The “one purpose” of MSCI’s ESG ratings is “to measure a company’s resilience to financially material risks.”<sup>7</sup>

The same mindset prevails at the biggest firms that use such ratings to construct ESG funds. Each of the “Giant Three” U.S. asset managers, BlackRock, Vanguard, and State Street Global Advisors, [which together control over 25% of voting shares in the S&P 500](#), take pains to link ESG goals with shareholder financial interests.<sup>8</sup> State Street describes its approach most directly, calling sustainability “a matter of value, not values.” Vanguard emphasizes the integration of a company’s sustainability strategy with its corporate strategy. For BlackRock—which leads the industry in rhetorical commitment to stakeholder values—ESG means looking at factors “that are material for enterprise [value creation](#), rather

than those that address a company’s impact on society.”<sup>9</sup> ESG has been defined in such a misleading manner that the pacesetter for environmental and social investing is not measuring how corporations are affecting the environment and society.

### Why it’s a fallacy

Defining ESG in terms of shareholder return is wrongheaded for several reasons. First, firms can do harm to society without suffering consequences. Reputational risk from pollution is minor if a firm lacks consumers who are attuned to environmental issues, or if its consumers fail to connect the dots. Reputational risk from labor abuse can be minimized by a firm outsourcing its low-wage labor, especially to suppliers in distant countries. Regulatory risk is trivial if a firm operates in an under-regulated sector, or can hire lobbyists to keep the market under-regulated. Perversely, framing ESG in terms of financial materiality rewards firms that are most adept at avoiding scrutiny of their environmental or social performance.

*Bloomberg Businessweek* points to the example of McDonalds, which received an ESG *upgrade* from MSCI in 2021 despite the expanding cloud of methane emissions in its beef supply chain. The fast-food giant enjoyed the upgrade because it made its packaging in Europe a bit less wasteful, in response to a legal requirement that it do so. MSCI does not see rising methane emissions from cattle flatulence as a financially material risk to McDonalds because there is no law in place, nor any widespread consumer awareness, that might hold McDonalds accountable for the huge climate costs of its beef consumption.<sup>10</sup>

The absence of a mechanism to hold a firm accountable for the ills it generates in the outside world—in other words, to internalize the costs of an external harm—does not make that harm any less real or important. On the contrary, the absence of such a mechanism is the *raison d’être* for ESG investing. The task of ESG investors is to impose *new* reputational costs on poor ESG performers. This may be done either by excluding or underweighting a stock, in the hope of impairing the firm’s ability to raise capital cheaply, or by exerting pressure through shareholder proposals and corporate engagement. ESG investment creates new pathways to discipline companies for injuring the environment or society. The need for it arises precisely when firms are not disciplined by existing legal or market pressures.

The second crucial problem with framing ESG as a matter of shareholder financial interest is that enlightened ESG policies can be expensive—perhaps especially in the realm of social concerns, or the S. Some S best practices are cost-neutral or cost-justified in the long run. But it is often the case that the steps needed to advance S norms—like paying fair compensation or safeguarding the safety of workers throughout the global supply chain—will add costs and reduce short-term profits.

Once ESG is reduced to a cold calculation of costs and benefits, the price of being humane often looms large. Even where ESG risks *are* material, the firm may decide that a safeguard would erode profit more than investors are willing to bear. If shareholder return is the only criterion, then a company might deem sweatshop wages to be worth the reputational or regulatory risk. That’s why ESG investing should promote the welfare of the low-wage worker, and not the welfare of the multinational enterprise whose demands create sweatshop conditions.

The third basic objection to conceptualizing ESG in terms of financial materiality is that it’s counter-intuitive—and therefore misleading. As forthrightly as MSCI states that ESG is not about corporate goodness, the funds built with its ratings are usually marketed with rhetoric about corporate goodness; and “ESG” is widely understood to connote corporate goodness. Most investors regard ESG investing as a signal that they support sustainable business. Many do not realize the extent to which these funds do not reflect their beliefs.<sup>11</sup>

### The origins of the fallacy

ESG traces its roots to “ethical investing,” initially championed by faith-based social justice activists. The Quaker Friends Fiduciary Corp. began screening sin stocks as far back as 1898. Methodist ministers founded Pax World Balanced Fund during the Vietnam War, with the aim of letting devout savers avoid the Agent Orange supply chain.<sup>12</sup> As mutual funds gained popularity in the last quarter of the twentieth century (fueled by new forms of retirement savings), several ethical funds with ties to the movements for peace, labor, or civil rights appeared on the scene, under newer labels such as “socially responsible investing.”<sup>13</sup> Still, social or ethical investing remained a financial backwater until after the turn of the millennium.

**ESG policies can be expensive—perhaps especially in the realm of Social concerns.**

The Wall Street and City of London establishments shunned social investing because they regarded it as a breach of the “fiduciary duty” that financial intermediaries owe their clients under law. Steeped in the ascendant free market principles of Milton Friedman, finance professionals rigidly assumed that social investing would *always* lower returns, because of a loss of diversification and a rise in administrative costs.<sup>14</sup> This attitude became so ingrained that even progressive Wall Street reformers viewed ethical investing as *necessarily* imprudent.<sup>15</sup>

Ethical investors entered the mainstream thanks to two conceptual shifts. First, they eagerly embraced the term “ESG,” coined in 2004 by a pair of UN agencies supported by a group of global banks.<sup>16</sup> The acronym caught on rapidly because there was utility in lumping those scorned E and S values with corporate governance, a well-established and venerable cause. Under the banner of good corporate “governance,” pension funds had been pushing since the 1980s to change board rules to make managers more accountable to shareholders.<sup>17</sup> By the time “ESG” arrived, scholars were in consensus that better governance boosts returns.<sup>18</sup>

Second, ethical investors began arguing that E and S factors are financially material as well. An influential report, drafted by the law firm Freshfields in 2005, concluded that ESG consideration is “clearly permissible and is arguably required” by fiduciary duty.<sup>19</sup> In the ensuing years, thousands of empirical studies appeared to

show that ESG investing yields returns comparable to those of conventional alternatives, or better.<sup>20</sup> As climate awareness rose, this became the new conventional wisdom. In time, institutions overseeing \$120 trillion would loosely pledge their loyalty to ESG, under the [UN Principles for Responsible Investment](#).<sup>21</sup>

These strategic innovations would ultimately attract inflows beyond the wildest dreams of the ethical-investing trailblazers. But the initiation of ESG into the mainstream came at a price.

The U.S. Social Investment Forum was founded in 1984 as a professional group for dyed-in-the-wool ethical investors who had roots in the movements for social justice and operated at the margins of the financial world. They realized that they were making progress when white-shoe commercial players like BlackRock and Bank of America began showing up at their meetings in the late 2000s. But the two cultures clashed, and new members were uncomfortable with a group that had “social investment” in its name. It wasn’t long before “U.S. Social Investment Forum” officially became “US SIF”.

The transformation of social investing into ESG, and of Social Investment Forum into SIF, was more than superficial. Oxford University’s Robert Eccles draws a fundamental distinction between *values-driven* and *value-driven* ESG investing.<sup>22</sup> The values-driven investor seeks to protect stakeholders, like workers, from abusive corporate actions. The value-driven investor aims to boost return by underweighting firms vulnerable to the reputational or regulatory fallout of ESG abuses. If a company harms workers without consequence to shareholders, that does not factor into the decisionmaking of value-driven raters.

The history of MSCI illustrates the tension—and shows how it tends to be resolved in favor of value. MSCI

started life as Morgan Stanley’s indexing unit. After being spun off as a separate, publicly traded company, MSCI in 2010 acquired both the *values-driven* ESG rater KLD, and the *value-driven* ESG rater Innovest. Launched by ethical pioneers like Amy Domini, KLD sought “a more just world” by rating companies on “how they treat all stakeholders.” Innovest, by contrast, studied how ESG hurt company finances, and took a relative approach, bestowing laurels on the least-bad polluter or rights abuser in a dirty or exploitative industry. MSCI stuck to its roots and went with profits over principle. In short order, it phased KLD ratings out of the market. Innovest’s core product [evolved](#) into the market-leading MSCI ESG ratings.<sup>23</sup>

ESG advocates opened the door to prioritizing shareholder value by conceding that financial materiality should be the ultimate criterion for investment. For a generation, ESG advocates have insisted that ethical factors *are* material. In retrospect, this was naive or disingenuous. To be sure, E and S factors often align with profitability, especially in the era of climate change. Allowing for that possibility was a healthy corrective. But it is also true that ethical considerations often add costs to businesses. Any attempt to wish away the tension between value and values has empowered those who see ESG as just another strategy to maximize return.

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# 3. The Popular Critiques

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The American ESG discourse has been hijacked by a group of conservative politicians who peddle ill-informed hysteria. The more insightful popular commentary, some of it by disillusioned ESG practitioners, dwells on the mismatch between the commercial reality of ESG funds, and their marketing hype.

## Right-wing hysteria

Today, the debate about ESG in the U.S. is dominated by cynical and ill-informed hysteria on the part of a group of conservative politicians and activists. The assault on the concept of ESG investing emerged in 2022 as an element of what some Republican politicians now call “woke capitalism.” In a video laden with negatively-charged images, including the flag of Communist China, Florida Governor Ron DeSantis accused bankers of using ESG to impose woke ideology on the American people.<sup>24</sup> Former Vice President Mike Pence called ESG a [pernicious far left agenda that empowers radicals to wreck the U.S. oil sector](#).<sup>25</sup> Anti-ESG attacks have carried over to these candidates' campaigns for the Republican nomination for president in 2024.

The conservative Heritage Foundation, meanwhile, maintains an anti-ESG website called [ESGHurts.com](#). Listed under the S pillar in this parallel universe, the three top priorities are Critical Race Theory, Abortion, and

Transgender Activism. Although ESG ratings in the real world cover a profusion of topics, these three are not among them.<sup>26</sup> The launch video for the ESGHurts campaign featured a commercial bank's “ESG officer” denying a small business loan to a businessman who explains that he wishes only to hire good people to drill for oil.<sup>27</sup>

GOP-linked groups have turned fanciful propaganda into real policy and law. The State Financial Officers Foundation and the American Legislative Exchange Council have helped push two model statutes, reportedly with input from the fossil fuel industry.<sup>28</sup> At least five red states, led by Florida, have barred state pension funds from investing with an asset manager who uses ESG for any goal except to increase returns. At least 17 red states, led by Texas, have banned state pension funds from investing with asset managers said to disfavor oil, gas, or firearms. Nineteen red state AGs sent a letter to BlackRock arguing that ESG investing violates their duty to safeguard their clients' money.<sup>29</sup>

The world's first anti-ESG fund manager was none other than Vivek Ramaswamy, who founded Strive Asset Management in 2022 and remains its majority owner. Before stepping down as Strive's chair to run for the Republican presidential nomination, Ramaswamy favored carbon stocks, and [encouraged companies to "focus exclusively on \[maximizing\] shareholder value, without advancing unrelated social or political agendas."](#)<sup>30</sup> Meanwhile, new anti-ESG groups like the National Legal & Policy Center are pushing shareholder proposals that are the mirror image of those favored by ESG coalitions.<sup>31</sup> One typical anti-ESG proposal demands company reports on how corporate diversity programs hurt white applicants and employees.

The multifront pushback against ESG seems to be having an effect. BlackRock's support of E resolutions at energy companies tumbled off a cliff last year, from 72% to 16%.<sup>32</sup> Suddenly, BlackRock is going out of its way to boast of investing \$180 billion in *non-renewable* energy.<sup>33</sup> Vanguard, facing similar pressures, has exited the Net Zero Asset Managers coalition, which had committed to align all investments with net zero greenhouse emissions by 2050.<sup>34</sup> All of the big U.S. asset managers have backed major oil companies in opposing corporate reporting of carbon emissions by suppliers and end users.<sup>35</sup> (BlackRock maintains that it is merely balancing the risks and benefits of its actions for clients. The firm claims that it voted against ESG proposals that were too "constraining" or "prescriptive.")<sup>36</sup>

And though most of the anti-ESG arguments are frivolous, one is potentially dangerous: that ESG investment managers are violating their fiduciary duties to clients.<sup>37</sup> This position, staked out by 19 Republican AGs in their letter to BlackRock threatening litigation, is

## ESG Done Wrong: BlackRock's ESGU Fund

"Passive" ESG index funds take the most flak from critics, and deservedly so. Aiming to mimic the returns of their benchmark index, these funds often have portfolios that are barely distinguishable from those indices. As Greg Davies of the financial consultancy Oxford Risk said in an interview, "They basically screen a few nasty stocks and slap a lick of green paint over the rest and hand it off to marketing."

With some \$12 billion in assets, BlackRock's awkwardly named iShares ESG Aware MSCI USA Exchange-Traded Fund (ESGU) is a prime example of ESG investing gone wrong. BlackRock's leading ESG fund and its benchmark's parent, the MSCI USA Index, shared nine out of 10 of their top holdings at the time of our analysis. And a significant number of their common holdings have been embroiled in E or S controversies.<sup>1</sup> We are not passing ultimate judgment on these corporations; nor on BlackRock, which offers a range of other ESG strategies on a smaller scale. Our point is that the inclusion and prominence of all these controversial holdings may be at odds with the values of many investors who buy the world's largest fund with ESG in the name.

The big tech stocks of Apple, Amazon, Tesla, and Alphabet dominate ESGU, despite a variety of human rights-related failings.<sup>2</sup> Tesla and Apple, as major battery users, are implicated in hazardous cobalt mining and child labor in the Democratic Republic of Congo, while Apple and Amazon have multiple suppliers linked to Uighur forced labor.<sup>3</sup> Tesla also leads U.S. carmakers in safety violations that jeopardize its direct workers, while Amazon repeatedly appears in the National Council for Safety & Health's Dirty Dozen Unsafe Employers.<sup>4</sup> Alphabet relies heavily on contract workers to help it oversee content moderation, and is failing to take adequate measures to address the spread of misinformation and other harmful content on [YouTube](#).<sup>5</sup>

Even Exxon Mobil, though somewhat underweighted, has remained in the fund's top 10. Johnson & Johnson, which is struggling to respond to a series of lawsuits alleging that its baby powder is toxic,<sup>6</sup> was underweighted just enough to slip to fifteenth at the time of our analysis. It was replaced in the top 10 by JP Morgan, a leading fossil fuel financier. Also in the top 20 were Chevron (another major fossil fuel producer), Meta (another social media company struggling to address misinformation), UnitedHealthcare (who some charge is operating on an industry model that is maximizing the denial of medical coverage), and Home Depot (a leading campaign funder of politicians who have supported false claims pertaining to the outcome of the 2020 election).<sup>7</sup>

In all, the BlackRock fund held eight companies with a CEO-to-worker pay ratio of over 1000 to 1 at the time of our analysis. It invested in seven of the worst performers on the “Good Jobs First” trackers of the firms with the most violations of labor or health and safety laws. It held 29 firms scoring in the lowest tier on As You Sow’s racial equity scorecard, and 21 in the lowest tier for gender equity.

Passive ESG index funds are among the most popular ESG funds because they have the lowest fees.<sup>8</sup> But they beg the question starkly posed by Carlos Joly, who helped to coin ESG nearly two decades ago, as the chair of the UN Asset Management Working Group: “[I]f the ESG fund looks very much like your non-ESG fund in terms of the sector composition and [the] companies in it, then what the hell is the difference?”<sup>9</sup>

<sup>1</sup> Holdings analysis conducted by the Center for Business & Human Rights as of late January 2023, with special thanks to our extraordinary research assistant, Celia Garrett of NYU School of Law.

<sup>2</sup> Apple, Microsoft, Amazon, Tesla, and Alphabet together comprised 21.5% of both the portfolio and the benchmark index when measured in summer 2022. Tech valuations have since fluctuated significantly.

<sup>3</sup> See, e.g., Dorothee Baumann-Pauly, *Cobalt Mining in the Democratic Republic of the Congo: Addressing Root Causes of Human Rights Abuses* NYU Stern Center for Business & Human Rights (February 2023); Tech Transparency Project, *Amazon Suppliers Tied to Forced Labor in Xinjiang* (March 7, 2022); Wayne Ma, “Seven Apple Suppliers Accused of Using Forced Labor From Xinjiang,” *The Information* (May 10, 2021).

<sup>4</sup> See, e.g., Alan Ohnsman, “Elon Musk Has Lots to Say About Workers at Tesla—Which Continues to Lead U.S. Carmakers in Safety Violations,” *Forbes* (June 6, 2022); National Council for Occupational Safety & Health, *Dirty Dozen Reports*; Sara Ashley O’Brien, “Amazon warehouse injury rate last year was more than twice the rate of other warehouses, study finds,” *CNN Business* (April 12, 2022); Christopher Weaver, “Amazon Routinely Hired Dangerous Trucking Companies, With Deadly Consequences,” *Wall Street Journal* (Sept. 22, 2022); Luis Feliz Leon, “‘They’re Playing Really Dirty’: Amazon Lashes Back in Staten Island Warehouses,” *Labor Notes* (April 14, 2022).

<sup>5</sup> See, e.g., Paul M. Barrett and Justin Hendrix, *A Platform ‘Weaponized’: How YouTube Spreads Harmful Content – And What Can Be Done About It* (NYU Stern Center for Business and Human Rights, June 16, 2022); Sebastian Moss, “Underpaid and overworked: Behind the scenes with Google’s data center contractors,” *DataCenterDynamics.com* (December 2, 2021).

<sup>6</sup> Casey Cep, “Johnson & Johnson and the New War on Consumer Protection,” *The New Yorker* (Sept. 12, 2022).

<sup>7</sup> Accountable.U.S. Donations Tracker – Top Corporate Donors to Election Deniers, 2021-22.

<sup>8</sup> Witold Henisz, “A New Way of Seeing Value,” *Harv. L. Sch. Forum on Corp. Governance* (September 24, 2021).

<sup>9</sup> Avery Ellfieldt, “They helped create ESG. Two decades later, some see a mess,” *E&E News* (July 26, 2022).

likely to eventually receive a hearing in a U.S. court. We will examine it more fully in the discussion of materiality on page 24.

## The real flaws in the current ESG model

The more insightful popular commentary, some of it by disillusioned ESG practitioners, dwells on the mismatch between the commercial reality of ESG funds, and their marketing hype. As BlackRock’s Chief Investment Officer, Tariq Fancy once stood at the pinnacle of ESG investing. But he emerged as one of the movement’s foremost critics in 2021 when he published *The Secret Diary of a “Sustainable Investor,”* in which he attacked ESG frameworks as a pointless distraction from direct state regulation of the climate.<sup>38</sup> “The marketing and sales people at BlackRock were all about ESG,” he wrote. By contrast, the portfolio managers just “wanted to pass the ‘ESG test’ and be left alone.” One of Fancy’s friends on the investment side confides: “Listen, you know it’s a marketing gimmick. You know it. We all know it!”

BlackRock fund managers seek to maximize short-term financial returns for their clients, and they design their ESG funds accordingly, Fancy wrote – but the firm’s marketers keep on talking about grand civilizational benefits. This is the common thread of several astute critiques of ESG, including NYU Stern Professor Hans Tapania’s [essay](#) in the *Stanford Social Innovation Review* and *BusinessWeek*’s investigation of MSCI upgrades.<sup>39</sup> Casual observers believe that investing in ESG funds “is helping to save the planet,” Andrew King and Kenneth Pucker wrote in *Harvard Business Review*. And no wonder: marketers “make lofty statements” routinely, “but the fine print reveals that the real goal is to assure shareholder profits.”<sup>40</sup>

## Why ESG is worth saving

Fancy takes his critique a giant step too far, by insisting that ESG efforts should be abandoned because they accomplish nothing. His main rationale<sup>41</sup>—that capital markets are indifferent to ESG investing—is a proposition worth considering, but it is far from an established fact. Regardless, it does not support the conclusions that ESG investing or reporting are pointless.

What happens when an ESG fund reduces its position in a “sin stock”? In an efficient market, Fancy maintains, a “sin fund” will always snatch up the shunned security propping up its price. Selling an objectionable stock or bond is futile, he argues, because “[i]n five milliseconds, someone who doesn’t give a shit will go buy it.”<sup>42</sup> On that basis, some theorists deny that ESG investing can affect a firm’s cost of capital.<sup>43</sup>

This debate is far from settled, however. Other finance scholars argue that [ESG investors do affect the cost of capital](#), by paying a premium for virtuous firms’ stock in pursuit of psychological rewards.<sup>44</sup> Moreover, sometimes markets are inefficient, and efficient markets theory doesn’t match reality. To judge from their lobbying, fossil fuel firms care intensely about ESG investing. Some portfolio managers, especially in the energy sector, forcefully attest that ESG investment drives capital market pricing.<sup>45</sup> Financial theory cannot settle the debate over divestment in the context of ESG investing any more than it could settle that debate in the 1980s in the context of commerce with apartheid South Africa.

In any event, affecting the cost of capital is not the only goal of those who consider themselves ESG investment managers. Often, it is not even their primary goal. Selling a “sin stock”

undeniably serves the purpose of aligning anti-sin investors with their personal values. Furthermore, many ESG funds hold on to their problematic stocks. The avowed strategy of these funds’ managers is to influence firms through shareholder activism and engagement, precisely because they think they can exert more sway by retaining their ownership in an imperfect business. For this stripe of ESG investment manager, “corporate stewardship” is the whole point of the ESG game.

Fancy’s dismay with ESG investing certainly doesn’t discredit the larger objective of improving ESG data through mandatory reporting. After all, ESG data can influence business in many ways. A firm’s skill at managing ESG risks may affect its desirability as an [M&A target](#), or as a borrower.<sup>46</sup> The achievement of certain ESG milestones might dictate the level of CEO compensation, or the terms of “sustainability-linked” bonds and loans. In the future, the Federal Reserve might use climate reporting data to redirect loans from high- to low-carbon ventures.<sup>47</sup> ESG disclosure can activate stakeholders and civil society activists to pressure businesses through publicity campaigns, human rights litigation, and increased employee demands. New supply chain laws in Europe are requiring mandatory ESG reporting. They provide leverage to change company culture through human rights “due diligence”—broadly conceived as a “comprehensive, proactive attempt to uncover human rights risks, actual and potential, over the entire life cycle of a project or business activity, with the aim of avoiding and mitigating those risks.”<sup>48</sup> The current deficiencies in ESG ratings are not an excuse to pull the plug on these ambitious nascent experiments.

Perhaps most importantly, better ESG data offers hope for the improvement of ESG investments themselves. Black-

Rock may be a marketing juggernaut whose biggest ESG funds are not now focused on helping the environment or society. But if ESG index funds typically make poor use of flawed data, that does not devalue efforts to upgrade the data, or employ it better. ESG investing should be overhauled, not discarded.



**BlackRock may be a marketing juggernaut whose biggest ESG funds do little to help the environment or society. But if ESG index funds typically make poor use of flawed data, that does not devalue efforts to upgrade the data, or employ it better.**



## 4. The Scholarly Critiques

“ Without insight into the global supply chain and the fissured workplace, investors cannot assess how much companies expose workers to the full range of Social problems, from sweatshop wages and forced labor in the developing world to inequality in the developed world. ”

Beneath the din of conservative anti-ESG talking points, many scholars have quietly focused on the failings of ESG ratings. They describe sharply divergent frameworks, each relying on its own secret mix of inconsistent criteria, with a tendency to give troubled companies high grades.

### Confusing the public

To attract investors, many ESG money managers brag in their marketing materials of what MSCI calls “corporate goodness.” Putnam Sustainable Leaders, to take a standard example, uses the phrase “sustainable business practices” in every other sentence of its strategy description.<sup>49</sup> Given that the underlying ratings usually eschew “corporate goodness,” even MSCI’s CEO has expressed the view (as paraphrased in the *Harvard Business Review*) that “ESG doublespeak has confused most individuals, many institutional investors, and even some portfolio managers.”<sup>50</sup>

Scholars find misleading marketing—known as greenwashing or ESG-washing—to be widespread. [One text analysis](#) of prospectus language concluded that ESG funds use virtually identical marketing language, regardless of a company’s real-world ESG performance.<sup>51</sup> [A similar analysis](#) identified 25 funds in the top 5% for including below-average ESG performers. These “egregious greenwashers” excelled at attracting inflows, while yielding a lower return.<sup>52</sup>

In the worst cases, ESG-washing can go well beyond marketing hype. In an explosive 2020 email leaked by a whistleblower at Deutsche Bank’s DWS money management unit, managers admitted internally that “only a small fraction” of their half trillion dollars in assets were “ESG-integrated.” Weeks later, their annual report claimed that *most* were ESG-integrated. Then the report took the hype a step further, bragging that ESG lay “at the heart of *everything* that we do.”<sup>53</sup> In response, German prosecutors raided DWS and the CEO of DWS resigned. Active greenwashing investigations of DWS were launched by the German financial regulator and German prosecutors, while a consumer NGO filed a civil suit in German court. The SEC recently concluded its own investigation by finding that DWS had made “materially misleading statements” with respect to ESG integration. While neither admitting nor denying that finding, DWS set a new high water mark for greenwashing settlements with the payment of a [\\$19 million](#) penalty.<sup>54</sup>

Lumping the E, S, and G into one composite score makes ESG a bundle of contradictions. The solution is to disassemble the bundle.

“Right now ESG investing in funds and ETFs is the Wild West,” concludes Andrew Behar, who oversees the “Invest Your Values” scorecard of ESG performance. He attributes the situation to the voluntary nature of ESG disclosures, the absence of widely accepted terminology, and limited enforcement.<sup>55</sup>

## An inexact science

The clearest signal that current ESG ratings are problematic is that the scores given to the same company by different raters are dramatically uncorrelated. Many ESG raters strike a scientific pose by using a letter system that evokes credit ratings. Credit scores that various agencies award a given firm tend to be almost identical; they enjoy a near-perfect correlation rate of 0.99. By contrast, studies by both the MIT Sloan School of Management and the European Corporate Governance Institute find an average correlation between two sets of ESG ratings in the range of 0.50.<sup>56</sup> In other words, only about half of companies are rated consistently by any two ESG raters. And disagreement is even more routine at the level of subscores. “S” ratings by MSCI agree with “S” ratings by Refinitiv or Sustainalytics for barely a quarter of rated firms.<sup>57</sup>

Nor are we talking about slight disagreements. Who does the rating may make the difference between an AAA and a B (Verizon); or an AA and a CCC (Nissan).<sup>58</sup> Tesla gets middling ratings from MSCI and Sustainalytics, yet was dropped altogether from the S&P

ESG index in May 2022 for poor ESG performance (prompting Elon Musk to tweet that “ESG is a scam”). To justify the move, S&P cited Tesla’s weak carbon strategy and ethics code, as well as a run of controversies over racial bias, working conditions, and self-driving accidents.<sup>59</sup> Whichever assessment of Tesla one prefers, the disparity shows that ESG ratings can be wildly inconsistent, and often are.

The ultimate test of a rating’s worth is whether it corresponds to real world outcomes. [One recent study](#) finds that most ESG scores do not meet this test. This finding is most pronounced in the S domain—where ratings and real-world outcomes often are *negatively* correlated. On average, firms that score better on ESG receive heavier fines from the Occupational Health & Safety Administration and the National Labor Relations Board.<sup>60</sup> The failure of ESG ratings to strongly correlate, either with reality or with other ESG ratings, is a sure sign that the system needs fundamental change. A great deal of other scholarship offers explanations for their failure.

## A secret stew of inconsistent criteria

The profusion of ESG ratings sows chaos because the systems diverge in many ways. Each rater assesses a unique mix of issues and sub-issues, giving each quality more or less weight. Then, the raters use various metrics to measure the same quality. The NYU Stern Center’s 2017 study of a dozen ESG frameworks counted 1,700 indicators just within the “S” pillar.<sup>61</sup> For any given attribute—say, worker safety—there might be 20 yardsticks to choose from.<sup>62</sup> Even supposing that two raters use the same metrics to assess certain qualities and assign them the same weight, they can skew results by benchmarking a firm’s performance to a different peer group.<sup>63</sup>

New problems arise when the requested data is undisclosed, as is routine. According to one study, companies worldwide in 2019 disclosed barely 30% of the S data points sought by Refinitiv.<sup>64</sup> According to research by the data service FTSE4Good, the U.S. in 2021 ranked 40th of 48 nations for ESG corporate disclosure, one spot above China and far below every EU nation. Meanwhile, the U.S. rate for corporate S disclosure remains below 30%.<sup>65</sup>

This missing data creates a dilemma for the raters. When a company doesn’t answer a query, does it deserve a subscore of zero or an average subscore? Each approach has drawbacks. Giving the non-reporter an average subscore discourages reporting by bad actors. But giving it a zero may distort reality more severely. ESG raters systematically favor large-cap firms because big firms have better reporting systems. By the same token, ESG ratings sometimes favor *polluters*, because heavily regulated firms are often required by law to disclose data. The anomalous result is that, in Refinitiv’s 2019 ratings, energy and utility companies received more favorable scores on emissions than tech and financial companies.<sup>66</sup>

Notwithstanding the challenges that flow from missing data, raters disagree most when firms divulge *more* data. This suggests that inconsistent criteria and metrics remain the biggest source of confusion.<sup>67</sup> A landmark 2020 study from MIT, titled “Aggregate Confusion,” attributes 38% of ratings divergence to the raters’ focus on different firm attributes, and 56% to the varied ways of measuring them.<sup>68</sup>

Exacerbating all these problems is a culture of secrecy. Each ESG rater puts on a show of transparency by publishing at least *some* aspect of their methodology: criteria, metrics, weighting, how the scores are put together, and what score each security receives. But in a study

of transparency on all five of those dimensions, the EU found that no major commercial player is fully open about their ratings.<sup>69</sup> Private raters like secret formulas because they can't be copied. That also makes them all but impossible to reform.

## The wrong criteria

For all their abundant criteria, raters may be missing the things that matter most. The [2017 report](#) by the NYU Stern Center found that 92% of "S" indicators focus on company procedures, like worker surveys, rather than outcomes, like higher wages.<sup>70</sup> Despite a wide consensus that this needs to change, *Bloomberg Businessweek* recently made compatible findings in its own investigation.

*Businessweek* studied all 155 ESG ratings upgrades made by MSCI over 18 months. Fully half of the upgrades resulted from tweaks in the *rater's* methodology, meaning that the company made no changes, even on paper. Most of the rest of the upgrades rewarded companies for bureaucratic moves like adopting a data protection policy. A grand total of one firm was upgraded for actually cutting carbon emissions.<sup>71</sup> Citi and Wells Fargo received upgrades in spite of lending tens of billions to fossil fuel firms.<sup>72</sup> It's hard to escape the conclusion that the leading ESG investor framework gives short shrift to real world impacts.

Within the S, some key issues are routinely ignored. According to a 2021 report by a respected ESG working group, Refinitiv fails to measure labor-law whistleblowing risks to union organizing among operators and suppliers, or the ratio of entry-level to local living wages—topics that SASB collectively assigns 15 measurement codes.<sup>73</sup> None of the six leading ESG raters ask whether companies minimize socioeconomic impacts on

local towns and businesses. Nor do they inquire if firms support state systems to protect the social welfare of the poor (by operating in nations with adequate safety nets and paying a fair share of taxes).<sup>74</sup> By the same token, raters fail to measure corporate political influence through lobbying or campaign funding.<sup>75</sup>

Perhaps the most basic unrewarded social virtue is job creation. In fact, ESG ratings tend to show bias in favor of companies that shed jobs. On average, ESG funds weight the tech sector 27% more heavily than do market indices.<sup>76</sup> Tech stocks may perform better on the E for the good reason that writing software requires little energy. But they may also score better on the S because they substitute technology for workers; or because they outsource labor for certain tasks, such as content moderation. To put it crudely, no visible labor means no visible labor problems. "ESG filters unintendedly reward the greatest illnesses of post-industrial societies," argues Vincent Deluard of the StoneX financial network, including "the disappearance of jobs for normal people." In Deluard's analysis, the 15 firms most overweighted in ESG funds employ only 40% as many workers as the 15 most underweighted firms. In keeping with Deluard's hypothesis, most of his "Virtuous 15" are in the tech sector, while about half of his Ugly 15 are industrials. "The more humans a firm employs," he ruefully explains, "the more reprehensible behaviors will be committed."<sup>77</sup>

The issues that receive the least attention relate to workers' rights in global supply chains. Formerly ignored, these problems are now typically placed in a silo. Raters will treat the value chain as a single ESG item, rather than recognizing that it accounts for a huge portion of the risks that multinational firms generate in their outsourcing of



**With BooHoo, the asset manager neglected supply chain issues by ignoring the indirect workforce; and the ratings provider mis-measured them by relying on a presumption in lieu of inspections.**



global production.<sup>78</sup> Indeed, a leading European consultancy estimates that the value chain accounts for 40% of all ESG impacts.<sup>79</sup> How can Apple be scored on the S without toting up the labor rights violations among its Asian assembly workers at Foxconn, which employs 1.3 million people?<sup>80</sup> How can Chevron be scored on any E factor without tracking the tailpipe fumes of every car that fills up with gasoline refined from Chevron's oil? Unless a rater scores the impacts from upstream and downstream suppliers and users, it can't capture a multinational's full effect on any dimension, whether it be human and labor rights, or carbon pollution.

The [Boohoo scandal](#) dramatizes how supply chain risks have historically been ignored or mis-measured, or both. Boohoo is a British fashion retailer that was riding high on an AA ESG rating from MSCI in June 2020. What seemed most impressive was that Boohoo earned a sub-score of 8.4/10 for supply chain labor standards, because it avoided Asian locales at higher risk for labor exploitation. Instead, it sourced its garments in the small British city of Leicester, which was simply *presumed* safer. Aberdeen Standard Investments is a UK asset manager that constructed and marketed a specialized "S" fund touting

companies that generated employment opportunities. Aberdeen's employment fund had Boohoo as its biggest holding until May 2020—in part because at the time it only evaluated *direct* employment (a policy it has since changed). Thus, the ESG asset manager neglected supply chain issues by ignoring the indirect workforce; and the ESG ratings provider mis-measured them by relying on a presumption in lieu of inspections.

In July 2020, a *Times of London* investigation accused Boohoo's Leicester suppliers of paying under half the UK minimum wage and forcing workers to keep working, at close quarters, during the pandemic.<sup>81</sup> Boohoo lost a third of its market value. Aberdeen and MSCI lost an indeterminate amount of credibility.

## A distorted grading system

Most U.S. ESG funds grade companies on an easy curve by using a method known as “Best in Class.” Under “Best in Class,” a firm is rated only relative to its direct rivals—even if the industry norm is objectively inadequate. All too frequently, “Best in Class” means best in a class where no one performs well.

At the same time, most ESG funds are assembled based on a single composite score for a firm's “ESG” performance—rather than separate scores for the E, S, and G, or for key sub-criteria. Unfortunately, as former Vice President Al Gore observes, “ESG doesn't lend itself to” a composite score, because its “factors sometimes work counter to one another.”<sup>82</sup>

The treatment of Exxon Mobil shows the dangerous interaction between the “Best in Class” method and composite ESG scoring. When compared with other oil and gas firms, Exxon doesn't look so bad on the E. Respectable S and G grades further pull up its composite rating. As a result, Exxon is only slightly underweighted in BlackRock's flagship ESG fund. [In early 2023 it ranked among the fund's top 10 holdings.](#)<sup>83</sup>

## Is Anyone Doing ESG Right?

### A Look at Some Leading Funds from Vanguard, Calvert, and Parnassus

The most basic test for an ESG fund is to avoid stocks that many values investors will regard as problematic. Can any large U.S.-based ESG equity fund pass that test? To investigate that question, we took a closer look at three of the most reputable among the Top 20 global ESG equity funds.<sup>1</sup> The offerings from Parnassus Asset Management and Calvert Investments merit attention because both are active managers and stewards with a tradition of ethical investing. While Vanguard Investments does not tout itself as values-driven, its [FTSE Social Index Fund](#) is benchmarked to the suggestively-named FTSE-4Good US Select Index. Its marketing material includes the quote: “For 20 years, the FTSE4Good index series has led the way in establishing clear and progressive criteria for environmentally and socially responsible business.”

To its credit, Vanguard uses the screening policies of FTSE4Good to exclude from its Social Index Fund nearly all the carbon and defense stocks—among them Exxon, Chevron, and Raytheon—that mar BlackRock's top ESG fund (see “ESG Done Wrong,” pages 10-11). FTSE4Good's carbon screen is only getting tougher.<sup>2</sup> However, its defense screen is porous enough to let in the surveillance software maker Palantir, which maintains controversial contracts with the U.S. military and immigration services.<sup>3</sup>

On the negative side of the ledger, the Vanguard FTSE Social Index Fund also holds 15 of the 19 Fortune 100 companies cited by the Center for American Progress for avoiding their fair share of taxes.<sup>4</sup> It holds 16 companies with a CEO-to-worker pay ratio of over 1,000 to 1. It invests in seven of the worst performers on the “Good Jobs First” trackers, which tally the firms that pay the highest total penalties for violating labor or health and safety laws.<sup>5</sup> It holds 42 firms scoring in the lowest tier on As You Sow's scorecard for racial equity and 70 firms scoring in the lowest tier for gender equity.<sup>6</sup> Invest Your Values gives the Vanguard fund C's for its support of deforestation and its ownership of private companies that run prisons.

Avoiding stocks that raise eyebrows is surely easier for an active fund picking 40 to 60 stocks than for an index fund picking 300 to 600. Accordingly, both the Calvert Equity Fund and the Parnassus Core Equity Fund steer clear of controversial mega-caps like Tesla, Meta, Johnson & Johnson, UnitedHealthcare, JP Morgan, and Exxon Mobil. For consumers who wish to invest based on their values, this is already a more useful approach. But beyond that, results vary.

Despite listing decent work as a social indicator, Calvert Equity Fund invests in a number of firms with S controversies. Two of its holdings – Dollar General and Starbucks – appeared on the National Council for Occupational Safety & Health's 2022 list of the Dirty Dozen Unsafe Employers.<sup>7</sup> Among other issues, each fired workers who either tried to organize a union (Starbucks) or blew

the whistle on unsafe conditions (Dollar General). A recent list of its top 10 holdings includes TJX Companies, which scores near the bottom of both the Know the Chain Apparel Benchmark and the Remake Fashion Accountability Report. Better known as TJ Maxx, TJX set itself apart by permanently declining to make local suppliers whole for orders completed at the pandemic's start.<sup>8</sup> A smaller Calvert Equity holding is Lowe's, which drew attention for stock buybacks totaling \$13 billion in 2021. With that sum, it could have given its workers a 150% raise. Instead, it *trimmed* median salary to \$22,700 that year; and has opposed unionization efforts.<sup>9</sup> Finally, Invest Your Values gives the Calvert fund a D for military involvement. Investors must decide for themselves whether a given controversy is disqualifying, or whether they accept the philosophy that active stewards may improve flawed holdings through engagement.

Parnassus Core Equity does a somewhat better job of dodging troublesome holdings. Invest Your Values gives it grades of A or B across every category measured. Although Parnassus currently avoids the tech firms that are most mired in controversy, it does invest deeply in Alphabet, which has not taken sufficient steps to address disinformation or other harmful content streamed by its YouTube subsidiary; as well as Apple, which has not adequately addressed its supply chain challenges in the Democratic Republic of Congo and Xinjiang.<sup>10</sup> Among the Parnassus fund's lesser holdings are Home Depot, a top funder of politicians who have denied the results of the 2020 U.S. elections; and Canadian Pacific, one of this year's Dirty Dozen Unsafe Employers.<sup>11</sup> What sets Parnassus apart from many active managers is that it's willing to divest when a company crosses a certain line—as it did for McKesson as a result of its opioid liability risk, and for Amazon as a result of its union strife and chronic workplace issues.<sup>12</sup>

On balance, while Parnassus will not please every values investor, it preserves the hope that an actively managed, values-driven approach can build a successful ESG fund worthy of the name.

<sup>1</sup> Holdings analysis conducted by the Center for Business & Human Rights, with special thanks to our extraordinary research assistant, Celia Garrett of NYU School of Law. Largest public equities ESG funds identified in Rumi Mahmood, "The Top 20 Largest ESG Funds – Under the Hood" (MSCI Research, April 2021).

<sup>2</sup> Steve Johnson, "Dozens of companies ejected from FTSE4Good indices," *Financial Times* (January 10, 2023).

<sup>3</sup> Lizette Chapman, "Palantir Extends Controversial Defense Contract That Google Abandoned," *Bloomberg* (September 29, 2022).

<sup>4</sup> See Center for American Progress, "These 19 Fortune 100 Companies Paid Next to Nothing—or Nothing at All—in Taxes in 2021" (April 26, 2022).

<sup>5</sup> The worst performers are defined here as among the 10 tracked companies paying the highest penalty total.

<sup>6</sup> The lowest tier is defined here as a score of 5 or lower on a scale of 20.

<sup>7</sup> See National Council for Occupational Safety & Health, "National OSHA Announces 2022 'Dirty Dozen' Unsafe Employers" (April 27, 2022).

<sup>8</sup> Ellie White, "Wage Theft & Safety Hazards: TJ Maxx, Marshalls, and Ross Aren't Just Selling Other Brands' Overstock," *Remake* (June 17, 2022).

<sup>9</sup> Molly Kinder et al., *Profits and the pandemic: As shareholder wealth soared, workers were left behind* (Brookings Institution, April 21, 2022); Michael Sainato, "Lowe's faces organization effort as U.S. unionization movement spreads," *The Guardian* (October 21, 2022).

<sup>10</sup> Dorothee Baumann-Pauly, *Cobalt Mining in the Democratic Republic of the Congo: Addressing Root Causes of Human Rights Abuses* (NYU Stern Center for Business & Human Rights, February 2023); Wayne Ma, "Seven Apple Suppliers Accused of Using Forced Labor From Xinjiang," *The Information* (May 10, 2021).

<sup>11</sup> Accountable.U.S. Donations Tracker – Top Corporate Donors to Election Deniers, 2021-22.

<sup>12</sup> Parnassus Investments, "The Value of Understanding Reputational and Material Risks" (August 31, 2021).

Exxon scores even better in a system that stresses the S over the E. The nonprofit JUST Capital weights various norms for corporate behavior based on their popularity in a poll of the U.S. general public. In its 2021 poll, 39% prioritized worker protection, compared with 10% prioritizing environmental protection.<sup>84</sup> The anomalous result is that JUST Capital ranked Exxon first in its class for the oil and gas sector in 2022.<sup>85</sup> As NYU Stern's Hans Taparia notes, "The bar for what constitutes a good corporate citizen is abysmally low."<sup>86</sup>

Even more commonly, aggregating the E with the S creates a severe distortion in the other direction: dressing up the worst S offenders as solid corporate citizens. ESG funds overweight tech stocks, because the tech sector scores extremely well on the E. But the use of one composite score masks the reality that Big Tech firms often have a weak labor rights record—actively undermining unions, or (like Uber) eroding the legal status of gig workers. At times in 2022, Tesla was the second-largest holding in BlackRock's iShares MSCI USA SRI UCITS ETF. Yet S&P Global regarded Tesla's S record as so disqualifying that it delisted the firm entirely.

There is rising awareness that some forms of clean energy, whose core business is E-friendly, also pose serious human rights risks. Electric batteries rely in part on cobalt extracted from Congolese artisanal mines, where child labor is rife and miners work under dangerous conditions.<sup>87</sup> Wind farms and rare metal mines sometimes impinge on indigenous territory.<sup>88</sup> The solar supply chain relies overwhelmingly on polysilicon ingots and wafers manufactured in the Xinjiang province of China, where Uyghur forced labor is commonplace.<sup>89</sup> And similar tensions can arise within the S. For instance, Ford and GM combine a relatively high respect for labor rights with a dependency on suppliers that also employ Uyghur forced labor.<sup>90</sup>

Selling guns or munitions has been viewed negatively by many social investors since Quakers invented the idea.<sup>91</sup>

**ESG's future** may entail both the disaggregation of ESG data and the disaggregation of ESG investment pools.

But again, evaluating this sector can be distended by a system that combines “Best in Class” with composite ratings. Safety and security funds specialize in weapons stocks, and, although they are not marketed as ESG funds, those stocks and funds receive ESG ratings. By the logic of “Best in Class,” a fund favoring “safety and security” stocks rates well on ESG if it leans toward gunmakers who simply score better on ESG than other gunmakers (perhaps because they excel in governance). In fact, the average safety and security fund rates “A” on ESG, according to MSCI.<sup>92</sup>

Lumping together the E, S, and G allows the world's worst polluters to effectively obscure their carbon plumes with worker surveys that yield positive results. It permits the nation's worst union busters to hide their anti-labor practices in a forest of carbon credits. And it lets gunmakers overcome a business model based on the sale of deadly products by boosting the independence of their directors. There is so much noise around the ESG signal that investors can't know what values they're embracing or what conduct they're encouraging.

## Conflicts of interest

Conflicts of interest within ESG data providers are widely suspected, because the field has come to be dominated by financial conglomerates. Documented self-dealing is less common. Although MSCI is the last top-tier rater not to be directly swallowed up by a conglomerate, the ownership

of its stock by institutional investors may create other potential conflicts. A [provocative working paper](#) finds that after MSCI acquired KLD, MSCI's sister companies (i.e., firms held by the same institutional owners as MSCI) began to receive higher ratings than before the merger.<sup>93</sup> It's certainly well known that some ESG scores can be boosted for a fee. For example, only companies that buy an “ESG Risk Rating License” are eligible to get a “Top-Rated ESG Badge” from Sustainalytics. Other raters, like ISS, openly sell consulting services to “improve ESG ratings.” The European Commission recently found that ESG data vendors are prone to conflicts when they sell ratings and data to the same customers; sell advice to help firms improve their ratings; or charge financial firms to display their rating on financial products. Its [proposed regulation](#) would compel ESG raters to take all necessary steps to avoid potential conflicts, subject to stiff penalties by the European Securities Markets Association.<sup>94</sup>

## An open secret

In sum, ESG raters unreliably measure wrong and inconsistent secret criteria in pursuit of wrong and confusing goals, handing out unreasonably high grades, and yielding random ratings that bear little resemblance to reality. The outpouring of critical scholarship should hardly surprise ESG professionals, as the many flaws of ESG ratings are common knowledge among their users. In a recent survey by the European Commission, 91% of respondents said they think ESG methodologies have “significant biases,” 83% worry about their lack of transparency, 81% worry about their lack of correlation, and 80% think the ESG market is prone to conflicts of interest. No wonder the Commission has bluntly concluded that “the current ESG rating market suffers from deficiencies and is not functioning properly.”<sup>95</sup> When

ESG's founders get together among themselves, says Hewson Baltzell, who founded Innovest and later served as an MSCI executive director, they often ask themselves if their creation is “making much of a difference” — or if it's “a lot of BS.”<sup>96</sup>

# 5. Five Design Solutions

“  
In fact, ESG ratings tend to be biased in favor of companies that shed jobs. Tech stocks score better on the S because they substitute technology for workers; or because they outsource labor. To put it crudely, no visible labor means no visible labor problems.”

To eliminate the worst flaws of the current ESG investing system, we need a more frank explanation of what is being measured, and more data on topics that really matter. To create a better product that matches the values of ESG investors, we need broader exclusions, narrower targets, and customized goals.

## 1. Greater transparency

“A lot of large firms use ESG as a marketing device rather than sincerely advancing social principles,” says Jerome Dodson, whose Parnassus Investments still hews close to its founding principles four decades after he hung out his shingle. “If the government really wants to step in and make sure ESG is consistent,” says Dodson, “I think that’s positive.”<sup>97</sup>

Regulators on both sides of the Atlantic are starting to address the field’s pervasive problem of deceptive marketing. The EU took the lead, as is increasingly typical. Adopted in 2019-2020, the Sustainable Finance Disclosure Regulation and Taxonomy set forth a two-part regime.<sup>98</sup> “Light green” (article 8) funds merely promote environmental or social characteristics. “Dark green” (article 9) funds have sustainable investment as their objective. The deeper the shade of green, the stricter the rules.

The EU’s system served as a rough model for U.S. truth-in-ESG-labeling rules. The SEC’s “greenwashing” rule, proposed in May 2022, would divide the ESG world into several parts.<sup>99</sup>

“Integration funds” focus mostly on non-ESG factors. “ESG-focused funds” give ESG criteria “significant consideration.” The SEC calls funds that aim to achieve a certain environmental or social result “impact funds.” Again, the more a fund promises, the more detail it must reveal. Separately, the SEC has recently finalized a strict new rule on the naming of ESG funds, to ensure that a fund’s holdings match the meaning of its name.<sup>100</sup>

Enforcement has increased since the Deutsche Bank whistleblower caught regulators’ attention. The SEC launched an “ESG-washing” probe not only of Deutsche Bank, but also Goldman Sachs and Bank of New York Mellon.<sup>101</sup> In 2022, Goldman and BONY paid \$4 million and \$1.5 million, respectively, to settle their greenwashing investigations.<sup>102</sup> The SEC warns that it is on the lookout for ESG “worst practices,” ranging from weak procedures and murky documentation to compliance teams unversed in ESG, funds stuffed with low-scoring companies, and false claims that holdings excel on the E or S when the fund uses a composite score.<sup>103</sup>



**Aggressive screening is the surest way to create an ESG fund with holdings that make clients proud, not embarrassed.**



The new labeling rules are a step forward, as is increased enforcement. In future guidelines, however, the SEC needs to force investment managers *and* data providers to be completely transparent about every ratings system that they design or employ. [An EU report](#) helpfully breaks down ratings transparency into five dimensions: criteria, metrics, weighting, how the scores are put together, and what scores each security receives.<sup>104</sup> The European Commission has predictably seized the lead on regulating ESG ratings. Under its proposal, ESG raters would be forced to disclose a “high level overview” of its methodology to the public, and a granular explanation to customers and companies. Notably, the commercial disclosure would detail the metrics used. The public explanation would specify whether the rater is assessing financial risk or social impact; and whether it is rating companies on ESG in the aggregate, or on a targeted set of issues.<sup>105</sup>

## 2. More and better data

The best way to improve sparse and haphazard ESG data is to make ESG reporting mandatory and uniform. The SEC is slowly taking this step in two important domains, though the details are in flux and legal challenges loom.

The SEC’s proposed climate rule would force firms to quantify their carbon emissions and report any climate risk likely to be material over any time frame.<sup>106</sup> Crucially, the plan covers the carbon coming from supplier smokestacks and consumer tailpipes, known as “Scope 3” emissions. However, the

Scope 3 provisions apply only to big firms, and give them wide latitude on whether or how to comply. Civil society groups have assailed this compromise as too lax; industry has attacked it as too strict. Red states promise to sue. The SEC should not further weaken its coverage of Scope 3 emissions. And if the SEC stands firm, we encourage civil society to help defend the agency’s rule in court.

Next on the SEC’s agenda is fuller reporting on the composition and compensation of the workforce—known as “human capital.” As of this writing, the SEC has deferred proposing its Human Capital Rule, which is sure to stir a partisan debate over the value of diversity in the workforce. When the SEC finally acts, we recommend that it gives all S issues their due.

In particular, the SEC should fill the gaping void in basic data on indirect workers—including outsourced or contingent labor in both the global supply chain and domestic markets—sometimes referred to collectively as the “fissured” workforce.<sup>107</sup> These vast, invisible swathes of the economy are most prone to labor and human rights abuse, not only because they are unregulated, but also because they must contend with the thinnest profit margins and heaviest cost pressures. Without insight into the global value chain and the fissured workplace, investors cannot assess how much companies expose workers to the full range of S problems—from sweatshop wages and forced labor in the developing world to inequality in the developed world. Rather than hold firms accountable for all problems to which they contribute, existing ESG ratings reward firms that hide their S issues by outsourcing labor.

The SEC should demand the reporting of disaggregated workforce cost data, including the number of people employed, the number of contingent workers who produce its goods or services, and the total compensation and training expenses for each category.<sup>108</sup>

Further, the SEC should provide this data for all U.S. and non-U.S. outsourced employees, as well as all fairly-attributable U.S. and non-U.S. employees of franchisees, contractors, subcontractors, and supply chain firms that are so tethered to a listed U.S. company that the issuer specifies their standards or practices. Importantly, the SEC should require that the number and compensation of workers be broken down by country and locality. This will enable ESG investors to evaluate whether an issuer or its suppliers pays a living wage in each of their markets and to gauge how much an issuer is exposed to labor abuses by operating in markets that are under-regulated or reliant on migrants or informal labor.

## 3. Broader exclusions

If a fund containing Exxon calls itself green, there are two reasonable responses. One is to stop the misleading labeling. The other is to exclude Exxon.

A typical BlackRock ESG fund [might screen out 10% of its benchmark index](#).<sup>109</sup> A model values-based manager, like Eventide Asset Management, screens out *three-quarters* of the MSCI All Country World Index. Overseeing \$7.5 billion, Eventide says it uses outside data and controversy flagging, plus its own research, to create a proprietary platform assessing firms on how they treat workers, manage suppliers, impact communities, serve customers, create social value, and limit their environmental footprint.<sup>110</sup> The only thing unusual about Eventide is its low threshold for what is acceptable. Aggressive screening is the surest way to create an ESG fund with holdings that make clients proud, not embarrassed.

Most ESG screeners have barely progressed beyond the Quakers’ rudimentary conception of sin stocks in 1898. But the Quakers themselves have progressed. Colin Baines, of the Friends Provident Foundation, encourages the use of systematic S exclusions for violating basic labor and human rights. Creative S exclusions could be

customized to the values of different clients. Some might balk at abusive supply chains or the failure to pay a living wage. Others might fixate on tax avoidance or the CEO-worker pay gap.<sup>111</sup> Committed values funds should experiment with any or all of these screens, and more. No one would accuse them of greenwashing.

#### 4. Narrower targets

Lumping the E, S, and G into one composite score can create a bundle of ESG contradictions. The solution is to disassemble the bundle and create a targeted E fund or a targeted S fund, or a targeted G fund. *The Economist* has argued for more targeted funds, but it would target only climate. At the end of an otherwise thoughtful [special section on ESG](#), *The Economist* blithely opines that firms should jettison all social concerns. In support, it cites one asset manager asserting that social issues are “extra-curricular.”<sup>112</sup> Needless to say, one opinionated journalist or source should not foreclose the choice of S funds for all investors who care about labor, diversity, or human rights. Polls find—no surprise—that ESG tastes vary.<sup>113</sup> Targeted funds would allow each investor to pick their own priorities, and allow asset managers to cater to all tastes.

Climate funds are already a significant product line, attracting tens of billions in assets. One study found that “Low Carbon Funds” fulfill their promised mission.<sup>114</sup> The NGO ShareAction found more equivocally that only 37% of 130 climate funds align with the Paris Agreement goal for limiting temperature rise.<sup>115</sup> The activists who conducted the study regarded this as a negative finding. But ShareAction shows that it’s entirely possible to design a fund to achieve a clearly-defined objective. Climate funds come across as a promising product currently suffering from spotty execution and labeling.

Within the S, only gender diversity funds have carved out a niche on both sides of the Atlantic.<sup>116</sup> By contrast,

funds focused on workplace issues are surprisingly rare in the U.S., especially given the sturdy evidence of their materiality and a venerable American precedent. The Parnassus Workplace Fund—founded in 2004 on the model of *Fortune’s 100 Best Companies to Work for in America*—outperformed the stock market by 3.7% annually for a decade.<sup>117</sup> Alex Edmans of the London School of Economics later found a robust relationship between job satisfaction and shareholder return in stock markets around the world.<sup>118</sup> But perversely, the Workplace Fund evolved into a generic ESG offering. Only recently have some European funds picked up the baton of S investing with [attention to the workplace](#).<sup>119</sup>

One intriguing European experiment that targets a range of S issues is the Aviva Social Transition Global Equity Fund. This small new fund seeks to reduce inequality while promoting gender equity and decent work, with an emphasis on worker relations and fair pay. Resisting easy classification, it holds a mix of companies that seek either to manage social risks or solve social problems. As is typical, Aviva’s social fund stirs together a number of commercial ESG ratings. Atypically, it employs a lead social analyst who cut her teeth at the Worker Disclosure Initiative, a nonprofit ESG rater rooted in the UK union movement. So the fund draws on NGO frameworks like Know the Chain, Behind the Brands, the Forest 500, Access to Nutrition, Access to Medicine, and, above all, the World Benchmarking Alliance. Aviva’s social fund notably avoids Amazon, Apple, Google, and Tesla over labor concerns.<sup>120</sup> It offers an interesting alternative, relying heavily on NGO frameworks and focusing on a more limited set of attributes.

The challenge with the creation of any targeted fund, especially within the S, is to find a focus that is both commercially viable and clearly measurable, like Paris Agreement alignment or gender diversity. For creative fund managers, it is a challenge well worth taking.

92% of Social indicators focus on company procedures, like worker surveys, rather than outcomes, like higher wages.

#### 5. Customized goals

ESG ratings are so problem-plagued that the best solution may be to stop using them. A growing number of institutional investors—especially in the U.S.—use raw ESG data to design portfolios tailored to fit a single client’s values (or their own values, if they’re investing on their own behalf). In a sense, individualized portfolios are the logical end of targeted E or S funds that cater to a group of investors with a distinctive taste. Values are not one-size-fits-all, and customized portfolios respond with full flexibility. The importance and valence of each subtopic varies for each investor. ESG’s future may therefore entail both the disaggregation of ESG data and the disaggregation of ESG investment pools.

Customization has many advocates, among them the Bank for International Settlements.<sup>121</sup> In fact, it is already upon us, with raw ESG data among the most popular products sold by U.S. data providers.<sup>122</sup> Over two-thirds of asset managers think customization of raw ESG data will dominate the industry’s growth.<sup>123</sup> Quoting the head of UBS Asset Management, *The Economist* agrees: “Customisation is coming fast.”

These five design solutions—greater transparency, improved data, broader exclusions, narrower targets, and customized goals—are essential to reforming ESG investment. But the field’s most fundamental problem is subordinating stakeholder protection to shareholder return. Addressing that problem demands a wholly new approach.

## 6. A Better Way Forward



The easiest pathway for ESG values investing is for investors to authorize their fiduciaries to sacrifice financial return by selecting a specified ethical strategy. In the final analysis, the choice of investment strategy falls to each investor.



A true commitment to ESG investing will often favor firms with increased operational costs. That leaves ESG investment advisers vulnerable to the charge of violating the duty that they owe to pursue their clients' best interests. However, most investors are free to modify fiduciary duties by agreement—and to select a strategy that overtly prioritizes values over value. With these clients, the way is clear for innovative asset managers and wealth managers to offer “ESG Values” funds, which incorporate the lessons learned from good-faith critiques of ESG investing.

### 1. Genuine ESG investing requires increased expenditures

Many ESG advocates operate on the assumption that they can make the world a better place and at the same time maximize financial returns, in essence claiming there is never tension between social purpose and profit.<sup>125</sup> A number of widely cited metastudies, reviewing thousands of articles, have concluded that ESG investing predictably provides comparable returns or better.<sup>126</sup> “If all that sounds too good to be true,” argues the legal scholar Ann Lipton, “it probably is.”<sup>127</sup> In *The Economist's* judgment, “It’s a myth that ESG investments inevitably outperform.”<sup>128</sup>

NYU Stern professor Aswath Damodaran dismisses much of the “ESG pays” discourse as anecdotal, advocacy-driven, and “statistically a mess.” Reviewing the finance scholarship, he and UCLA’s Brad Cornell characterize the evidence that markets reward good companies as “weak to non-existent,”

with the results dependent on how both ESG and profitability are assessed.<sup>129</sup> While accepting that there is substantial support for ESG funds’ outperformance, Max Schanzenbach and Robert Sitkoff agree that “this support is far from uniform, [and] is often contextual.”<sup>130</sup> More aggressively, Tariq Fancy argues that the data in such studies can be unreliable, and the reasoning motivated by conscious or unconscious bias. “After reading a few pro-ESG papers whose methods and conclusions I found rather dubious,” he writes, it “occurred to me [that] there’s always money to be made from telling people what they want to hear.”<sup>131</sup>

The simplest explanation for the outperformance of ESG funds over the past 15 years is the [over-representation of tech stocks](#).<sup>132</sup> That would certainly explain why ESG funds underperformed in 2022, when tech stocks fell sharply.<sup>133</sup> Whatever the reason for past patterns, theorists of capital asset pricing believe that ESG stocks should *underperform* the market when they are correctly priced, because investors

are willing to overpay for “virtuous” assets that provide reputational benefits. Some confidently predict that ESG funds will underperform in the future, because markets eventually adjust to mispricing. It seems that leaning on empirical studies to legitimize ESG investing may be dangerous, because empirical results can change over time.<sup>134</sup>

Stepping back, the conclusion that “ESG pays” derives from the study of funds that lump E, S, and G factors into one unitary rating. These studies, even if impeccable, have limited relevance for funds that target specific themes or subthemes within the E or the S.

For that matter, the funds supporting the conclusion that “ESG pays” are based on ESG ratings that suffer from all of the flaws that we’ve reviewed. In our view, their biggest flaw is that they are *designed* to provide comparable returns rather than to protect society. Accordingly, we should hardly be surprised if they provide comparable returns. The vaunted outperformance of existing ESG funds only underscores that they aren’t socially conscious in any meaningful way. The deeper problem is that existing ESG funds underreward the sort of outcome-based policies that would be most costly, yet would be most protective of the environment and society.

The fact is that paying workers fairly adds appreciable costs. It’s expensive to install a rigorous inspection regime to guard against supply chain abuses. Removing obstacles to unionization may well raise operating expenses. We recognize that there will be cases where these costs will be financially justified in the long run. At the same time, it’s self-evident that the strict financial risks of some ESG policies outweigh their financial benefits, and the social benefits of some goals may be pursued past the point of narrow economic gain. “In at least a subset of corporate decisions,” notes the legal scholar Jill Fisch, “there is a true conflict between the interests of different stakeholders, and a decision that

benefits one class of stakeholders will harm another.”<sup>135</sup> The harsh reality is that protecting stakeholders may come at a cost to shareholders in a particular firm, especially in the short run. A number of forthright former ESG leaders acknowledge that truth.

The “win-win belief at the heart of ESG has led to widespread wishful thinking,” says Duncan Austin, who was a partner at Generation Investment Management.<sup>137</sup> The idea that ESG investing is highly profitable is a “wishful fantasy in the extreme,” agreed Robert Zevin of Zevin Asset Management.<sup>138</sup> “Unfortunately, many things that are lucrative are also bad for the world,” adds Tariq Fancy. “There’s a reason that Exxon pollutes and Facebook tries to addict us to their apps: It makes money.”<sup>139</sup>

## 2. Fortunately, many investors are free to prioritize their values

Many ESG advocates deny the trade-off between genuine ESG goals and financial return for one crucial reason: They fear being accused of violating the law of fiduciary duty. In a nutshell, U.S. investment professionals owe a duty of loyalty to serve their client’s best interest or their sole interest.<sup>140</sup> We can set to one side the fraught question of how much this obligation restricts those ESG advisers who are unable to escape tight fiduciary duties. (See sidebar on page 24.) Happily, many investment advisers are considerably less constrained than pension advisers. The way to slip the knot is to recognize that many investors have the power themselves to modify fiduciary duties by agreement.

The easiest pathway for ESG values investing is for investors to authorize their fiduciaries to sacrifice financial return by selecting a specified ethical strategy in their investment guidelines and services contract. Such an approach would be consistent with basic principles of agency and contract law —as well as the SEC guidance on the federal fiduciary duty for investment advisers.

**One of every 3** wealthy private investors said that they are prepared to accept higher risk and/or lower returns as the price of positive impact in a majority of their investments.

Interpreting the Investment Advisers Act of 1940, the SEC stated in 2019 that “[t]he fiduciary duty follows the contours of the relationship between the adviser and its client, and *the adviser and its client may shape that relationship by agreement*, provided that there is full and fair disclosure and informed consent.”<sup>141</sup> While an adviser’s federal fiduciary duty is not susceptible to a general or blanket waiver, the SEC noted that a principal may always consent to specific types of investment by an agent, and repeated that the duty’s application “may be shaped by agreement.”<sup>142</sup> (State law is guided by the same precepts, without being bound by the federal interpretation).

In its recent report on fiduciary duty and sustainable investing, the global law firm Freshfields notes that a mutual fund is free to organize itself as a fund with non-financial objectives that take precedence over financial return, provided that it forthrightly discloses the risk of a lower return. After all, “mutual funds are premised on the ability and freedom of beneficiaries to select the fund they wish to invest in on the basis of informed choice.”<sup>143</sup>

Opting in to a values-driven fund would be straightforward for individual investors or family offices. Some personal trusts and charitable foundations should also be eligible, depending on their governing documents and applicable state law. Personal trusts and charities enjoy wide autonomy to prescribe a non-financial purpose, and a personal trust’s beneficiaries may shield the trustee from liability.<sup>144</sup> Commentators influenced by the “law and economics” school remain

## What to Do with a Problem Like Materiality?

Our report avoids grappling with the problem of materiality by aiming ESG funds at investors who are free to loosen the fiduciary duties owed by their financial advisers. But some financial professionals are more constrained. In particular, both public and private pension advisers are bound by a strict and unalterable duty of loyalty.<sup>1</sup> Fortunately, the meaning of materiality is flexible enough to allow even funds aimed at pension investors to adopt an ESG strategy.

Pension advisers must always act in the “sole interest” of their beneficiaries.<sup>2</sup> The Trump Labor Department construed this principle under federal law to forbid them from even considering ESG factors. The Biden Labor Department reversed course and declared that pension advisers may consider ESG factors so long as they are financially material.<sup>3</sup> The upshot is that, even under the more progressive Biden rule, pension investors are constrained by materiality.

However, the U.S. Supreme Court has always defined materiality from the “reasonable” investor’s viewpoint: A fact is material if a reasonable investor would likely consider it important to their investment decisions.<sup>4</sup> It follows that market players can shift the shared understanding of what is material by broadening their investment goals, time horizon, and frame of analysis. If enough investors consider something material, then by definition it’s material. The legal culture can evolve by virtue of market players embracing a wider view of investment in their actions.

Constrained investors can reframe materiality in a number of creative ways. The most novel reframing—“double materiality”—demands that firms assess impacts on other stakeholders in parallel with impacts on shareholders. Double materiality is built into the EU’s new mandatory standards for ESG reporting, and comports with Europe’s most popular voluntary standards.<sup>5</sup> But the U.S. tradition of securities regulation is based on the principle of investor protection, and has resisted a multistakeholder approach.<sup>6</sup>

The alternative approach to materiality that has gained the most traction in the U.S. is the adoption of a longer-term time horizon. This approach recognizes that a sole pre-occupation with short-term returns imposes vast costs on all who rely on the stability of living in an equitable society on a livable planet—and that includes all investors. In the long run, all shareholders face material risks from global warming and from social inequality and instability.

Increasingly, international standard setters expect companies to report on any risks that could reasonably be expected to affect their financial returns over the

short-, medium- and long-term. Indeed, the newly-issued disclosure standard known as IFRS S1—which culminates a grand effort at harmonization by global groups setting corporate reporting standards—refers to the “long term” no fewer than 17 times in its general requirements for sustainability disclosure.<sup>7</sup> On that basis, the standard-setting IFRS Foundation has advised that all firms facing significant climate risks are likely to find them material under the IFRS Sustainability Disclosure Standards.<sup>8</sup> Investors need to reach the same conclusion for many significant social risks.

A final alternative is to define materiality at the portfolio level. Because ESG risks are systemic (meaning they cannot be diversified away), ESG factors may be seen as uniquely material to diversified investors—regardless of whether they’re material to individual companies within the portfolio.<sup>9</sup> To justify ESG investment, Columbia Law professor John Coffee has proposed that an asset manager find merely that its strategy will benefit the portfolio as a whole. Meeting this test also would comply with the strictest U.S. fiduciary rule, and comport with the SEC’s traditional role of investor protection.

Even for ESG funds that cater to pension investors, fiduciary duties need not be a straitjacket, for materiality is a capacious concept. Shareholder and stakeholder interests do not always align. But when they are viewed in the long run or at the portfolio level, they often do.

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- <sup>1</sup> See *Central States Pension Fund v. Central Transportation*, 472 U.S. 559, 568 (1985) (“[T]rust documents cannot excuse trustees from their duties under ERISA”).
  - <sup>2</sup> On the applicable fiduciary standards, see Freshfields Bruckhaus Deringer, *A Legal Framework for Impact: Sustainability impact in investor decision-making*, commissioned by PRI, UNEP Financial Initiative, and the Generation Foundation at 510-13 (July 2021).
  - <sup>3</sup> U.S. Department of Labor, “Final Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights” (November 22, 2022).
  - <sup>4</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988).
  - <sup>5</sup> See, e.g., European Financial Reporting Advisory Group, *Proposals for a relevant and dynamic EU sustainability reporting standard setting at 7-8* (March 8, 2021); Global Reporting Initiative, “Why double-materiality is crucial for reporting organizational impacts” (May 31, 2021).
  - <sup>6</sup> The SEC’s statutory mandate is to make rules “necessary or appropriate for the proper protection of investors.” Securities Exchange Act of 1934, § 13(a), 15 U.S.C. § 78m(a) (1988). See also Ann M. Lipton, “Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure,” 37 *Yale J. Reg.* 499, 502 (2020).
  - <sup>7</sup> IFRS S1, General Requirements for Disclosure of Sustainability-related Financial Information (issued June 26, 2023, effective January 1, 2024).
  - <sup>8</sup> IFRS Foundation, “General Requirements for Disclosure of Sustainability-related Financial Information Prototype Developed by the Technical Readiness Working Group, chaired by the IFRS Foundation, to provide recommendations to the International Sustainability Standards Board,” at paras. 10-18 and Appendix C, Guidance on Implementing Materiality (November 2021) (“[I]t is likely that all entities exposed to significant climate-related risk would assess information about the governance of that risk to be material.”).
  - <sup>9</sup> See John C. Coffee Jr., *The Future of Disclosure: ESG, Common Ownership, and Systemic Risk*, 2021 *Colum. Bus. L. Rev.* 602 (2021). On systemic change, see generally William Burckart and Steve Lydenberg, *21st Century Investing: Redirecting Financial Strategies to Drive Systems Change* (2022).

skeptical that the fiduciary of a personal trust or charity may give precedence to non-financial goals.<sup>145</sup> But a 2018 Delaware law expressly lets trusts prescribe ESG investing “without regard to investment performance,” while letting trustees account for financial needs and personal values. In the final analysis, the choice of investment strategy falls to each investor.

### 3. There is a pathway forward for investors who wish to prioritize their values

To instantiate their values, investors should be prepared to promote stakeholder well-being [even if it comes at a cost](#).<sup>147</sup> Oxford Risk behavioral scientist Greg Davies argues that, in fact, a critical mass of investors are willing to accept the stubborn tradeoff between purpose and profit. “ESG coming at some cost need not eliminate the demand for responsible investing,” he writes, “as long as the industry is open about this and designs its products and marketing based on an understanding of real investor preferences.”<sup>148</sup>

After all, Davies argues, money is not the only form of return. Values-driven investors are maximizing a combination of financial and *emotional* returns, to borrow a term from the finance scholar Meir Statman of Leavey School of Business.<sup>149</sup> A study of impact funds in the *Journal of Financial Economics* has concluded that investors pursuing social impact are willing to forego between 2.5% and 3.7% in annual return. But perhaps the strongest evidence that values-driven investors are prepared to take a hit is that, for ESG funds, inflows and outflows are less sensitive to financial performance than for non-ESG funds—as has been shown by three independent scholarly studies.<sup>150</sup>

If self-reported preferences are taken at face value, altruistic attitudes may be found in significant numbers among investors of all sizes and types—albeit to varying degrees. According to a [PwC survey](#) of global institutional investors,

64% said they were prepared to sacrifice financial return in exchange for benefits to the environment or society. However, when pushed to be more concrete, only 7% of the full sample said they were willing to accept a blow to their financial return of greater than 2%.<sup>151</sup>

In a survey of retail U.S. investors who invest in ESG products outside their retirement plans, 58% claimed to be at least somewhat willing to sacrifice financial return in pursuit of non-financial goals.<sup>152</sup> A separate poll by U.S. Bank found especially strong sentiments among Gen Z retail investors, with 30% willing to accept an annual return between 3% and 6% to support causes they care about. However, a recent National Bureau of Economic Research paper casts some doubt on the reliability of self-reported altruism by small retail investors. Comparing the actual behavior of Vanguard investors with their survey responses, the authors found that money is a key motive even for ESG investors who claim to be driven by values. Among self-reported altruists, only those who expected ESG funds to outperform the market invested meaningfully in ESG funds; and the more outperformance they expected, the more they invested.<sup>153</sup>

Arguably, altruistic attitudes are most common in the large and burgeoning segment of family offices and ultra-high-net-worth individuals (UHNWIs). Globally, the consultancy CapGemini counts 10,000 family offices managing \$7 trillion—exceeding the size of the hedge fund industry—and 210,000 UHNWIs controlling \$28 trillion. Over three-quarters of those UHNWIs, according to CapGemini, view ESG impact as a key investment objective.<sup>154</sup> In the most recent annual survey of wealthy private investors by Campden Wealth and Barclays Private Bank, one third said that they are prepared to accept higher risk and/or lower returns as the price of positive impact in a

majority of their investments. Ten percent would accept lower returns for *all* their investments.<sup>155</sup>

### 4. The Solution: A return to ESG Values

The marketplace is ready for a form of ethical investing that corresponds to the original, common-sense understanding of the phrase, and aims to safeguard society from business excess. Investors who are strongly committed to social reforms should have more opportunities to take such an approach—call it ESG Values investing—by expressly stating that they prioritize values over value.

An ESG Values fund could incorporate all of the design improvements that emerged from our review of the critical literature and described in Section 4. It would be transparent about every dimension of its methodology, and reject current marketing schemes or deceptive labeling. It would rely on more and better data, drawing widely on the assessments of nonprofits and on the rivers of more consistent reporting that eventually flow from new mandatory rules on both sides of the Atlantic. An ESG Values fund would employ broader exclusions and more targeted principles of inclusion, based on clearly measurable attributes within the E, or especially the S, generating a portfolio that matches the likes and dislikes of a defined investor pool, or even customized to the ethical priorities of a single investor.

Working creatively within the bounds of fiduciary law, we must be prepared to admit that the tradeoffs between purpose and profit often are real. Breaking that taboo will open up new opportunities for asset and wealth managers, catering to the critical mass of diverse investors—including many individuals and family offices and some foundations—who are prepared to prioritize values and willing to sacrifice financial return in pursuit of a more just and equitable society.

## Recommendations to ESG Investment Advisers and Data Providers

- 1 Recognize that the ultimate goals of ESG investing** are to protect the environment and society, and to faithfully express investors' values.
- 2 Label and market your financial products forthrightly.** Tell the public your objectives and reveal every facet of your methodology.
- 3 Be willing to exclude broad swathes of the market** in assembling values-driven portfolios or benchmark indices. Strive to create a fund with holdings that will not appall investors who are genuinely values-driven.
- 4 Use metrics that measure real-world outcomes**—not meaningless procedures, or empty promises of future outcomes.
- 5 Abandon “Best in Class” scoring.** Instead of comparing a firm to its peers, judge it by an objective standard of responsible conduct. If every firm in a sector is objectively failing, then exclude the sector.
- 6 Think about the global supply chain in analyzing every ESG sub-factor;** Supply chain issues are pervasive, and should not be treated as one isolated detail.
- 7 Don't limit your analysis to commercial ESG ratings.** Draw widely upon non-profit ESG frameworks that foreground the public interest.
- 8 Stop lumping the E, the S, and the G** into one incoherent composite score. Score every sub-factor separately.
- 9 Don't assemble the E, the S, and the G into a Frankenstein financial product.** Instead, design a targeted values fund. Identify a coherent theme—like a fair workplace, or a just transition. Use whatever ESG data is pertinent to pursue a well-defined set of social and/or environmental objectives.
- 10 When feasible, personalize the portfolio** to match the values of each investor—because ethical priorities are personal.
- 11 Adopt a long-term view of financial materiality.** Recognize that an ESG factor is material if it is apt to influence investment decisions based on assessments of value over any time frame.
- 12 Offer values-driven investors who are legally eligible the option of authorizing their adviser to accept less than a comparable financial return** in pursuit of specified ESG objectives, while agreeing to modify their adviser's fiduciary duty in accord with their chosen strategy.

## Recommendations to the SEC

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- 1** **Move forward swiftly on every ESG front where progress has stalled:** (a) finalize the rule to curb “greenwashing” by investment advisers; (b) finalize the rule on “climate disclosure” by corporations; and (c) propose the rule on “human capital disclosure” by corporations. Crack down on deceptive marketing to restore integrity to the ESG marketplace. Mandate that companies report more and better data as the first essential step to reforming ESG investment.
- 2** **In the rule on human capital disclosure, compel both public and private issuers** to report on the size and compensation of their workforce. Require a breakdown of all data by country and locality to enable comparisons with the local living wage.
- 3** **Fill the void in basic knowledge of the indirect workforce** by requiring issuers to report the above data on all forms of outsourced or contingent labor. Broadly define the indirect workforce to encompass all U.S. or non-U.S. outsourced workers, and all fairly attributable U.S. or non-U.S. employees of franchisees, contractors, subcontractors, as well as firms in the global value chain that are so tethered to a listed U.S. company that the issuer specifies their standards or practices.
- 4** **In the rule on climate disclosure, brush aside the attempt by the fossil fuels lobby—** and its allies in asset management—to weaken the keystone requirement that firms report “Scope 3” emissions of greenhouse gases by suppliers, customers, and users.
- 5** **In the rule on greenwashing, clarify that investment advisers and investment companies—**including ESG information providers—must be transparent on every dimension of every system of ESG rating or ESG investment selection that they design or employ. Demand transparency on every assessed attribute, every metric of assessment, the weight assigned to each variable, the precise scoring methodology, and the scores awarded to each rated entity.

# Endnotes

- 1 See, e.g., Bloomberg Intelligence, “ESG May Surpass \$41 Trillion Assets in 2022, But Not Without Challenges, Finds Bloomberg Intelligence” (January 24, 2022) (extrapolating from Global Sustainable Investment Alliance figures).
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- 4 Anne-Laure Foubert, “ESG Data is Now Worth It,” Opimas Report (April 19, 2022).
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- 15 See, e.g., Roberta S. Karmel, National Speech to the Investor Relations Institute New York Chapter (April 2, 1978), available at <https://www.sec.gov/news/speech/1978/041278karmel.pdf>. As late as the 1990s, the Uniform Prudent Investor Act scoffed at the “suppos[ed] benefit[s]” of “so called ‘social investing.’” See Uniform Prudent Investor Act, section 5 commentary (Uniform Law Commission 1994).
- 16 See UNEP Finance Initiative, *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing* (June 2004), available at [UNEPFI.org](http://UNEPFI.org); UN Global Compact, *Who Cares Wins—Connecting Financial Markets to a Changing World* at ii (June 2004), available at [IFC.org](http://IFC.org). See also Saijel Kishan, “ESG Pioneer Expects Shakeout for Funds Hyped by ‘Fairy Dust,’” *Bloomberg Green* (March 20, 2022); Saijel Kishan, “Ex-Tabloid Reporter Who Coined ESG Label Says Backlash Is Good,” *Bloomberg Green* (December 4, 2022).
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- 118** Alex Edmans, et al., “Employee Satisfaction, Labor Market Flexibility, and Stock Returns Around the World,” European Corporate Governance Institute, SSRN (June 6, 2022); Alex Edmans, “The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility,” *Academy of Management Perspectives* (November 2012).
- 119** Among the offerings in this category are the Global Happy@Work fund from Sweden’s Sycomore Asset Management, the EdRF Human Capital Fund, the Nordea 1 Human Development Fund, and the Pictet Human Fund. As a group these funds use a hybrid of ESG-style investing, picking firms that treat workers well; and impact-style investing, picking firms whose business models cultivate human capital.
- 120** Interview with Aviva Social Pillar Lead Vaidehee Sachdev, October 7, 2022.
- 121** Torsten Ehlers et al., “Deconstructing ESG Scores: How to invest with your own criteria,” BIS Working Paper No. 1008 at 4 (BIS Monetary & Economic Dept., March 2022).
- 122** IOSCO Sustainable Finance Task Force, *ESG Ratings and Data Products Providers* (International Organization of Securities Commissions, November 2021).
- 123** Deloitte Insights, “Advancing ESG Investing: A Holistic Approach for Investment Management Firms,” at 9 (February, 2020).
- 124** “Asset managers: The saviour complex,” *The Economist* (July 21, 2022) (quoting Suni Harford).
- 125** See, e.g., Corporate Governance Improvement and Investor Protection Act, H.R.1187, 117th Cong. (2021) (resolving, in a bill passed by the House: “It is the sense of Congress that ESG metrics are... de facto material”). For a softer form of the same thinking, see Allison Herren Lee, “A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC,” March 15, 2021 (“Th[e] supposed distinction—between what’s ‘good’ and what’s profitable... is increasingly diminished.”).
- 126** NYU Center for Sustainable Business, “ESG and Financial Performance: Uncovering the relationship by Aggregating Evidence from 1000 Plus Studies Published between 2015-2020” (February 2021); Mozaffar Khan, *Corporate Governance, ESG, and Stock Returns Around the World*, 75 J. Sustainable Fin. & Inv. 103 (2019); Gunnar Friede, et al., “ESG and financial performance: aggregated evidence from more than 2000 empirical studies,” 5 *Journal of Sustainable Finance and Investment* 210 (2015).
- 127** Ann M. Lipton, “Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure,” 37 *Yale J. Reg.* 499, 528 (2020).
- 128** “The Warm Glow,” *The Economist* (July 21, 2022).
- 129** Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” at 10, available at <https://pages.stern.nyu.edu/~adamodar/pdfiles/country/ESGShortNew.pdf>; Bradford Cornell & Aswath Damodaran, “Valuing ESG: Doing Good or Sounding Good” at 15-16, 19 (February 10, 2020). For other skeptical views on the “ESG pays” literature, see Lipton, “Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure,” at 527-31 and authorities cited in nn.167-69.
- 130** Max Schanzenbach & Robert Sitkoff, “Reconciling Fiduciary Duty and Social Conscience,” 72 *Stan. L. Rev.* 381, 390 (February 2020).
- 131** Tariq Fancy, “The Secret Diary of a ‘Sustainable Investor’ — Part 2,” *Medium* (August 20, 2021).

- 132 Akane Otani, "Big Technology Stocks Dominate ESG Funds," *Wall Street Journal* (February 11, 2020); Camila Hodgson, "Funds Branded 'ESG' Are Laden with Technology Stocks," *Financial Times* (August 14, 2020).
- 133 Tommy Wilkes et al., "ESG funds set for first annual outflows in a decade after bruising year," *Reuters* (December 19, 2022) (providing year-to-date comparison of change in total net assets). See also Isla Binney and Ross Kerber, "Analysis Money before climate; market downturn spurs ESG fund exodus," *Reuters* (November 11, 2022); Siri Christiansen, "ESG funds have struggled in 2022, report finds," *Citywire* (September 1, 2022).
- 134 See Cornell and Damodaran, "Valuing ESG" at 12-13 (reviewing the theory and evidence); Schanzenbach & Sitkoff, "Reconciling Fiduciary Duty," *72 Stan. L. Rev.* at 390, 443-44 and accompanying notes; Lucian A. Bebchuk et al., "Learning and the disappearing association between governance and returns," *93 Journal of Financial Economics* 15 (2013). In 2021, Abraham Lioui of EDHEC Business School found that ESG funds were outperforming less, and foresaw that they were on the verge of lagging. "Soon we will be at the stage where the relationship between ESG and performance will be negative as it [logically] should be," Lioui said. See Emma Boyde, "ESG outperformance looks set to end, study suggests," *Financial Times* (July 6, 2021); Abraham Lioui & Andrea Tarelli, "Chasing the ESG Factor," *Journal of Banking and Finance* (forthcoming), SSRN (July 1, 2021, last revised April 4, 2022).
- 135 See Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 *J. Corp. L.* 637, 646 and authorities cited at n.47 (2006).
- 136 Cf. *Freshfields Report 2021* at 26 ("[N]ot all sustainability factors will necessarily be financially material to a portfolio, even in the long-term.").
- 137 Saijel Kishan, "Corporate Climate Efforts Lack Impact, Say Former Sustainability Executives," *Bloomberg Green* (July 12, 2021). See also "The Warm Glow," *The Economist* (July 21, 2022) (quoting Generation co-founder David Blood to similar effect).
- 138 Robert Zevin, "Socially Responsible Investing: Whence Did We Come? And Whither Are We Going?" *Greenmoney* (Fall 2012).
- 139 Tariq Fancy, "The Secret Diary of a 'Sustainable Investor'" (August 2021).
- 140 The fiduciary duties of asset managers are governed by state corporate law and the federal statutes regulating investment companies and advisers. The sole interest rule applies to pension managers under state pension law and ERISA and to trustees under the default state law of trusts. For extended discussions of investment adviser fiduciary duties, see Max Schanzenbach & Robert Sitkoff, "Reconciling Fiduciary Duty and Social Conscience," *72 Stan. L. Rev.* 381, 402 (February 2020); Susan N. Gary, "Best Interests in the Long Term: Fiduciary Duties and ESG Integration," *90 University of Colorado Law Rev.* 731 (2019); and Freshfields Bruckhaus Deringer, *A Legal Framework for Impact: Sustainability impact in investor decision-making*, commissioned by PRI, UNEP Financial Initiative, and the Generation Foundation at 510-13 (July 2021).
- 141 SEC, "Commission Interpretation Regarding Standard of Conduct for Investment," 84 Fed. Reg. 33669, 17 CFR Part 276 (July 12, 2019), text accompanying footnote 26 (emphasis added).
- 142 *Id.* at nn.29-31 and accompanying text. Notably, the SEC withdrew as misleading its proposed language that "the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty." *Id.* at n.30 and accompanying text. As the Commission explains: "One commenter disputed this broad statement, believing that it called into question 'the ability of an investment adviser and client to define the scope of the adviser's services and duties.'" [citing ABA Letter]. We have modified this statement to clarify that a general waiver of the fiduciary duty would violate that duty and to provide examples of such a general waiver." In the examples provided for clarity, the SEC explains that the rule against general waiver applies to "(i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act." For a broad contractarian account of fiduciary law, see Tamar Frankel, "Fiduciary Duties as Default Rules," *74 Or. L. Rev.* 1209 (1995).
- 143 Freshfields, *A Legal Framework for Impact* at 26.
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