

The Anti-ESG Trend: State-Level Pushback Comes for ESG

Key Takeaways

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- Conservative attacks on ESG have increased markedly, with critics, most notably state officials, claiming ESG investing strategies prioritize an ideological agenda over financial returns
- Such claims stand in contrast to robust data showing positive financial returns associated with ESG; further, failure to account for ESG factors may lead to adverse outcomes and higher risk
- Asset managers serving state investment fund managers in states skeptical of ESG should account for new dynamics by highlighting financial returns associated with ESG

Background

ESG investing strategies have become conservatives' latest target, as [conservative think tanks](#), media [commentators](#), and [politicians](#) have publicly criticized ESG as enforcing an environmental or social agenda at the expense of financial returns. Most notably, under Governor Ron DeSantis, Florida recently passed a resolution ordering the state's fund managers to invest in a manner that prioritizes the highest return on investment [without considering](#) "the ideological agenda of the environmental, social, and corporate governance (ESG) movement." The exact language of the resolution directs state fund managers to consider only "pecuniary factors," defined in the resolution as having "a material effect on the risk and return of an investment." The resolution states explicitly that "pecuniary factors do not include the consideration of the furtherance of social, political, or ideological interests." In other words, state fund managers should only consider returns when making allocation decisions. However, the end result of such directives is ultimately up to interpretation. Because ESG strategies have been shown to increase returns and decrease risk, it is difficult not to classify ESG factors as "pecuniary."

Florida is joined by a host of other states seeking to insulate their investment strategies and state-run financial systems from ESG strategies. Idaho is considering a similar policy [restricting public entities from utilizing ESG strategies](#) in a manner that would "override the prudent investor" rule. Fossil fuel producing states such as [Texas and West Virginia](#) have divested state funds from or restricted engagement with financial actors deemed to be "boycotting" the fossil fuel industry, most notably investment giant BlackRock. Despite BlackRock's [significant fossil fuel holdings](#), Texas and West

Virginia are joined by [18 other states](#) who have publicly condemned BlackRock for its climate initiatives.

Anti-ESG sentiment from conservative lawmakers has firmly placed the investment strategy in public discourse. But how will this dialogue ultimately impact asset managers and the state fund managers they serve?

ESG, Impact and Returns

At the heart of this missive is the notion that, by considering ESG factors, fund managers are prioritizing an environmental and/or social agenda at the expense of returns. Standing in stark contradiction to this philosophy is that ESG investing strategies have been robustly shown to *increase* financial returns, with [ESG funds generating greater returns](#) than their conventional counterparts. For instance, Bloomberg's [SASB Large Cap ESG Select Index](#) fund has produced a total return of 150% since it was formed in 2014; the [Russell 3000 fund](#), a conventional analogue, has produced returns 14 points lower in that same period. In the past five years, ESG indices such as the Select Index have [appreciated 74%](#), 5 points higher than the market writ large. More granularly, [studies investigating performance at the company-level](#) have shown that in addition to higher profitability, companies with high ESG ratings experienced lower risk, as indicated by less volatile earnings, lower systemic volatility, and lower costs of capital.

Ultimately, under new anti-ESG pushback, asset managers may need to rethink how they frame their investment strategies to state investment fund managers who are caught between anti-ESG directives and their fiduciary responsibilities to generate higher returns. Though the higher returns generated by ESG investment strategies likely maintain their viability to such managers, asset managers would be well advised to gauge their funding partners from such states when describing their investment theses. Notably, asset managers may need to more significantly reconsider their fundraising strategies related to impact funds. Whereas ESG investing is focused on risk mitigation in pursuit of maximizing returns, impact funds prioritize social or environmental agenda, sometimes at the expense of returns. As a result, impact funds may be more likely to draw scrutiny from state investors concerned with sacrificing pecuniary factors for ideological agenda; asset managers fundraising for impact funds may be wise to assess legislative regimes in states from which they source capital.

Impact on Asset Managers

Asset managers, such as private equity firms, serving state investors now face muddy waters when engaging state investors, who have been handed top-down direction to prioritize returns without considering ESG. Further, it is unclear how, or even if, anti-ESG policies will be enforced. If a state investor allocates funds to a private equity firm that leverages ESG strategies and achieves higher returns as a result, is the state investor scrutinized by state officials? Alternatively, will the situation be moot, as the private equity firm prioritized returns? The answer is still [unclear](#), and thus how asset managers choose to engage investors in these states remains unclear as well.

What is most likely to occur is a mixture of these two outcomes. If state investment fund managers prioritize the return maximization aspect of their mandates, based off of historical data they should support ESG investment. However, if they follow the direct instruction of anti-ESG resolutions, they may decline to invest in funds utilizing ESG strategies. As such, risk averse asset managers may choose to decline engagement in states with anti-ESG investment policies, fearing failed fundraising efforts or legal complications. However, asset managers utilizing ESG strategies who are tolerant of this risk may choose to continue engagement in these states; however, they may be well served to highlight the financial returns of their portfolios without explicitly noting ESG strategies used to maintain them. Further, some firms may be likely to rebrand their ESG efforts, avoiding the acronym itself, without significantly altering their strategies.

Impact on State Investment Fund Managers

Fund managers in states with anti-ESG policies may face more difficulty in abiding by new guidelines. State investment fund managers directed to disregard ESG may push back against asset managers who have integrated ESG strategies across their portfolios. However, in response to such pushback, asset managers may point to higher returns associated with ESG, demonstrating alignment to the anti-ESG policies through prioritization of returns. Caught between the proverbial rock and a hard place, state investment fund managers must decide whether to maximize returns through proven ESG strategies, or follow anti-ESG guidance, which could lead to lower returns due to less nuanced long term risk mitigation strategies. They must also decide how to align new anti-ESG directives with existing portfolio allocations. For instance, Florida allocated [\\$7.2B to BlackRock](#), the anti-ESG movement's asset manager lightning rod, as well as [\\$50M to TPG Capital's Rise Fund II](#), an impact fund focused on delivering not only financial but social and environmental returns.

In addition to reducing returns, disregarding ESG factors may increase risk within and external to state investment fund portfolios. For instance, Florida's state pension fund failed to divest from Russian assets after Russia's invasion of Ukraine. As a result, the fund [lost nearly \\$300M in value](#). Sanctions compliance and consideration of geopolitical trends both fall under ESG investing strategies; if Florida's pension fund managers had adopted ESG strategies, strategies they are now directed to disregard, this loss may have been avoided. Repudiation of ESG factors may result in more than lower investment returns; after Texas lawmakers excluded major banks for their purported anti-fossil fuel policies, the state's municipalities were forced to borrow from a less competitive loan market, resulting in [higher interest rates and \\$300 - \\$500M](#) in increased costs. Given these pitfalls, some investors are unsurprisingly pushing back against anti-ESG rhetoric, noting that the failure to take ESG into consideration engenders long-term risk, which is likely to impact returns. Investors in states with anti-ESG policies, such as the Teacher Retirement System of Texas, have noted that ESG factors may [continue to be considered](#) if "deemed material to long term risk."

Conclusion

Ultimately, recent attacks on ESG practices are counterintuitive and lack substance. Despite claims that ESG strategies prioritize a social or environmental agenda over financial returns, the truth is that

ESG may be one of the few instances where investors can eat their cake and have it too. ESG principles focused on long-term risk mitigation have been shown to generate increased returns and make for more successful businesses. Still, despite the hollowness of anti-ESG claims, resolutions and asset allocation directives restricting the use of ESG strategies are coming into effect. Asset managers fundraising from these states will need to assess their risk tolerance for such uncertainty. Though they should continue to utilize ESG strategies and enjoy the enhanced returns they generate, they would be well advised to market the financial aspects of their returns to certain actors, rather than or in addition to the marketing of 'ESG' principles of their strategies.

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