Brent Sheather's RESEARCH

Private Asset Management Ltd

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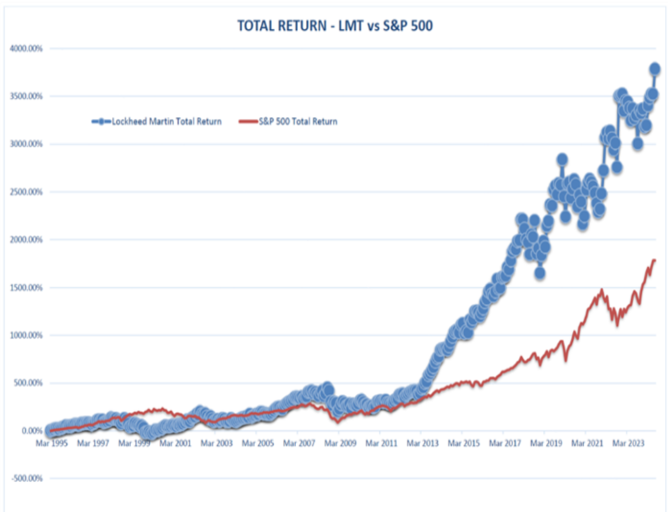
BEHAVIOURAL FINANCE AND THE ESG HUSTLE: Part 2

Dear Gentle Reader, the last column introduced Hersh Shefrin's paper, "ESG and Behavioural Finance" then detailed some of his notable findings in the field of behavioural finance. This week we will take a look at the ESG hustle through the lens of behavioural finance.

I am very sceptical of the ESG investment proposition, as it is currently configured. At best I think it is a useful method for fund managers to exploit naive retail investors so as to increase funds under management and divert attention away from more important factors like fees and performance. At worst it is an investment strategy that raises the cost of capital of the defence and oil industries thus potentially weakens the West's competitive position in those sectors relative to bad actors like China and Russia. The impact of the first factor is obvious and is particularly concerning given the aggressive stance of the CCP in our backyard and Putin's aspirations for Eastern Europe. Numerous equity research organisations are now hiring geopolitical analysts and promoting their research on the topic. Better late than never I guess. The second factor means that we end up buying more oil from the Middle East thus reducing our leverage over those governments on issues like human rights. I haven't mentioned the negative impacts of exclusion on performance but here's a graph of Lockheed Martin shares and the S&P500 over the last 29 years which is as far back as Refinitiv goes. (Full disclosure: I'm a shareholder).



Source: Private Asset Management and Refinitiv

Probably the most compelling evidence that all is not what it seems with the ESG investment proposition is that fund managers, stockbrokers and financial advisers embrace it so fervently. Any stock broker who dared recommend Shell or Northrop Grumman is likely to receive a visit from the compliance department alleging that that individual has brought the firm into disrepute. Nevertheless, and at the risk of upsetting the climate change deniers, most people acknowledge that climate change is a clear and present threat to humanity so capital markets need to accommodate that reality. The trick is not throwing the baby out with the bath water and not paying excessive rents to the financial sector.

Professor Shefrin cites five main psychological elements characterising ESG investing, as follows:

- ESG investors care about the source of their returns, as it embodies their values, and the magnitude of the returns
- The marketing activities of fund managers, financial advisors, stock brokers, etc influence investors' judgements about ESG related issues
- Opaque framing. Framing bias occurs when people make a decision based on the way the information is presented as opposed to just on the facts themselves. We will examine this issue in more detail in part 3.
- Biased judgements about both returns and ESG impact. Shefrin is concerned at the pricing of ESG assets and specifically the presence of incongruous judgmental errors both about returns and the lack of transparency relating thereto.
- Sentiment driven asset pricing – Shefrin cites a paper by Pastor, Stanbaugh and Taylor which finds that while green assets have lower expected returns, they outperform the market at times when there is an increase in demand for green assets.

As regards ESG investors caring about the source of their returns Shefrin notes "ESG benefits to investors are typically intangible in the same way that viewing media entertainment, music concerts and sporting events are intangible." ESG investing is also a useful way for individuals who identify as ESG investors, but not so much as to make any substantial changes in their consumption centred lifestyle, like travelling overseas with its large carbon footprint, to launder their guilt and thus feel better about ruining the planet.

The fund management industry responds to investor demand, including demand that it itself stimulates, in the same way it always has: "if the ducks quack, we feed them".

Table 1

ESG Screened S&P 500 ETF			Core S&P 500 ETF	
Top Holdings (%)			Top Holdings (%)	
Microsoft Corp	7.92		Microsoft Corp	7.23
Nvidia Corp	7.25		Nvidia Corp	6.61
Apple Inc	7.24		Apple Inc	6.61
Amazon Com Inc	4.22		Amazon Com Inc	3.85
Meta Platforms Inc Class A	2.64		Meta Platforms Inc Class A	2.40
Alphabet Inc Class A	2.55		Alphabet Inc Class A	2.33
Alphabet Inc Class C	2.14		Alphabet Inc Class C	1.95
Berkshire Hathaway Inc Class B	1.76		Berkshire Hathaway Inc Class B	1.60
Eli Lilly	1.72		Eli Lilly	1.57
Broadcom Inc	1.67		Broadcom Inc	1.52
TOTAL	**39.11**		**TOTAL**	**35.67**

Source: Company reports

Using an example of white eggs and brown eggs Shefrin makes the point that companies wish to maximise profits by differentiating their products – essentially selling the same thing at a higher price. ESG is thus a gold mine for fund managers in that it allows them to differentiate their product thereby transforming a commodity into a brand. Shefrin describes a simple marketing model in which there are only two products – white eggs and brown eggs – and whereby consumers prefer white eggs. His analysis describes how firms will produce white eggs from brown eggs and thus increase margins. The analogy in the financial markets today is that, as illustrated in Table 1 adjacent, an ESG branded S&P500 fund has essentially the same stocks as the S&P 500 ETF but, crucially, the annual fees are 2.7x higher. Coincidentally in NZ we have seen a similar scam where eggs from chickens in cages were sold as free range so as to capture the ESG premium. In the fund management industry ESG providers and their financial advisory cheerleaders are engaging in the same sort of deception but on a much larger scale. As an aside note that Nvidia is the second largest holding, at 7%, in the ESG screened S&P 500 ETF. A recent edition of the Economist magazine made the point that artificial intelligence will transform the character of warfare and that America and China both see AI as the key to military superiority. This is potentially a huge market for Nvidia, so how likely is it that Nvidia, the largest producer of chips for AI applications, will not be selling its chips to the likes of Northrop Grumman and Lockheed and various other armaments companies so as to hasten the despatch and improve the efficacy of their weapon systems? Again this sort of obvious relationship is conveniently overlooked by fund managers, financial advisors and all the others on the ESG gravy train.

ESG investing is huge – according to all its cheerleaders. In a recent story NBR reported that a survey by Mindfull Money found that 77% of kiwis expect their Kiwisaver will be managed ethically. In other words the spin is that everyone is into it. However Shefrin cites a paper suggesting that the actual "impact" of everyone getting the ESG religion hasn't done much to move the dial: "Pástor, Stambaugh, and Taylor (2024) report that in 2021 "the total dollar ESG-related tilt was approximately 6% of the industry's assets under management (AUM) in equity investments." They conclude that by "this measure, there is much less ESG investing than commonly reported." Shefrin comments "especially striking is their finding that between 2012 and 2021, the tilt has been stable around 6%. From a behavioral perspective, the large increased interest in ESG investing and the low, stable ESG-tilt are mutually consistent, if the increased demand has been met with cosmetic changes in supply, and related minor adjustments. This is why branding, promotion, and distribution – key elements of marketing -- play important roles in financial markets. What is important to understand is how the financial sector influences investors' mental processes, because those processes are at the core of the intangible benefits underlying investors' motivations for ESG-investing".

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.