Brent Sheather's

RESEARCH

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Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

BEHAVIOURAL FINANCE AND THE ESG HUSTLE: Part 3 The Black Arts

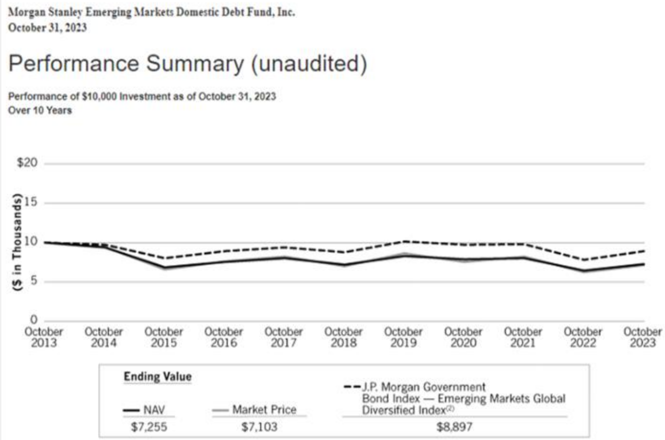
Today, in the final story on Professor Shefrin's paper, we look at the behavioural traits involved in and exploited by fund managers in the marketing of ESG such as decision framing, product branding and promotion.

One of the major issues Shefrin highlights in the marketing of ESG products is what he calls "opaque framing". In behavioural finance framing bias occurs when people make a decision based on the way the information is presented as opposed to just on the facts themselves. An example is : While doing your groceries, you see two different beef products. Both cost and weigh exactly the same. One is labeled "80% lean" and the other "20% fat." Comparing the two, you feel that 20% fat sounds like an unhealthy option, so you choose the 80% lean option. Obvious, really. ESG marketers working for fund management groups exploit framing effects and opacity so as to achieve their sales objectives.

By email Professor Shefrin advised that the best cases of opaque framing involved green washing and the link he provided gave a few examples. Greenwashing is using deceptive marketing and making misleading, vague or false claims about ESG matters. The practice is typically undertaken by companies or fund managers. The examples included Exxon Mobil, whose carbon footprint is apparently equal to that of Canada, yet the CEO of Exxon stated in 2020 that the company was focussing on solving climate change for society – without reducing its' emissions. One of the most elaborate attempts at greenwashing was orchestrated by Volkswagen who installed software in their cars to detect when the vehicle was undergoing an emissions test and temporarily reduced the emissions at that time.

In his book, Beyond Greed and Fear, Shefrin writes that the term "frame dependant" "means that the way people behave depends on the way that their decision problems are framed". In other words our decisions are influenced by the way information is presented. The financial world understands this and is an expert in framing decisions so as to get the answer it wants – the most obvious and egregious examples here involve the presentation of performance and choice of benchmarks. A local example of framing, in my opinion, was highlighted in a story back in November 2022 ESG Investment - Standing Next To A Short Benchmark. That story focused on the use of inappropriate benchmarks by the Responsible Investment Association Australia in the RIAA Benchmark Report. This report purported to show that products certified as responsible provided higher returns. However, despite the designation, the Morningstar "benchmark" was not actually a conventional industry benchmark – it was in fact just the average performance of all the relatively high cost managed funds in the Morningstar NZ overseas equity category. So not a benchmark at all in the accepted use of the term. So the ESG fund returns were being framed against easy to beat benchmarks. Even with the right benchmark one can frame (describe) performance in such a way as to minimize the impact of the information presented. Back in March 2024 in the story "Fund Management – Moving the Performance Goalposts" we showed how the choice of the size of the Y axis could alter the presentation of relative performance. In the USA, the SEC mandated fund performance versus the benchmark information is communicated via a line chart. This format potentially gives prospective investors a better insight into relative performance, particularly long term returns. As Figure 2 below shows any disparity between fund and benchmark returns is reflected in the gap between the two lines, with gap potentially widening the longer the fund has been in operation. However even the effectiveness of this mandate can be impaired by employing an oversized Y axis, as in this case.

Figure 2



Source: Fund Manager

Professor Shefrin enlisted the help of Professor Edward Macquarrie of Santa Clara University to provide a marketing perspective on ESG investing. As set out in Part 2 all firms try to maximise the price at which they can sell their products. They do this using the strategies of branding and promotion as outlined by Professor Macquarrie below:

"**Branding:** The goal of brand marketing is to escape economic rationality. No brand manager wants to compete in an economic world where there is full information available to rational, self-interested consumers on all choice-relevant features of each good on offer.

The goal of a brand is not to be a commodity. A commodity is subject to perfect economic rationality: the lowest cost producer wins and profits are driven down to what that lowest cost producer can charge and make.

An index fund—the market portfolio--represents a commodity in the investment sphere.

A brand has no substitutes—it is not a commodity.

Branding is the art of finding uniqueness, differentiation—the not-commodity element. ESG can serve the branding purposes of a Morgan Stanley, Blackrock, etc. So can fundamental indexing or any other flavor of the month.

A brand, with no substitutes, can charge some premium over a commodity. The premium may not be economically justified, i.e., justified on the commodity properties of the offering. But if intangible value is delivered—affiliation, identity support, tribal membership, yada yada—a premium can be charged and the customer will willingly pay.

Promotion: "Sell the sizzle, not the steak." Now what does that mean?

Sell the signifier, not the substance. Sell the dream of savory deliciousness, not the mundane experience of chewing some animal protein for sustenance. Dreams are more powerful than facts.

Or as Charles Revlon put it: "In the factory we make cosmetics. In the store we sell hope.

Thus, I put my money into ESG investments. I am making a difference in the world. I have value because I contribute to a valuable cause.

Blackrock has value because they enable me to contribute value.

ESG facilitates branding. ESG helps brands promote themselves to investors."

Properly implementing an ESG strategy is near impossible in my view because virtually every stock and bond listed on financial markets has some relationship with products and companies unacceptable to ESG type people. Here is a good example of the problem: Earlier this month

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I suggested a client allocate some funds to a global bond ETF. She said "yes go ahead but please ensure that you have taken my aversion to armaments and petroleum companies into account and that I won't have any exposure to these industries via this fund." So I checked out the ESG policy of the fund and, predictably, it was all good – no exposure to bonds issued by companies operating in these sectors. But then I got to thinking – there was a 30% holding in US government bonds and, goodness me, the US government is the biggest spender on armaments in the world. The portfolio was full of lots of other government bonds issued by Western countries, all of which have huge defence budgets. Therefore, indirectly, this client would be spending some of her money on cluster munitions, nuclear bombs and himars to name but a few nasties. This example illustrates how pervasive and debilitating an ESG policy would be, if implemented properly i.e. not by a fund manager or local ESG expert who wants the client to feel good, pay the higher fees but not do things so rigorously that there is nothing to invest in. I haven't heard from the client since then – presumably she is in shock and thinking "oh dear, wtf". Bottom line is that a truly ESG compliant portfolio, i.e. one that actually does what it says it's supposed to do, is likely to be completely undiversified and might even be limited to putting your money under the bed. Even then there are probably ESG issues with that strategy I haven't thought of.

A pragmatic strategy for individuals concerned about climate change and the environment is to invest widely, ignore ESG marketing and make a difference without getting robbed by the finance sector by donating to organisations supporting environmental issues. That's what I tell my clients to do and that's what I do personally. It's also very rewarding to get outside every day and do something to rehabilitate the native bush.

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