STRIVE

The Fiduciary Focus

Investment News From a Pro-Shareholder Perspective

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This Week: BlackRock draws criticism for "fundamental errors" in new research piece; U.S. economy pulls away from Europe; An Eye on Energy discusses energy and inflation; and more.

BlackRock Draws Heat For "Fundamental Errors" In Paper Linking Diversity To Financial Return

Last week, BlackRock released new research entitled "Lifting Financial Performance by Investing in Women" claiming that firms with greater gender parity produced greater financial returns.

That same day, London Business School Finance Professor and ESG proponent Alex Edmans reviewed the piece and concluded the authors made "fundamental errors." These errors included "using dubious measures of financial performance (and switching between them, perhaps cherry-picking the ones that work), using dubious measures of gender diversity (and switching between them), and omitting basic controls."

For example, when trying to prove that firmwide diversity leads to better financial outcomes, the paper looks at return on assets (RoA)—a peculiar choice given that BlackRock shareholders make money based on shareholder return, not a firm's internal RoA. But when trying to prove that diversity in the middle management ranks leads to better financial outcomes, the paper switches to looking at total shareholder return over benchmarks, without providing any explanation for the switch. And in a third part of the study looking at the impact of promoting women, the authors switch measurements again, this time looking at alpha compared to the world market alone. The only logical conclusion for such switches is that the authors are searching to find metrics of financial performance that correlate with diversity; the other metrics are likely not disclosed because they did not produce BlackRock's desired result.

These concerns echoed those by another diversity advocate and London Business School faculty member Tom Gosling, who criticized the study for using misleading metrics of gender diversity. Specifically, BlackRock purports to find a "sweet spot" for corporations where the greatest gender parity—which one would presume to be closest to a 50/50 balance—leads to the greatest financial success. But the authors are not measuring female representation, or even whether companies are achieving gender parity. Instead, they are measuring whether a company is lagging or leading as compared to other companies, and finds that middle-of-the-pack companies are doing the best. But middle-of-the-pack companies tend to have only about 1/3 of their workforce as women, not 50%. As a result, the true conclusion of the study, according to Professor Gosling, is that "women are only helpful up to 1/3rd of the workforce and above that start being a drag on performance"—hardly the headline that BlackRock is trying to sell.

As Professor Edmans concludes, "the academic consensus (including that written by strong diversity advocates) is that the link [between diversity and financial performance] is mixed or negative." Indeed, BlackRock's current study comes on the heels of an academic piece published by University of Pennsylvania law school professor Jonathan Klick in late October showing that the market reacted favorably to the court ruling striking down a California law requiring racial and gender diversity on company boards, and that companies with the least diverse boards got the greatest boost.

BlackRock has not yet responded to the criticism.

Gap Between U.S. and European Economies Widening

The gap between the U.S. and European economies is widening, according to the Wall Street Journal.

The EU's gross domestic product dropped 0.4% annualized in the third quarter, compared to 4.9% annualized growth in the United States.

The Journal points to many factors contributing to the yawning gap, including skyrocketing energy prices across Europe that have dampened manufacturing and consumer spending. Many countries in the EU, including the UK and Germany, are grappling with whether to pull back on sustainability policies and even subsidize traditional fossil fuel production to lower energy prices for struggling industries and citizens.

The piece comes months after the Financial Times released an analysis showing EU companies lagging behind their U.S. counterparts in nearly every industry—from technology to education to energy to semiconductors, where the EU fell from enjoying a 40% market share to just 9% over the past three decades. The piece noted, unsurprisingly, that the one place where Europe remains a world leader is in regulation.

On that front, there is little doubt. Due to both cultural differences and formal regulation, European companies face significant pressure to prioritize other stakeholders, like suppliers, workers, and the environment, over shareholder profit—particularly compared to their U.S. peers. A 2022 McKinsey study, for example, showed that Europe far exceeds the U.S. on sustainability metrics like carbon emissions and inclusion metrics like the social progress index. This focus on climate and social fronts, however, has been accompanied by far slower economic growth. According to McKinsey, "Europe's per capita GDP is still some 30 percent lower than that of the United States," and "[f]orty percent of this gap is due to consciously different" choices on social issues.

Now, it appears that the impacts of these choices are being felt not only by shareholders, but by the European citizenry as a whole, as worries about the continent's sluggish economy mount and European living standards continue to fall.

Delta Chief Sustainability Officer Talks About Solving Climate Change And Social Justice, Not Shareholders

On Thursday, Delta Chief Sustainability Officer Amelia DeLuca spoke with the Wall Street Journal about Delta's sustainability efforts, with nary a mention of shareholders or any financial calculation of these efforts' supposed returns on investment.

During the interview, Ms. DeLuca touted the company's efforts to fight climate change and social injustices, including committing to reducing the company's carbon footprint and investing in diversity, equity, and inclusion efforts. She was also candid that these efforts were intended to promote other stakeholders, rather than company shareholders. When discussing Delta's net zero commitments, for example, she explained: "Two years ago, the net-zero commitments were made. Now, it's becoming a business imperative and the conversation is really: . . . How are you making this economically viable?" In other words, the climate commitment came first, and figuring out how Delta is going to pay for it came later.

In fairness, DeLuca did claim that Delta's pledge to transition to sustainable aviation fuel would help the company's bottom line because sustainable fuels are renewable, while fossil fuels are a "finite resource." But DeLuca failed to mention that sustainable fuels are up to eight times more expensive than conventional fuel and are expected to continue to be much more expensive even if the industry grows to meet aviation demand.

International Air Transport Association director general Willie Walsh recognized this reality last year, telling CNBC that moving to sustainable fuels would cause "a significant hike in the airline industry's cost base" that "ultimately, consumers will have to pay." Mr. Walsh said the trade group nonetheless supported the airlines' commitments to sustainable fuels because, "This is such an important issue [that consumers] will be willing to pay."

The gamble is one that the airline industry currently appears willing to take, despite the fact that aviation is a notoriously price-sensitive industry and consumers overwhelmingly indicate that price is the single most important factor when choosing flights. Along with Delta (which has committed to switching to 95% sustainable fuel by 2050), American Airlines has committed to 100% renewable fuel by 2046, and Southwest has committed to 10% renewables by 2030 and carbon neutrality by 2050.

"ESG Is Beyond Redemption," NYU Business Prof Says

"ESG is beyond redemption," NYU Stern School of Business Professor Aswath Damodaran wrote in the Financial Times last week.

At the company level, improving ESG doesn't increase their bottom line. "Consultants, trying to sell companies on their indispensability, assert that improving ESG increases value," he explained. "That assertion is false." Rather, academic research shows that "improving ESG makes scaling up more difficult, has little or no effect on profitability and is as likely to decrease value as increase it."

ESG fails at the investor level too: "Adding an ESG constraint to investing will lower expected returns, with the only question being how much, leaving fund managers who have fallen for its charms in a fiduciary bind."

And, according to Aswath, ESG isn't even good for society. On the "E" front, "ESG pressures have led publicly traded fossil fuel companies to reduce spending on exploration and to divest fossil fuel assets, but private equity has filled the investment void." On the "S" front, ESG advocates are "like pyromaniacs complaining about the fires around them" because they "chose to be arbiters of social good in a world divided on many issues [yet] protest that ESG has been politicised." And on "G" issues, the ESG movement's position is "puzzling" as "it replaces the original notion of corporate governance, where managers are accountable to shareholders, with one where managers are accountable to all stakeholders, effectively making them accountable to none of them."

Professor Aswath has been an early and vocal critic of the ESG movement, calling it "false advertising" to suggest that businesses that pursue ESG improvements will deliver greater returns. His seminal research on the issue—coauthored with UCLA business professor Bradford Cornell in *The Journal of Impact and ESG Investing* in 2020—found that ESG strategies did not lead to greater financial returns for either companies or investors. The authors concluded:

> The more that we have examined the arguments that advocates for ESG make for why companies should expand mission statements, and the evidence that they offer for the proposition, the more we are inclined to side with [the American economist Milton] Friedman [who advocated for shareholder primacy]. In our view, what is needed is an open, frank, and detailed dialogue concerning ESG-related corporate policies, with an acceptance that being good can add value at some companies and may destroy value at others, and that in the long term, investing in good companies can pay off during transition periods but will typically translate into lower returns in the long term.

Three years later, few seem to have heard the call.

An Eye On Energy

Energy and Inflation Expectations

Will geopolitical fear of an increase in energy prices and inflation lead to monetary tightening by the Federal Reserve?

Recently, there has been greater focus on whether central banks can use monetary policy to manage inflation expectations. The Federal Reserve (Fed) and Bank of England (BOE) remain committed to their goals of 2% inflation in parallel with maximum employment. But the "last mile" of returning inflation to target is considered the hardest.

On November 1, the Fed held interest rates at 5.25-5.5%, and the BOE held rates at 5.25% the following day. Core personal consumer expenditures (PCE) price index was at 3.7% year-on-year in September and headline PCE inflation was at 3.4%. In the UK, the twelve-month consumer price index (CPI) was at 6.7%. The Fed believes the core PCE index is a more accurate inflation indicator than the CPI, because the spending basket of goods used to calculate it is updated monthly, and considered a good reflection of consumer expenditure patterns.

As of today, the focus of both central banks is not on the spot oil price as they set interest rates. But they are paying attention to the risks. BOE Governor Andrew Bailey mentioned that the Israel-Gaza war poses inflation risk because the war's effect on energy markets could push inflation higher. According to some estimates, about 40% of oil is traded on the spot market, but the price of oil is highly visible. Its price changes and fluctuations are influenced by real-time data and forecasting information flows that are monitored daily by the public.

Could higher oil prices lead to monetary tightening by central banks?

Many believe that the price of oil will have less of an influence on inflationary trends because of investor confidence in the central bank's ability to manage expectations and respond to inflation risks. Chairman Powell said that despite elevated inflation, longer-term inflation expectations appeared to remain "well anchored." The BOE reiterated this message the next day. This was because central banks use inflation expectations as indicators that price increases are "anchored" consistently with their policy targets.

The conventional wisdom is that the Fed will not focus on spot energy prices as it sets rates and will remain focused on core inflation. High oil prices will not, on their own, force additional interest-rate increases, and any price changes would need to persist to impact central bank decision-making.

However, gasoline prices influence household expectations by more than their weight in consumption because the price is visible at gas stations. We believe that consumer inflation expectations will be affected more than in the past by oil and gasoline prices, because they will be highly visible, currently being linked to geopolitical events, and it is reasonable to assume that they will influence market sentiment.

If household and firms get used to sustained, higher inflation—above 3%—and adjust to these price shifts, how will they seek to make up for lost purchasing power and profits? While the answer is not totally clear, it could feed through to core inflation and cause the central banks to raise rates in response to higher energy prices.

The Best of the Rest

Additional stories about ESG investing, company happenings, and more.

- Consumer goods company Unilever commits to dropping social purpose and focusing on shareholders; "it turns out that Hellmann's mayonnaise is just something you dip your chips into, and not, as we were previously told, an eggy way of saving the world," the Telegraph reports.
- CCP cements control over finance, signaling commitment to security but undermining rhetoric of welcoming foreign investors; "Beijing wants to have market forces play an important role and to have better control over the financial system at the same time," Shanghai business school professor says. "But it is hard to have your cake and eat it too."
- ESG becomes point of contention in Kentucky's treasurer's race; Democrat Michael Bowman claims to "understand[] the intricacies of investments" while Republican Mark Metcalf vows to "defend Kentucky against the work interests that are trying to use our tax dollars and pension funds for political objectives."
- Two offshore wind projects canceled in blow to President Biden's green energy goals; European wind energy developer Orsted axed two projects off New Jersey's coast due to inflation, supply chain issues and rising interest rates rendering the projects economically unviable.
- Shell and BP balk at mergers and acquisitions, even as Exxon and Chevron pursue megamergers.
- Texas Instruments broke ground on second semiconductor plant in Utah; $11 billion facility is part of industry's efforts to expand manufacturing footprint in the United States.
- U.S. oil output reaches record levels; has now reached 13.1 million barrels per day.

Strive News

Late last month, Strive Co-Founder Anson Frericks debated Harvard Law Professor Robert Eccles on the merits of stakeholder capitalism.

The debate—hosted by the Center for Freedom and Western Civilization at Colgate University—centered on the ESG movement versus free market capitalism. It pitted Frericks, whom the Colgate Maroon-News described as a proponent of "absolute free-market decisions by investors and firms" against Eccles, an advocate for responsible business practices.

"A business should focus on the consumer, products and services . . . You're not going to be able to do that if you repeatedly get involved in issues that upset half of your consumer base," Frericks said.

According to the outlet, "Eccles conceded that it was largely not in the interest of companies for brands or CEOs to make political statements that could lose them consumers," but claimed that wasn't really what ESG is about. "ESG is not about trying to go from 90 to 95 on your DEI score," Eccles reportedly said, despite having conceded earlier that many pro-ESG bills are indeed pushing companies to focus on "sustainability and other non-profit-related goals."

The debate took place just days after Frericks debated former BlackRock executive and "ESG heretic" Tariq Fancy at the Financial Times's Moral Money Summit. In that debate, the outlet noted that the pair found surprising common ground. Specifically, the two agreed that anything that is financially material to a company's bottom line should be considered by management and investors, regardless of whether that financially-material risk relates to the environment, supply chain issues or otherwise. "If you actually talk about efficiency, you talk about margin enhancements, you talk about how we're using less resources, by definition that's going to actually increase your bottom line," Frericks said. "And I think that's what we need to start talking more of as it relates to ESG."

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Our research team conducts deep analysis of macro economic trends, market developments, and industry- and company-specific metrics to identify potential risks and opportunities for our clients. We then incorporate the results of this research into our engagement and voting strategy, and share it with our clients in the form of white papers and market research reports so they can make the most educated investment decisions possible.

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