ESG or ESV: Implications for Firm Structure

At the core of all investment-related activities is the theory of the firm, that is, the firm's raison d'être (literally "reason to be"). Like fish in water not recognizing they are in water, the theory of the firm lies at the heart of financial management and is often quickly passed over. From running a startup to managing the largest pension plan, the theory of the firm is foundational to whether economic systems result in human flourishing or human destruction. Two mutually exclusive theories of the firm are reviewed, environmental, social, and governance (ESG)-based and enhancing shareholder value (ESV)-based. We note two distinct firm structures that are drawn from these theories.

A link is explored between the typical wealth managers' crafting of their views on market direction rather than the focus on their clients' needs for justifying the abandoning of the ESV-basis for the theory of the firm. Finally, the biblical foundation for firm structure is briefly introduced. The goal is to better understand how a firm's pivot away from being ESV-based to ESG-based affects investment management decisions.

Investment Management Foundation

Before exploring the impact of the theory of the firm on investment management, a few definitions with supporting explanations are in order. *Caution*: The power to define is the power to destroy. Thus, if you strongly disagree with subsequent arguments, most likely our disagreement rests with the definitions proposed here.

Enhancing Shareholder Value (ESV)-Based Theory of the Firm

Since my formal academic finance training started in the late-1970s, the goal of the firm was clear. In a popular textbook, Ross, Westerfield, and Jaffe assert,

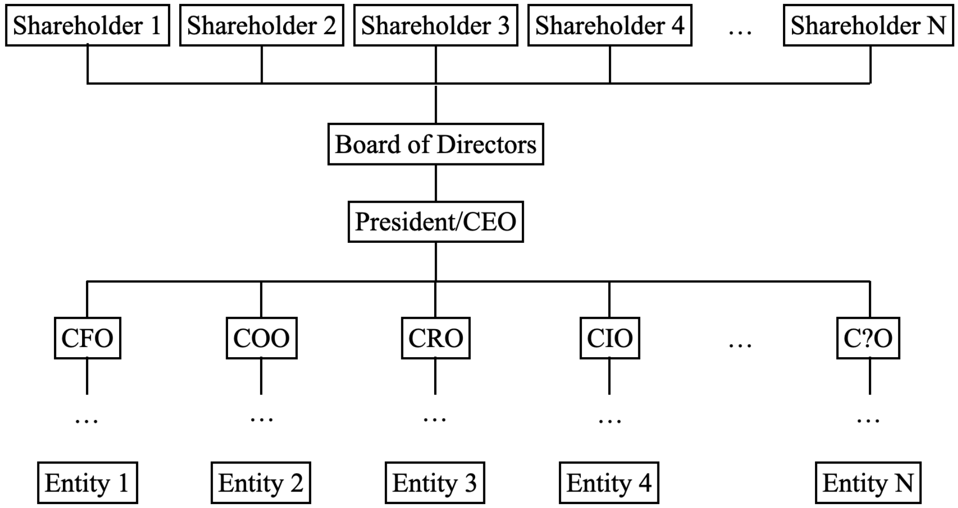
"*The goal of financial management is to maximize the current value of the existing stock.*"

(Italics mine.) They further assert, "(t)there is no ambiguity in the criterion. There is no short-run versus long-run issue or safe versus risky issue. We explicitly mean that our goal is to maximize the *current* stock value. … By maximizing stock value, managers can also make the firm's other investors and stakeholders better off. This occurs because the stockholders in a firm are residual owners. By this we mean that they are entitled only to what is left after employees, suppliers, and creditors (and everyone else with legitimate claims) are paid what they are due." [1]

ESV-based firms enjoy a coherent organizational structure as illustrated in Figure 1. Shareholders elect a board of directors whose fiduciary duty is to represent shareholder interests. The board of directors oversee the President/CEO who manages various other C-suite executives, and they manage various aspects of the firm. The "Entities" illustrated include the various groups with an interest in the firm's activities including employees, suppliers, customers, regulators, creditors, and members of related communities.

[1]Stephen A. Ross, Randolph W. Westerfield, and Jeffrey Jaffe, *Corporate Finance* 13th Edition (McGraw-Hill Irwin, New York: 2021), p. 12.

Figure 1. Coherent structure of ESV-focused firms



It is important to note that since worldviews are mutually exclusive and the Christian worldview is correspondent, it is not surprising that boards of directors and C-Suite executives seeking to run their firms closely aligned with the Christian worldview do in fact enhance shareholder value. Obviously, original sin, its consequences, and the resulting fallen world makes managing firms a continuous struggle.

> ***Genesis 3:17b-19*** *17b "Cursed is the ground because of you; through painful toil you will eat*
> *food from it all the days of your life.* ***18****It will produce thorns and thistles for you, and you*
> *will eat the plants of the field.* ***19****By the sweat of your brow you will eat your food until you*
> *return to the ground, since from it you were taken; for dust you are and to dust you will*
> *return." (ESV)*

Environmental, Social, and Governance (ESG)-Based Theory of the Firm

Since my formal academic finance training began, the importance of the firm behaving ethically and legally has been clear. Historically, the worst environmental entities with little concern of social issues and egregious governance have existed in countries most hostile to the Christian worldview. Although no authoritative source could be found, from an ESG-based perspective, the following theory of the firm is asserted.

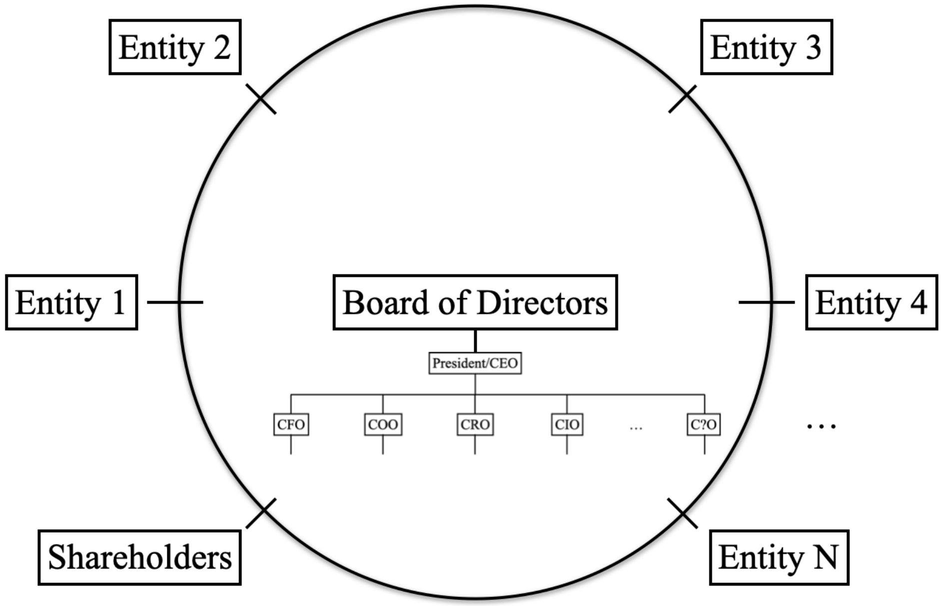
The goal of financial management is to do good things.

The ambiguity of the doing "good things" mandate results in irresolvable conflicts. The ESG effort seeks to make all stakeholders pari-passu (on equal footing) much akin to statist-based political systems (e.g., communism and socialism). The ESG goal appears to equally share the firm's resources among all entities. Thus, shareholders are on equal footing with employees, suppliers, customers, regulators, creditors, and members of related communities. Every entity is entitled to share any residual claim.

ESG-based firms have an incoherent organizational structure as illustrated in Figure 2. Shareholders are just one of many entities that influence the selection of a board of directors whose duty is to be sure the firm is doing "good things." Again, the board of directors oversee the

President/CEO who manages various other C-suite executives, and they manage various aspects of the firm. Somehow firm managers seek to satisfy the interest of all the various entities by doing the "good things" as defined by each entity. Each entity has a different definition of what it means to be doing "good things," hence, incoherence is the only possible result.

Figure 2. Incoherent structure of ESG-focused firms



When transitioning away from ESV-based to ESG-based, the firm's management team seeks to reallocate shareholder value to other stakeholders based on some yet-to-be determined reallocation scheme. This is a clear breach of fiduciary duty through denigrated shareholder property rights. The following statements appear to support the move to the incoherent ESG-based corporate structure.

> *"Behaviors are going to have to change and this is one thing we are asking companies, you have to force behaviors and at BlackRock, we are forcing behaviors," Larry Fink, CEO, BlackRock, The New York Times: DealBook 2017.*

> *"By giving stakeholder capitalism concrete meaning, they* [business leaders] *can move beyond their legal obligations and uphold their duty to society* [doing good things]. *They can bring the world closer to achieving shared goals, … If they really want to leave their mark on the world, there is no alternative." Klaus Schwab, "Why We Need the 'Davos Manifesto' for a Better Kind of Capitalism," World Economic Forum, December 1, 2019.*

> *"Capitalism as we have known it is dead. This obsession we have with maximizing profits for shareholders alone has led to incredible inequality and a planetary emergency." Marc Benioff at the "Stakeholder Capitalism: What Is Required from Corporate Leadership?" session, 2020.*

Logical Definitional Consequences
Without clear definitions as given above, ESG-focused individuals and ESV-focused individuals will be talking past each other. ESG folks will argue that ESG implies ESV whereas ESV folks will argue that ESV implies ESG.

With the clear definitions given above, we can easily see that either a firm must be ESV-based or the firm must be ESG-based.[2] It is logically impossible to have both a coherent and incoherent organizational structure. This mutually exclusive result negates the possibility of satisfying both approaches. Obviously, in practice, an ESV-based organization can be sensitive to some ESG-based activity for doing "good things," but it is a very short journey to a direct breach of the board of directors' fiduciary duty.

Investment Management Implications
The investment management industry has many professionals serving various needs. A wealth manager and a client are illustrated here. One well known crack in the investment management's foundation is illustrated that perhaps is responsible in part for the discord between a firm being ESG-based or ESV-based.

The wealth manager often has fiduciary relationship with the client. "A fiduciary is someone who manages money or property for someone else. When you are named a fiduciary, you are required by law to manage the person's money and property for their benefit, not yours."[3] A fiduciary is held to very high standards of conduct. Key to understanding a fiduciary's obligation is that the fiduciary must act only in the investor's best interest—decisions should be best for the investor, not necessarily best for the manager or anyone else. Fiduciaries have a duty of care where they must manage resources carefully, keep investor's funds separated from the managers, and keep accurate records.

Clients have their own needs and objectives when they retain a wealth manager. Business creators also have their own needs and objectives when they seek investment capital. The wealth manager intermediates in some way between clients and business entrepreneurs.

A wealth manager's fiduciary duty requires focusing on the needs of the client. Often the client's explicit or implicit liabilities drive portfolio design. For example, the client's expected cash outflows after retirement often drive the wealth manager's recommended asset allocation. Termed liability-driven investing, the client's portfolio is constructed such that the investment portfolio's value changes with the present value of these liabilities (termed pseudo-liabilities). The overarching goal is to maximize the likelihood that the client's cash outflow requirements are easily met. The key insight is that the wealth manager is seeking to maximize the probability that the client succeeds on the client's stated mission. Due to the nature of fiduciary duty, all other potential missions, such as doing "good things," are subservient to the client's mission.

Unfortunately, modern investment managers have often abandoned the client's needs in favor of view-driven portfolio construction regardless of the client's objectives and constraints. Thus, many wealth managers focus on market analytics, such as fundamental analysis, technical analysis, and even AI-based predictive decision-making, all to identify discrepancies between the

[2] We side-step the obvious logical possibility of other the firm structures.
[3] See https://www.consumerfinance.gov/ask-cfpb/what-is-a-fiduciary-en-1769/.

observable market price and the unobservable "fair value." The risk of client portfolios is solely market-based rather than needs-based (i.e., incorporating the client's pseudo-liabilities).

Interestingly, wealth managers' performance is often solely focused on asset returns relative to some pre-stated market benchmark, such as the S&P 500 total return index. It is easy to demonstrate that a wealth manager can outperform some stated benchmark—although few are able to do it long term—and still reduce the likelihood of the client succeeding on the client's mission. For example, if the benchmark is down 20% and the wealth manager's fund is only down 15% the consequence may be that the client's daughter can no longer afford to go to college. In a questionnaire, the client may easily assert that they are aggressive in financial risk taking, not realizing that it may result in the failure of the client's mission.

Thus, even with modern technology, much of the wealth management industry could be improved through a more needs-driven approach. The discrepancy between modern view-driven investment management practice and the more appropriate needs-driven investment management practice is a foundational breach creating an opening for the statist-oriented ESG over the liberty-oriented ESV. Any valued fiduciary should be following age old wisdom.

> ***Matthew 7:12*** *So in everything, do to others what you would have them do to you, for this sums up the Law and the Prophets. (ESV)*

In sum, the Christian worldview appears to better support a more needs-driven approach to wealth management, especially given the extreme difficulty of economic forecasting. Further, there is emerging empirical evidence that ESV-based companies serve their shareholders better than ESG-based companies.[4]

One solution to the current confusion related to the theory of the firm is for ESG-focused companies to change their corporate charter (C corporation) to a public benefit corporation. Thus, shareholders can clearly choose between ESV-focused companies and ESG-focused companies. For example, Coursera (COUR) is a Delaware public benefit corporation and as such are no longer bound to the fiduciary duty to solely serve shareholders. One would expect ESG-focused investors to be attracted to Coursera and ESV-focused investors to screen out Coursera and other public benefit corporations from their set of investable stocks.

Biblical Basis for ESV

The foundation for the hierarchical structure within the ESV-based theory of the firm mirrors the structure found in the Bible.

> ***Psalm 24: 1-4, 10*** ***1****The earth is the Lord's, and everything in it, the world, and all who live in it;* ***2****for he founded it on the seas and established it on the waters.* ***3****Who may ascend the mountain of the Lord? Who may stand in his holy place?* ***4****The one who has clean hands and a pure heart, who does not trust in an idol or swear by a false god. …* ***10****Who is he, this King of glory? The Lord Almighty—he is the King of glory. (ESV)*

[4]See, for example, https://www.wsj.com/articles/is-esg-profitable-the-numbers-dont-lie-benchmarks-analytics-politics-neutral-fiduciary-duty-market-woke-5da4a533?mod=Searchresults_pos1&page=1.

Thus, from creation, God is the owner of everything, including financial instruments. Further, there is ample evidence of a God-orchestrated hierarchical structure. Adam and Eve were to serve in a fiduciary capacity to manage God's resources in a prescribed manner complete with responsibilities and restrictions. In many respects, it is the fact of human's being created in God's image (Latin: imago dei) that separates an ESV-focus and an ESG-focus. Absent imago dei, then hierarchy is lost and there is no rational basis for anything, including a firm's organizational structure.

> ***Genesis 1:26-28*** **26***Then God said, "Let us make man in our image, after our likeness. And let them have dominion over the fish of the sea and over the birds of the heavens and over the livestock and over all the earth and over every creeping thing that creeps on the earth."* **27***So God created man in his own image, in the image of God he created him; male and female he created them.* **28***And God blessed them. And God said to them, "Be fruitful and multiply and fill the earth and subdue it, and have dominion over the fish of the sea and over the birds of the heavens and over every living thing that moves on the earth."*

Interestingly, Adam and Eve sought to be pari-passu with God regarding moral knowledge and committed the original sin that saturates all of us. Thus, it appears that the desire to move away from a hierarchical structure is nearly as old as humans.

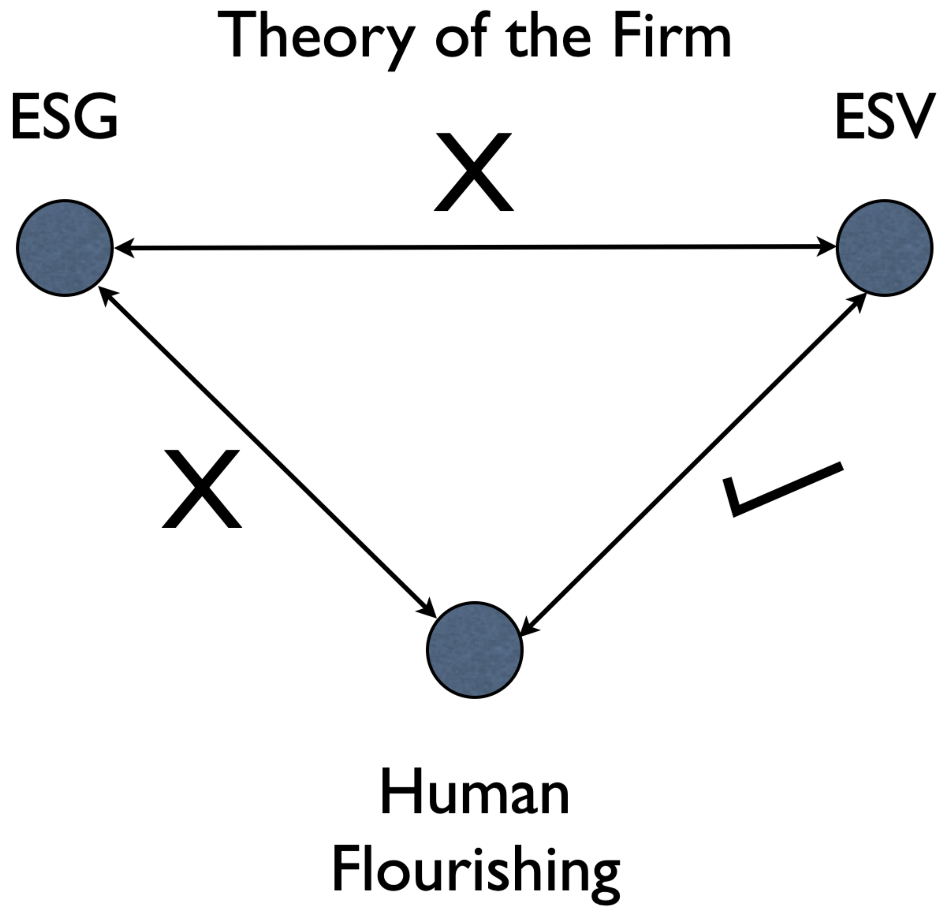
Finally, recall the eighth commandment given to Moses, "You shalt not steal." (Exodus 20:15). Business leaders' redistribution of shareholder wealth to other entities based on an ESG focus steals future earnings from those who seek to be faithful and responsible stewards. This wealth loss directly results in the lower likelihood of meeting critical future needs.

Conclusion

We need to bring clarity to the raging debate between ESV-focus and ESG-focus as the firm's raison d'être. We have seen here two mutually exclusive theories of the firm, ESG-based and ESV-based, were explored. Further, the potential biblical foundation was highlighted for selected presuppositions in support of an ESV-focus. The goal here was to better understand how a firm's pivoting away from ESV toward ESG affects investment management decisions.

Figure 3 illustrates the contrast between ESG-based and ESV-based theories of the firm. ESG-based approach is inconsistent (X) with human flourishing as it ultimately seeks a non-hierarchical firm organizational structure. Clearly, a firm cannot ultimately be ESV-based and ESG-based (X) as they are mutually exclusive in hierarchical structure. Finally, the traditional ESV-based approach has resulted in phenomenal human flourishing through economic growth (✓).

Figure 3. Two Basis for the Theory of the Firm: One Coherent and One Incoherent



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