DOI: 10.1111/jacf.12609

Journal of APPLIED CORPORATE FINANCE

ORIGINAL ARTICLE

Rational sustainability

Alex Edmans

London Business School, CEPR, and ECGI, London, UK

Correspondence
Alex Edmans, London Business School, CEPR, and ECGI, London, UK.
Email: aedmans@london.edu

I thank Russell Chaplin and Chris Miller-Jones of Europa Capital for a discussion that sparked the term "Rational Sustainability," and the Editor Don Chew, many readers, and numerous conference attendees for helpful comments.

INTRODUCTION

ESG is under attack from all sides. Opponents object to the incorporation of environmental, social, and governance ("ESG") issues in investment decisions, arguing that it allows fund managers to pursue their own agendas at the expense of client returns. Proposed solutions range from disinvesting from ESG funds to banning ESG outright. In January 2024, Republican lawmakers in New Hampshire introduced a bill to prohibit the state from investing in funds that consider ESG factors; violation would be a felony punishable by up to 20 years in prison.

Supporters range from true believers, who view ESG as a surefire way to achieve both financial returns and social impact, to opportunists who saw ESG – at least historically – as a means to exploit a bubble. Asset managers launched ESG funds; companies courted capital, customers, and colleagues by touting their ESG credentials; and authors, influencers, and professors reinvented themselves as ESG experts even if they never previously cared for the topic. But both true believers and opportunists are recognizing the shifting sands – the former are ploughing ahead but calling it something different; the latter are reversing course and looking for the next fad. In June 2023, BlackRock's Larry Fink, a previously outspoken ESG supporter, announced that he'd no longer use the ESG term because it had become "weaponized," but not change his actual stance. A January 2024 *Financial Times* article noted that just six funds citing ESG factors launched in the second half of 2023, as compared with 55 in the first half.[1] On the same day, the *Wall Street Journal* dubbed ESG "the latest dirty word in Corporate America."[2]

Alongside the true believers and opportunists lies a third group of supporters. They believe that the *practice* of integrating some – but not all – ESG factors, can create value, but the *term* "ESG" has several problems. In a 2023 article entitled "The End of ESG," I argued that ESG is "extremely important" because it is critical to long-term value and thus should be of interest to anyone, but the term "ESG" implies that it's niche. I also claimed that it is "nothing special" compared to other intangible assets such as productivity, innovation, and culture, but the term "ESG" puts it on a pedestal.[3] This is far more than a semantic issue since the term ends up affecting the practice; the "incorporation" of environmental, social, and governance factors sometimes morphs into their "prioritization" or "exclusive consideration." Some companies allocate capital to initiatives that can be labelled ESG over those that might create more long-term value, or make misguided decisions designed to improve ESG metrics even when they are not material to the business. Some investors buy a stock that satisfies ESG criteria with little regard for its price, or automatically vote against the appointment of a new director if it does not achieve their board diversity target, irrespective of that director's other credentials. Some clients pile into funds marketed as ESG irrespective of their actual performance. On the flipside, ESG skeptics have an allergic reaction to funds labelled "ESG" even when the funds use ESG for purely financial goals.

"The End of ESG" was the first in a series of three 2023 articles I wrote to address the problems with ESG. In that first one, I advocated that the ESG *practice* become both more mainstream and more nuanced.[4] In the second, I argued that the *term* itself should be scrapped.[5] And in the third, I highlighted yet another issue: the tendency of the term "ESG" be replace clear-headed thinking by

[1] Schmitt, Will. 2024. "Launches of ESG Funds Plummet as Investors Pull Back." *Financial Times*, January 9, 2024.

[2] Cutter, Chip and Emily Glazer. 2024. "The Latest Dirty Word in Corporate America: ESG." *Wall Street Journal*, January 9, 2024.

[3] Edmans, Alex. 2023. "The End of ESG." *Financial Management* 52, 3–17.

[4] Edmans, Alex. 2023. "The End of ESG." *Financial Management* 52, 3–17.

[5] Edmans, Alex. 2023. "A Progressive's Case for Getting Rid of 'ESG'." *Wall Street Journal*, August 19, 2023.

implying that it's somehow different from mainstream business.[6] As a result of this tendency, investors and corporate managers are misled into thinking that the insights from decades of research don't apply and resort to "gut feel" when practicing ESG.

But if we scrap ESG, what do we replace it with? Retiring the term without changing the practice fails to address the many legitimate concerns about ESG. Abandoning the practice entirely will throw the baby out with the bathwater and lose the many benefits of considering ESG factors in corporate and investment decisions. In "The End of ESG" I suggested that we replace the term with either "long-term value" or "intangible assets," but neither term is perfect. ESG supporters argue that, even though in theory "long-term value" should lead us to consider any relevant factor, including ESG, in practice we may not, and "ESG" usefully reminds us to do so. "Intangible assets" has the virtue of directing us to look beyond tangible factors to create value, but we may only think to study brand and innovation rather than a company's impact on the environment and communities. A separate issue is that practitioners typically consider intangible assets only for financial reasons, but ESG may be pursued for social objectives.

This article proposes the term and practice of "Rational Sustainability" as an alternative to ESG. "Sustainability" refers to the goal: creating sustainable, long-term value, which is relevant to all job functions and political beliefs. It considers all factors that create value, regardless of whether they fall under an ESG label, and deprioritizes immaterial factors even if they can be called ESG. "Rational" refers to the approach: it recognizes diminishing returns and trade-offs; it is based on evidence and analysis; it questions many widespread sustainability conventions and practices rather than following the herd; and it guards against being caught up in irrational sustainability bubbles.[7]

Rational Sustainability is not about putting old wine in new bottles; it is about a fundamental shift in the way sustainability is practiced, not just labelled. It has ten features, the first five focusing on "sustainability" and the second five on "rational":

1. Rational Sustainability is About Value Creation, not Politics.
2. Rational Sustainability is About Outcomes, not Labels.
3. Rational Sustainability is Intrinsic, not Instrumental.
4. Rational Sustainability is Core, not Peripheral.
5. Rational Sustainability is Enabling, not Prescriptive.
6. Rational Sustainability Builds on Evidence and Analysis.
7. Rational Sustainability Recognizes Diminishing Returns and Trade-Offs.
8. Rational Sustainability Sets Boundaries.
9. Rational Sustainability Guards Against Irrationality.
10. Rational Sustainability Challenges and Questions.

I now go through these 10 features in turn.

[6] Edmans, Alex. 2023. "Applying Economics – Not Gut Feel – to ESG." *Financial Analysts Journal* 79: 16–29.

[7] Over time, the term "rational" will hopefully not be needed; even now, I am not advocating for "Rational Sustainability" to be in a job title or fund name. Instead, the term "rational" is to stress the importance of approaching sustainability in a rational way and guard against the irrationalities in current practice. By analogy, "enlightened shareholder value" highlights the need to invest in stakeholders to pursue shareholder value, even though it would be an overreach for someone to call themselves "enlightened" for doing this.

RATIONAL SUSTAINABILITY

Rational sustainability is about value creation, not politics

The goal of Rational Sustainability is to create sustainable – that is, long-term – value. Creating sustainable profits, companies, economies, and societies should be of interest to everyone, irrespective of their job title, their political persuasion, or their age. In contrast, ESG is widely seen as being of interest only to ESG executives, those on the left, and the young. It is surprising that some Republicans wish to ban ESG on the grounds that they are the party of big business, when considering environmental, social and governance factors can help companies become more successful, more profitable, and more innovative.

ESG, at its core, is the expansion of an investor's information set to incorporate environmental, social, and governance factors. Increasing information should never make an investor worse off, as it can be discarded if it has no value.[8] It is true that ESG is sometimes used to pursue different objectives, such as ticking ESG boxes as Principle #2 will discuss. However, ESG can instead be used to pursue the same objective (value creation) in a more informed manner. There should be no controversy about investors using more information.

In my second 2023 article, "Applying Economics – Not Gut Feel – To ESG," I argued that the term "ESG" has become so politicized that it prevents clear-headed thinking; as a result, we sometimes need to remove it from a sentence and evaluate what remains in order to make logical assessments. Some critics argue that considering ESG risks is inconsistent with fiduciary duty, but this is illogical since considering risks is an essential part of fiduciary duty. Such politicization is unlikely to be the case with sustainability, because "sustainable" simply means "long-term." Lawmakers are unlikely to seek to punish the consideration of sustainability risks with 20 years in prison, and are even less likely to ban the consideration of long-term risks or rationality.

In my book *Grow the Pie*,[9] I argued that the term "sustainable" is so uncontroversial that it is somewhat bland; almost all companies seek to be sustainable.[10] I wrote that "a stakeholder-focused company is often described as 'sustainable,' but 'sustainable' simply means 'long-term.' ESV [Enlightened Shareholder Value, the pursuit of purely financial goals] could be called 'sustainable' as it also takes a long-term approach, albeit to maximize profits rather than social value. We'll thus not use 'sustainable' in this book."

But I wrote all that *before* the recent politicization of ESG, and I've had to update my view. Advocates and critics have become so caught up in cheerleading and criticizing ESG, or scoring points against the other side, that they've lost sight of the shared

[8] I write "should" never make an investor worse off rather than "can" since information can make an investor worse off if used incorrectly. This explains the "rational" component of Rational Sustainability.

[9] Edmans, Alex. 2020. *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*. Cambridge University Press.

[10] Even if executives want their companies to be sustainable, this may not be optimal for society. For example, a company set up to make face masks in the onset of the COVID-19 crisis should shut down after the pandemic was over, if there was insufficient demand for its masks for other purposes. More generally, Schumpeter's notion of "creative destruction" argues that it is socially optimal for companies to close if their products and services are no longer in demand.

goal – to create long-term value. Today's environment calls for a bland term that goes back to basics.

Rational sustainability is about outcomes, not labels

The current practice of ESG gives special status to something just because it can be called ESG. ESG funds attract inflows even if not justified by performance; business schools boost their league table ranking by reporting more hours of ESG teaching; some investors, employees and customers put more weight on a company's ESG claims than delivering great returns, being a great place to work, or offering great products.

Certain ESG advocates argue that the label should be expanded so that more activities can get credit. Some enlarge it to "EESG," with an extra E for Employees as they are too important to be considered a subset of S;[11] others argue that any extra E should stand for Equity.[12] When I was a panelist at an ESG conference, an audience member questioned why we were using such an outdated term and advocated BESG given the importance of biodiversity. Companies may end up in an arms' race to add letters and move to BEEESG, just as some organizations focus more on expanding LGBT to LGBTQIA2S+ rather than actually being inclusive.

Such labeling can mask the lack of action. In a recent working paper, three economists calculate that, despite the supposed surge of ESG investing, ESG-related portfolio tilts represented only 6% of the investment industry's total assets in 2021.[13] A 2005 *Journal of Finance* article found that, when a mutual fund changes its name to reflect a current "hot" style, it enjoyed 28% extra inflows despite no improvement in performance and irrespective of whether its holdings match its new name.[14]

Rational Sustainability is concerned with outcomes, not labels. The goal of sustainability is to create long-term value; a fund that adds "ESG" to its name without changing its holdings or engagement approach is not investing more sustainably. A fund that adds ESG to its name *and* changes its holdings is also not investing more sustainably if those actions do not enhance long-term returns.[15]

Rational Sustainability also both widens and focuses our perspective. It widens our perspective by stressing the need to consider any factor that creates sustainable value, even if it does not fall under an ESG label – such as productivity, innovation and culture. It focuses our perspective by cautioning against pursuing a factor simply because it falls under the ESG umbrella, if it does not create sustainable value. Yet Rational Sustainability may be superior to "long-term value", as the inclusion of "sustainability" highlights the need to consider societal factors that may have otherwise been overlooked.

[11] https://www.responsiblebusiness2030.com/its-all-about-the-culture/what-do-we-mean-by-eesg-metrics/.

[12] https://www.rsm.global/southafrica/insights/risk-advisory-insights/moving-esg-eesg.

[13] Pastor, Lubos, Robert F. Stambaugh and Lucian A. Taylor. 2024. "Green Tilts." Working Paper, University of Chicago.

[14] See Cooper, Michael J., Huseyin Gulen, and P. Raghavendra Rau. 2005. "Changing Names With Style: Mutual Fund Name Changes And Their Effects On Fund Flows." *Journal of Finance* 60: 2825–58. While the study is on investment styles in general, such as value and growth, the insights likely also apply to ESG. Another *Journal of Finance* article found that higher fund sustainability ratings led to significantly higher fund inflows. See Hartzmark, Samuel M. and Abigail B. Sussman. 2019. "Do Investors Value Sustainability? A Natural Experiment Examining Ranking And Fund Flows." *Journal of Finance* 2789–837.

[15] As discussed later in this article, these may be financial or social returns.

Rational sustainability is intrinsic, not instrumental

Why is there such a focus on labels? One reason is that there are instrumental benefits from being called ESG – funds enjoy inflows and companies attract customers. What matters is not so much doing ESG but being seen to do so.

Companies should instead ask themselves: "If you couldn't tell anyone you were doing it, would you still do it?" The answer might be "No" for many ESG initiatives, since their only benefit is instrumental. In contrast, a word that is often paired with "sustain" is "self"; we have self-sustaining organizations, ecosystems, populations, and organisms. Sustainability is pursued for intrinsic reasons – that is, because it's good for you. It allows organizations, ecosystems, populations, and organisms to thrive for decades, even centuries.

An instrumental approach to ESG undermines one of its key rationales. In theory, there should be no need for the ESG acronym to have ever been coined. Executives should know to invest in anything – including ESG – that ultimately creates long-term value, just as they'd improve a company's productivity, innovation, and culture, even though there's no PIC acronym. However, one rationale for ESG is that the financial benefits of ESG (unlike PIC) are hard to predict, no matter how far-sighted the executive. An explicit ESG objective could encourage an executive to make an investment because of its ESG benefits, and those benefits ultimately manifest in financial returns. But because these returns were difficult to forecast, financial considerations alone might not have justified the investment.[16] For example, Vodafone launched the mobile money service M-Pesa in 2007 for the social return from improving financial inclusion in Kenya, but was later able to turn this into a financial return by charging a small percentage of every transaction.

If instead ESG is pursued for instrumental reasons, this narrows the freedom that ESG provides. M-Pesa does not improve any of the common ESG metrics that companies are scored on, such as carbon emissions, water usage, CEO-to-worker pay ratio, or gender diversity. It would have never been sanctioned under an instrumental approach to ESG. Sustainability frees a company to create long-term value, irrespective of whether it will get a gold star for doing so.

Rational sustainability is core, not peripheral

Generating long-term, sustainable value is widely accepted as being the core function of business. Finance 101 teaches us that shareholder value is the present value of *all future* cash flows; any business decision should be evaluated by its long-term consequences. Sustainability is thus the responsibility of every executive within a company, irrespective of your job title.

[16] Edmans. 2020. *Grow the Pie*.

In contrast, ESG is often viewed as a peripheral cost center. In some asset management firms, the investment team focuses on forecasting long-term cash flows; ESG is a side analysis done by a separate team so that they can tell clients they are "doing ESG." They then hire "ESG integration" specialists to force fund managers to have at least a cursory glance at the ESG analysis rather than reaching for the bin. Sustainability recognizes the criticality of analyzing a company's impact on society, because many of those impacts will ultimately feedback and affect its profits. The analysis may still be conducted by a separate department given its specialist nature, and there may still be integration professionals given the expertise required, but such analyses are eagerly welcomed and would still be even if the fund managers could not tell their clients.

A word often used interchangeably with "sustainability" and "ESG" is "purpose," which I advocated in *Grow the Pie*. I continue to strongly believe in the power of purpose to generate financial and social value. However, at least as commonly practiced, "purpose" has been reduced to a slogan; the branding team comes up with a snappy-sounding purpose that has little effect on a company's decisions. Fund manager Terry Smith famously criticized Unilever for coming up with a "purpose" for mayonnaise when it is nothing more highbrow than salads and sandwiches. Ben & Jerry's claims that "we believe that ice cream can change the world" but it is unclear whether executives truly believe this and, if they did, how it would affect any corporate decision. If so, purpose has no purpose.

Rational sustainability is enabling, not prescriptive

I've referred to the goal of sustainability as "long-term value," but been deliberately vague about what this value is. Is it purely financial value, or does it include social value? And if it does, which societal objectives, and how much financial value should you be willing to sacrifice for them?

In "The End of ESG," I argued that ESG investing is often just investing, because an investor should consider all factors relevant for generating long-term returns, both ESG and non-ESG. However, I acknowledged that one way in which ESG investing is *not* investing is that investors may have non-financial objectives, such as reducing negative externalities and creating positive externalities. Rational Sustainability allows for such non-financial goals. The value that it creates can be a mix of financial and social value, and thus it fully accommodates investors' willingness to sacrifice the former for the latter. However, Rational Sustainability differs from ESG in three ways.

First, any societal objectives are pursued in a sustainable way: the goal is a mix of *long-term* financial and social value. Targeting diversity, equity, and inclusion (DEI) by hiring minorities irrespective of their ability may improve a company's short-term DEI statistics, but backfire in the long term as those hires do not succeed and leave. The company itself suffers worse performance, hindering its ability to hire in the future. Thus, workers also lose out.

Second, any societal objectives are pursued in a rational way. This involves recognizing diminishing returns and trade-offs, as Principle #7 will discuss in more detail. These trade-offs include trade-offs with financial returns. It can still be entirely rational to operate in the zone of diminishing – even negative – financial returns because financial returns are not investors' only objective. However, investors should be aware of the trade-offs so that they understand the financial sacrifice that they are making.[17] The trade-offs also include those with other societal returns, such as the fact that rapid decarbonization may lead to a significant loss of jobs. Rationality also involves using evidence to inform the strategies that are most effective in creating social returns, rather than (for example) divesting from all emitting companies because gut feel suggests that it would be effective.[18]

Third, Rational Sustainability emphasizes the need to be explicit about any non-financial objectives. To achieve long-term goals, you need to state what those goals are. Internally, it clarifies what employees should aim for; externally, it brings transparency and allows customers to go somewhere else if they're not aligned. A fund may choose to sacrifice financial returns to address climate change, but it needs to make this sacrifice clear in its prospectus rather than claiming that everything's a win-win. Otherwise, if the fund ends up underperforming, clients may withdraw their money as they were promised outperformance.

The above consideration also guards against the risk of becoming an "ESG Chameleon." Some ESG advocates promote ESG based on claims that ESG improves financial performance, often backed up by flimsy research parading correlations between ESG and stock returns. When this research has subsequently been shown to be flawed due to data mining, omitted variables, or sample selection issues, they sometimes respond "well that was never the motive for ESG anyway; it was to save the world." When evidence is presented suggesting that ESG's social and environmental impact is limited,[19] they sometimes respond, "but the reason for ESG is to invest in companies that reflect our values." Rational Sustainability highlights the importance of being clear about one's objective.[20]

The permissiveness of Rational Sustainability highlights that the definition of "long-term value" is an area about which there *can* be legitimate disagreement between Republicans and Democrats, and that some politicization cannot be avoided. Republicans might define long-term value as exclusively financial value, while Democrats may argue that it should also include social value. There may also be legitimate disagreement about which social objectives should be included and their relative importance. However, there should be less disagreement that,

[17] For example, assume the investor's objective places 50% weight on financial returns and 50% on social returns. Investment A yields financial returns of 10 and social returns of 0, investment B yields 6 of each, and investment C yields financial returns of 0 and social returns of 10. Choosing B over A is fully rational, even though it sacrifices financial returns, as the investor's utility rises from $50\% \times 10 = 5$ to $50\% \times 6 + 50\% \times 6 = 6$. However, choosing C over A is irrational since the investor's utility is 5. The loss of financial returns outweighs the gain in social returns.

[18] See Edmans, Alex, Doron Levit, and Jan Schneemeier. 2023. "Socially Responsible Divestment." Working Paper, London Business School and Hartzmark, Samuel M. and Kelly Shue. 2023. "Counterproductive Sustainable Investing: The Impact Elasticity of Brown and Green Firms." Working Paper, Boston College.

[19] For surveys on this point, see Gosling, Tom. 2024. "Universal Owners and Climate Change." Working Paper, London Business School and Kölbel, Julian, Florian Heeb, Falko Paetzold, and Timo Busch. 2020. "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact." *Organization & Environment* 33, 554–74.

[20] Investors can, of course, change their objective over time in the light of evidence. However, ESG Chameleons suggest that their revised objective was always their objective all along.

whatever objectives are chosen, they should be pursued in a rational and sustainable manner.

Rational sustainability builds on evidence and analysis

The next five principles highlight the key features of "rational" sustainability. In theory, there should be no need for such emphasis because people should always act rationally – just as in theory there should be no need to emphasize sustainability since people should always think long-term. However, there is widespread evidence of irrationality in many other contexts,[21] and irrationality is likely even more severe for sustainability given confirmation bias. Sustainability advocates may believe that sustainability is always beneficial; detractors may think it is always harmful.

One important example of irrationality is in the interpretation of data and evidence. A huge number of sustainability studies abound, often written by commercial organizations with limited research credentials and whose goal is a PR boost rather than the truth. They get it by claiming what people want to hear – that sustainability always improves performance. Often, these studies are lapped up uncritically by readers who like the findings even if the analysis is weak. In my 2024 book, *May Contain Lies*,[22] I highlight the numerous ways in which people fall for fluff: headlines are written about a study that does not exist; a study exists but doesn't conduct any analysis; the authors claim the opposite of what their analysis finds; the analysis doesn't actually measure sustainability or performance; the authors conducted dozens of analyses and only reported the ones that work; and the authors trumpet causation when there is only a correlation.

These errors appear so basic that it seems implausible that anyone would fall for them – how could you believe a claim when the results show the opposite? – but rationality goes out of the window when confirmation bias is at play. In contrast, studies uncovering inconvenient truths are dismissed out of hand, as "one study out of many" or as being politically motivated.

A rational look at the data finds that the evidence is much more nuanced than either side commonly claims. Some ESG factors are associated with higher long-term financial returns, such as corporate governance,[23] employee satisfaction,[24] and customer satisfaction.[25] However, even those results may not be universal: corporate governance is uncorrelated with returns in competitive industries,[26] employee satisfaction does not lead to outperformance in countries with heavily regulated labor markets,[27] and ESG only generates high returns in crisis periods.[28]

In contrast, some of the factors that ESG advocates are particularly passionate about may have no or a negative correlation with returns. Companies that emit more carbon enjoy *higher* returns[29] and these higher returns arise from outperformance, not risk;[30] moreover, they are not robust to different methodologies.[31] Multiple McKinsey studies claim that diversity is strongly correlated with company performance but they suffer from elementary flaws;[32] a review of the highest-quality academic evidence finds a zero or negative link between diversity and company performance.[33]

Rather than being piqued by negative findings and wanting to ignore or attract them, a rational response is to use them to practice sustainability more effectively. Knowing that certain factors are not linked to financial performance allows you to focus on the ones that are (if your goal is solely, or predominantly, financial returns). Alternatively, it may prompt you to go deeper and analyze more complex measures of sustainability than the ones featured in the study. The lack of a link between demographic diversity and performance need not imply that DEI has no value, only that demographic diversity is a blunt measure of DEI. In a 2023 working paper, my coauthors and I find that a holistic measure of DEI, which incorporates equity and inclusion, is positively linked to financial performance.[34]

In addition to a careful approach to the data, Rational Sustainability involves a careful approach to analysis and logic. Sometimes, caution goes out of the window when considering ESG, viewing it as a "magic word" that defies the need to conduct analysis – for example, the belief that a fund should always boycott fossil fuels due to their ESG risks, and always invest in electric cars due to their ESG opportunities.[35] Rational Sustainability involves treating ESG like any other factor. Just as a rational reader applies the same scrutiny to an ESG study as to any other study, a rational investor compares an ESG stock to its price just like any other stock. A company could be risky, but the risks could be more than discounted; it could be attractive but overpriced due to a bubble.

[21] See, for example, Ariely, Dan. 2008. *Predictably Irrational: The Hidden Forces That Shape Our Decisions*. HarperCollins; and Kahneman, Daniel. 2011. *Thinking, Fast and Slow*. Farrar, Straus, and Giroux; for popular summaries.

[22] Edmans, Alex. 2024. *May Contain Lies: How Stories, Statistics, and Studies Exploit Our Biases – And What We Can Do About It*. Penguin Random House.

[23] Gompers, Paul, Joy Ishii, and Andrew Metrick. 2003. "Corporate Governance and Equity Prices." *Quarterly Journal of Economics* 118: 107–56.

[24] See Edmans, Alex. 2011. "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices." *Journal of Financial Economics* 101, 621–40; Edmans, Alex. 2012. "The Link between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility." *Academy of Management Perspectives* 26: 1–19; and Boustanifar, Hamid and Young Dae Kang. 2022. "Employee Satisfaction and Long-Run Stock Returns, 1984-2020." *Financial Analysts Journal* 78: 129–51.

[25] See Fornell, Claes, Sunil Mithas, Forrest V. Morgeson III, and M.S. Krishnan. 2006. "Customer satisfaction and stock prices: High returns, low risk." *Journal of Marketing* 70: 3–14 and Fornell, Claes, Forrest V. Morgeson III, and G. Tomas M. Hult. 2016. "Stock Returns on Customer Satisfaction Do Beat the Market: Gauging the Effect of a Marketing Intangible." *Journal of Marketing* 80: 92–107.

[26] Giroud, Xavier and Holger M. Mueller. 2011. "Corporate Governance, Product Market Competition, and Equity Prices." *Journal of Finance* 66: 563–600.

[27] Edmans, Alex, Darcy Pu, Chendi Zhang, and Lucius Li. 2023. "Employee Satisfaction, Labor Market Flexibility, and Stock Returns around the World." *Management Science*, forthcoming.

[28] Lins, Karl V., Henri Servaes, and Ane Tamayo. 2017. "Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis." *Journal of Finance* 72: 1785–824.

[29] Bolton, Patrick and Marcin Kacperczyk. 2021. "Do Investors Care About Carbon Risk?" *Journal of Financial Economics* 142, 517–49.

[30] Atilgan, Yigit, K. Ozgur Demirtas, Alex Edmans, and A. Doruk Gunaydin. 2023. "Does the Carbon Premium Reflect Risk or Mispricing?" Working Paper, Sabanci University.

[31] Aswani, Jitendra, Aneesh Raghunandan, and Shiva Rajgopal. 2024. "Are Carbon Emissions Associated with Stock Returns?" *Review of Finance* 28: 75–106. Zhang, Shaojun. 2024. "Carbon Returns across the Globe." *Journal of Finance*, forthcoming.

[32] Green, Jeremiah and John R. M. Hand. 2024. "McKinsey's Diversity Matters/Delivers/Wins Revisited." *Econ Journal Watch* 21: 5–34.

[33] Fried, Jesse M. 2021. "Will Nasdaq's Diversity Rule Harm Investors?" *Harvard Business Law Review* Online, 1.

[34] Edmans, Alex, Caroline Flammer, and Simon Glossner. 2023. "Diversity, Equity, and Inclusion." Working Paper, London Business School.

[35] Edmans, Alex. 2023. "Applying Economics – Not Gut Feel – to ESG." *Financial Analysts Journal* 79: 16–29.

One potential objection to the concept of "rational" sustainability is that the qualification is unnecessary because there is no such thing as "irrational" sustainability. Sustainability – concern for people and the planet – is a "good thing," so it cannot possibly be irrational. Such an objection conflates the goal with the approach. Even if the goal is laudable, it can be pursued in either rational or irrational ways. Dieting, exercise, and hard work are generally seen as good things, but you can have irrational dieting, irrational exercise, and irrational hard work. ESG and sustainability are not "magic words" that defy the laws of gravity, or the laws of economics, and are immune to irrationality.

A second potential objection is that it is unclear how to define "rational." Aditya may think it's rational to pursue only financial returns, and Beatriz to seek a mixture of financial and social returns. However, this again conflates the goal with the approach. It is entirely reasonable to have non-standard objectives if they are pursued in rational ways. This has long been recognized in the behavioral economics literature. For example, in their 2001 model of prospect theory, Nicholas Barberis, Ming Huang, and Tano Santos note that "While our preferences are nonstandard, this does not mean that they are irrational in any sense: it is not irrational for people to get utility from sources other than consumption, nor is it irrational for them to anticipate these feelings when making decisions."[36]

But how do we define being "pursued in rational ways?" Again, the behavioral economics literature offers guidance: taking all information into account and updating your beliefs according to Bayes' Rule. Irrationality may come in many forms, such as confirmation bias: rejecting information that contradicts your beliefs, and overweighting information that confirms them. Rationality does not mean that there is only one way to interpret information. There may be legitimate disagreement as to whether an ESG factor will increase or decrease returns, particularly if no research has been conducted on the topic. Where information is ambiguous, rationality means treating it as ambiguous and allowing for differences in opinion, rather than interpreting it in a way that confirms your beliefs about sustainability.

Rational sustainability recognizes diminishing returns and trade-offs

In January 2024, I was discussing sustainable real estate with two investors, Russell Chaplin and Chris Miller-Jones of Europa Capital. They questioned whether a potential investment should always have more green building certifications than fewer or, having bought a building, whether to follow the common industry trend of trying to get as many certifications as possible. They saw the value of sustainability but recognized the diminishing returns to each additional certification, as well as the increasing costs – both in renovating the building to qualify for certification and investing the time and money to get certified. I then described their approach as "Rational Sustainability."

Irrational sustainability involves pursuing a project, investment, or certification just because it is viewed as sustainable. Even if it actually sustainable and has genuine benefits rather than just ticking a box, there will be costs to it – direct financial costs of making the investment, and indirect costs of time diverted from other activities that create financial or social value. In addition, more is not always better; as with any investment, returns are diminishing and can turn negative.

Rational Sustainability recognizes that sustainability factors are subject to the same laws of gravity as everything else. It encourages us to look at the big picture – rather than getting engrossed with the benefits, to step back and consider the costs. This continues to apply even if our goal is more than financial returns. Estimating the financial cost is necessary to discern whether the additional social payoff is sufficient to outweigh the reduced financial payoff, rather than ploughing straight ahead because social returns are a "good thing."

Rational sustainability sets boundaries

Principle #7 highlighted that, if you consider a given ESG factor, more is not always better. This principle highlights the economic reality that a greater number of ESG factors is not always better.

Irrational sustainability involves trying to tick as many ESG boxes as possible. The more you tick, the higher your ESG rating will be, and the less likely that customers will boycott you for failing to tick their preferred box. Rational Sustainability recognizes that, while a company has responsibilities to society (either for financial or social reasons), there are limits: Apple should not be culpable if its excellence hastens the decline of BlackBerry, nor if its hiring standards prevent low-quality applicants from getting jobs.[37] A company is not responsible for addressing all of society's challenges or pursuing all 17 Sustainable Development Goals; that's the role of governments.

Rational Sustainability sets boundaries. It establishes a framework for analyzing what a company's responsibilities should and should not be. This framework in turn guides decisions on how to allocate capital, headcount, and time. A company can then be held accountable for delivering on the responsibilities that it has set out. Without such boundaries, anything goes; it is not clear how an executive should navigate trade-offs, or what investors should hold her accountable for.

In *Grow the Pie*, I propose two criteria to establish such boundaries.[38] One is *comparative advantage*: a company should focus on those sustainability activities in which it has unique expertise. Vodafone should invest in M-Pesa since it has telecoms expertise; it should not donate money to charity because it has no special ability to evaluate which charities are most worthy or effective.

A second is *materiality*. If a company's only goal is financial returns, this entails *business materiality*: a company should prioritize those stakeholders that are most important for its business model. Apple should invest in specialist suppliers such as Corning, which provides the touch-screen glass for its iPhones, but commodity suppliers are less material. If a company's goal includes

[36] See Barberis, Nicholas, Ming Huang, and Tano Santos. 2001. "Prospect Theory and Asset Prices." *Quarterly Journal of Economics* 116: 1–53.

[37] Edmans, Alex. 2023. "What Social Responsibilities Should Companies Have? A New Approach." *Wall Street Journal*, October 1, 2023.

[38] Edmans, Alex. 2020. *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*. Cambridge University Press. I also had a third criterion, *multiplication*, but it is often subsumed by comparative advantage.

social returns, this also involves *intrinsic materiality*: the non-financial objectives its shareholders and stakeholders care about (rather than, for instance, the ones that happen to be in the news).

My criteria are certainly not the only set of legitimate criteria. Companies may choose their own criteria, but *some* criteria are needed otherwise decisions are arbitrary.

Rational sustainability guards against irrationality

The irrationality that plagues sustainability is not limited to confirmation bias. Another behavioral bias that is particularly relevant for sustainability is herd mentality, where people pile into something because everyone else is doing so. Professors rush to teach courses on ESG irrespective of expertise, companies like Target, Bud Light and Disney raced to embrace liberal issues without thinking about their conservative customers, and investors jump on the latest DEI fad.

One example of the latter is the big market delusion that surrounded electric vehicles ("EVs") in early 2021.[39] Investors were so excited about the sustainability credentials of EVs – their potential to generate financial returns and address climate change – that they bid up the values of EV stocks to nonsensically high levels. Adding up the price of each EV company led to an implausible value for the total EV industry, even under the most optimistic scenario for the uptake of EVs. However, investors forgot this "adding-up constraint" in their mania.

A second irrationality is the "zero-risk bias," which leads people to seek the complete elimination of a risk, even if its substantial reduction is sufficient. As an everyday example, consumers pay for overpriced extended warranties even if the risk of a breakdown is already small, to reduce it to zero.[40] In a sustainability context, many companies have signed up to be "net zero," perhaps due to the attractiveness of "zero." However, society as a whole can be net zero as a whole without every company being net zero. Some industries, such as reforestation, will naturally be carbon-negative; for other industries, such as construction, it is impossible to be net zero without the use of offsets, whose validity and effectiveness has been challenged and whose purchase is inconsistent with comparative advantage.[41]

In addition to guarding against your own irrationality, Rational Sustainability allows investors to exploit market irrationality – selling sustainable companies that are overpriced, or buying sustainable companies that are underpriced because they do not tick ESG boxes. One might question whether it is responsible – sustainable, even – to exploit others' irrationality. Launching funds with ESG labels to capitalize on people's misbelief that ESG always pays off might be seen as irresponsible.[42] This is why I have referred to "market irrationality" rather than "consumer irrationality." Participants in financial markets who choose to trade individual stocks when they could buy mutual funds should know that they are swimming with sharks. Moreover, exploiting irrationality corrects mispricing, making market prices more accurate signals for corporate decision makers.[43] For example, deflating the EV bubble will prevent EV companies from raising cheap equity when the industry is already over-capacity and needs a shake-out; buying underpriced sustainable companies will help the market recognize their value.

Rational sustainability challenges and questions

Principle #9 highlighted how the herd mentality can lead to market bubbles and crashes. It can similarly distort executives' decisions by leading to them taking actions indiscriminately, just because everybody else is doing it.

For example, many companies have signed up for net zero without even understanding what "net" or "zero" is. Starting with the former, it is not obvious whether it is appropriate to net off negative emissions, thus treating them as equal to emissions reduction. Moving to the latter, it is unclear how to define zero due to indirect positive effects (manufacturing semiconductors releases greenhouse gases, but semiconductors may be used in solar panels) and indirect negative effects (electric cars may use electricity from fossil fuels). Furthermore, it is not clear whether every company needs to be net zero even if society should be, whether firms have calculated the financial cost of net zero (compared to, say, a 95% reduction in emissions), and whether "net benefit" (which includes environmental and social impacts beyond carbon) is a better target than "net zero."

Principle #7 highlighted the importance of stepping back and looking at the big picture of a decision – its costs as well as its benefits. Challenging and questioning involves stepping back even further and looking at the big picture of the problem the decision is trying to solve. For example, in 2023 the Financial Conduct Authority, a UK regulator, proposed to regulate the diversity of a company's workforce under the claim that their Consumer Duty is to ensure fair provision of financial services to customers.[44] But if this is their goal, then the solution is to regulate directly the fairness of provision of financial services to customers, not the demographic diversity of employees which is very far removed.[45] However, given frequent calls to regulate diversity from pressure groups, and the herd mentality of following regulators in other countries, a particular regulator may pounce on doing so without asking what problem it is a solution to, and whether a non-sustainability regulation would solve it more effectively.

[39] See Arnott, Robert D., Bradford Cornell, and Lillian J. Wu. "Big Market Delusion: Electric Vehicles." March 9, 2021. Available at SSRN: https://ssrn.com/abstract=3801052 or https://doi.org/10.2139/ssrn.3801052. The term "big market delusion" was first applied to dot com retail, online advertising, and cannabis rather than electric vehicles or sustainability. See Cornell, Bradford and Aswath Damodaran. 2020. "The Big Market Delusion: Valuation and Investment Implications." *Financial Analysts Journal* 76: 15–25.

[40] A related phenomenon is "probability weighting," where people overweight the likelihood of very low probability events as long as that probability is greater than zero, such as winning the lottery.

[41] For example, Gosling, Tom. 2023. "Self-tax don't offset." May 7, 2023. https://www.tom-gosling.com/blog/self-tax-dont-offset

[42] Alternatively, one might argue that it is responsible as it is catering to consumer demand; investors may get feel-good factors from investing in ESG funds which offset any financial loss.

[43] See Bond, Philip, Alex Edmans, and Itay Goldstein. 2012. "The Real Effects of Financial Markets." *Annual Review of Financial Economics* 4: 339–360.

[44] Financial Conduct Authority. 2023. "Diversity and Inclusion in the Financial Sector – Working together to Drive Change." Consultation Paper CP23/20.

[45] Edmans, Alex. "Response to FCA Consultation Paper CP23/20." November 11, 2023.

CONCLUSION

This article has proposed “Rational Sustainability” as an alternative to ESG – a term and set of practices that started off with much promise and good intentions but has failed to achieve this promise, owing to naïve implementations by true believers, blind opposition by equally zealous adversaries, and exploitation of the ESG movement by opportunists and imposters.

Rational Sustainability is sustainable. Its goal is long-term sustainable value, not political objectives; it includes everything that improves long-term value irrespective of whether it is labelled ESG; it is pursued by companies even if they can’t tell anyone they’re doing so; it is embraced as a core profit center not resented as a peripheral cost center; and it accommodates different definitions of value.

Rational Sustainability is also rational. Its approach is based on evidence and clear-headed analysis; it recognizes diminishing returns and trade-offs; it sets boundaries rather than thinking that “anything goes”; it guards against your own irrationality and capitalizes on market irrationality; and it challenges and questions rather than follow the herd.

Rational Sustainability has the potential to create long-term value for shareholders and society, fulfilling the promise that ESG failed to.

KEYWORDS
CSR, ESG, responsible business, SRI, sustainable investing

How to cite this article: Edmans, A. 2024. “Rational sustainability.” *Journal of Applied Corporate Finance* : 1–8. https://doi.org/10.1111/jacf.12609