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Gary: Welcome to *Sustainable Minds*, exploring the interplay of the corporate brand, core beliefs, and ESG, brought to you by Baker. In every episode, we'll investigate how purpose, vision, and values can guide your company's sustainability actions, behaviors, and mindsets.

Rocket: We'll discuss their impact with the help of ESG-focused guests from around the globe. I'm your host, Rocket.

Gary: I'm your host, Gary. Let's get started.

[music]

Gary: I'm very excited to be talking to you today. Your bio reads you're interested in how to account for a firm's environment, social, and governance efforts and integrate the information into the portfolio decision-making process. According to the Financial Times, your research on ESG was a turning point in how investors viewed and integrated ESG information, and the methodologies suggested in your work have been widely implemented across asset managers, and I would guess, the financial industry overall.

Your work is regularly cited by Bloomberg, Forbes, The New York Times, and Wall Street Journal. You received multiple awards for your research and teaching, including the Best 40-Under-40 recognition from Poets & Quants, and the Chairs' Core Teaching Award from Kellogg, the best desertion award from American Accounting Association. You earned your doctorate from Harvard and your master's and bachelor's from Northwestern.

Prior to academia, you worked as an equities sales trader and research analyst at Credit Suisse. We're so excited to be talking to you today. I'm a little curious, I've got to ask you, in your youth, who or what influenced you from a business point of view or a culture or a social--? Obviously, your parents were a huge influence, but I'm just curious if there were other influences you had?

Aaron Yoon: The guardian family as-- they were very good people. They were Korean Americans, first-generation immigrants, and basically, what happened was they used to live in LA, had multiple huge Korean restaurants, went bankrupt, and then they fled to Champaign, Illinois and they were working three, four jobs.

They were courageous enough to be my guardian and sponsor, but then you can imagine that as a 13, 14-year-old, with a guardian family who's really struggling, you'd never get to see them because they're always working to provide for their family. In that sense, it builds a lot of character and a lot of resilience. When I went into the military, to serve in the Korean military sometime after, it was a breeze.

I'm very thankful to pretty much everyone, all the supporters that I've met over my life. I think Northwestern was somewhere where I really met a lot of support, professors, and mentors, as well as at Credit Suisse and at Harvard, and back at Kellogg. I think it's almost like a lifetime journey. You meet people throughout who are willing to guide you and provide you with that benefit of the doubt. As an educator, my goal is to do something similar for my students.

Gary: Well, I think it's really important to have mentors and good advisers and good teachers. There also is a certain joy in helping people. One of our core values is about being of service to others as well. I think you certainly must feel that within your profession as teaching and just offering the research you do.

Aaron: Yes. I saw in your website that the clients that you pretty much started with are still with you, so that was--

Gary: Well, many have. One company actually just exited, and they were here from the beginning, 38 years ago. That was the Capital Group. They are a large investment asset company. I actually started to work with them even before I started this. I've always been in corporate reporting and I used to create their annual report and tell a story for them around each one of their different mutual funds. That's the work we did for the Capital Group.

I'm going to use this as a segue, you're pioneering a new world. I started this business in the world of annual reports, and I see that as a checkerboard. I see ESG as chess but on a Rubik's cube [laughs] dimension. I'm curious, what was the problem you saw, and what motivated you for your work and your research in ESG?

Aaron: Prior to going into graduate school at Credit Suisse, I used to trade single stocks and worked as an analyst. Our traditional financial evaluation framework is effectively anchoring on accounting and financial numbers to link these firm-level investment activities to value. When I was there, which it's almost 13 years ago now, like 13 years ago what not, there were talks about our sustainability, CSR, and responsible investing, but people were dismissing that as fluff.

They're like, "What is this? How do you even relate to this? Nothing is reported. It must be just brand management and charitable contribution." Then from an accounting and corporate financing 101 perspective, currently, I teach my students that if there is a dollar input of firm resources on something, there has to be output. That firm or a particular firm that turns that dollar around would be different across firm characteristics like whether they have great managers or whether they have great culture or whether they care about stakeholders, et cetera, et cetera.

My fundamental thesis going into graduate school, and, of course, I met great wonderful people that guided me along and worked together, but if this ESG investment is using up shareholder value and firm resources, can we uncover this link between ESG efforts or back then CSR efforts and core value? That was the big question that shaped a lot of my research agenda. It got shaped during my time in HBS pretty much.

Gary: That makes sense.

Rocket: It's very interesting. The changes, the acceleration, and climate change and everything that's happened, the conversation in the last 10 years, it's interesting how that converged with an existential crisis that is causing, that you can't evaluate a business by just its financials anymore, that you've got to take into consideration the risks and the opportunities that this catastrophe is offering to us. I thought your foresight starting so long ago to just when it was still about dollars going out and what that equates to has the acceleration of what has gone on is fascinating.

Gary: We did a little homework on you. The work is fascinating. I want to talk about-- I think is the most current working paper, which is titled, *Which Corporate ESG News does the Market React to?* If I can ask you just to tell us some of the key takeaways that you guys found in this area?

Aaron: Sure. The main punchline of that paper is that market actually reacts to ESG news, but it actually reacts to positive ESG news, in a positive manner. Prior to that paper, the consensus was that the market reacts negatively to both positive and negative ESG news**.** The prior papers had looked at ESG as an agency issue. If a firm engages in ESG, it's because self-motivated managers were exploiting shareholder wealth and then doing it for their own interest.

What this paper is showing is that essentially that could be true, 10, 15 years ago using limited data. What we're doing is we're using this natural language process data that collects news from hundreds of thousands of sources and creates a sentiment score, and effectively shows that the tide has turned and the market reacts to positive news in a positive manner. ESG is just like any other investment, where when you have something positive, it reacts positively, when you do something negative with it, it reacts negatively. That's point one.

Then secondly, of course, within ESG issues, there is a multitude of ESG issues, E, S and G, you name it but there are issues that are more closely related to your sector practices, which folks call it financially material. It's anchoring our sustainability accounting standards board's definition of financial-- what issues are more relevant to that particular sector. That paper or this particular paper highlights that the market reacts more strongly to those issues that are closer to your sector's core competence pretty much.

For example, if British Petroleum had an oil spill, the market will react to that particular thing. Whereas if a bank like Goldman Sachs says, "We care about the environment, we would like to go into a LEED Platinum Plus building." That's great, but it's not like that tied to their core banking practice. We're effectively separating those and finding stronger results and issues that are closer to your business operations.

Gary: Interesting. You work with a lot of data, we work-- You know what? I'm going to get into that in a minute.

Rocket: I was wondering, is there a part of the E, S, and G, it's all just what SASB industry standards claim as the things that you should be reporting on that are material to investors, that there's not one of those categories, the E, the S, or the G that they tend to respond to the strongest news in that category?

Aaron: Within this new paper. That's what you're asking?

Rocket: Yes.

Aaron: Got it. There are a few things to know. Let me perhaps give you a little bit of background information. You know how we classify E, S, and G these days, and ESG you separated the E, S, and G. People have different definitions as to what ESG means but then broadly speaking, most people will agree that it is CSR plus G that became ES and G-

[laughter]

Aaron: -broadly speaking. In that particular paper, what we document is the following, SASB cuts ESG, not into E, S, and G but into five themes. First is social capital, second is human capital, third is natural capital, which is effectively your environment, fourth is ESG leadership and governance and then five is business model innovation. What we find is that there is the strongest result in social capital issues.

You can interpret this market reaction as an abnormal reaction, so the market is not pricing it in. It makes really a lot of sense because social capital, especially after Black Lives Matter, it's become a thing, but it's very hard to quantify and not many people pay attention to these important issues. It's related to how ESG issues are reported because none of it is mandated and that even within E, S, and G, G and E are very unquantifiable.

How many women are on your board? How many diverse folks are on your board, et cetera? E, How much admission divided by revenue but S is very subjective and very hard to quantify. That's where we see the most market reaction, which is what's very fascinating to me.

Rocket: Yes, and there's a lot of controversy and discussion about should companies be making claims about social justice or reform or these types of things. Some people don't think that they should come out and talk about, take a side on gun reform, and all of these things. I think that's particularly fascinating. Why do you think that that may be so?

Aaron: This discussion is probably the trillion-dollar question that ESG folks are thinking about these days. Let me tell you why I think so. We first have to understand why this ESG space took off. I have my own view. It's the following. Since the market is not doing so well in the past three months, since 2008, the market has been going on 15 degrees because of quantitative easing. We've been pumping in money like crazy. When the market goes up like that, there is no room for active investment or hedge funds.

Gary: That's why indexes are so huge.

Aaron: That's exactly right. All you really need to do--

Gary: BlackRock is okay.

Aaron: All you really need to do is track an index, and you'll make 15%. The active guys obviously will charge more than the index funds, in terms of a commission is squeezed left and right. If you look at even BlackRock and Vanguard, which is one of the largest index providers, their business has shifted a lot from active to index because of these growth index funds**.** Whether that will persist, we don't know, given this whole recession talks that we're having to make.

How did ESG take office the following? In my view, these asset managers needed to have a new marketing product, in some sense because if you claim to do ESG, it's very hard to actually monitor you. This is in line with the current events of Goldman getting rated, and DWS getting rated by their regulators.

Then you can, in theory, charge more or as much because it's hard to quantify, it's harder to keep track of, et cetera, et cetera. In this sense, it became a new hot marketing tool, and it's a great way to attract capital because let's say you're delivering, you're tracking the index for the most part, and have a little bit of active stock pick on ESG, whether you can screen or whether you exercise some implementation strategies or engagement strategy.

You can effectively say to your investors, for example like myself or you, who would like to do some good, but also make 14 1/2% instead of 15%, which is great. Say that we're saving the world, we're saving the planet. What I'm trying to get at is the following, I think the motivation behind ESG is really wonderful. There's this capitalism 2.0, or stakeholder capitalism or more responsible capitalism, obviously, is where my heart is going, and where I encourage my students to think about.

Well, we also have to think about what drives capital markets, it's money. It's the flow of capital, it's the commissions, et cetera. With that background, what you're talking about is effectively this impact versus ESG. There's a lot of talk about the impact these days. What impact folks are advocating at the blog level is the following. They're advocating that a firm should engage in GHG reduction for the benefit of society and societal welfare.

I think it's great, but you also have to think about who is initiating these impact campaigns. They're oftentimes activist hedge funds or activist asset managers, and their compensation is also dependent on their performance as well as some impact. In order to get to this impact stage, which I believe will come in the very near future, it's first established with ESG that there is that link between shareholder value.

Once that mispricing is close, and we have a good understanding of how firms make ESG investments, and what the return on the sustainable investments is, then I think it has to be coupled with actual follow-through impact performance, whether it is GHG reduction or promoting VEI and all these things. We're at this phase where ESG took off in the past three years just in an exponential manner that the sustainability advocates have skipped the importance of this link between shareholder value and ESG, and they're moving towards impact.

That's also great but what I'm trying to get at with my research is that there's still money left on the table highlighting this link between ESG and shareholder value because ESG is a firm investment activity that uses up firm resources. That's my overall research thesis.

Gary: I love it. I love it. Before I build on that, I wanted just to go back and talk about-- and I think this relates to your 2016 article, *Corporate Sustainability, First Evidence On Materiality*, and materiality is huge today, but there are so many rating agencies, frameworks, and standards and there's so much conversation of consolidation of SASB and others. Where do you see that going and what do you think, from your point of view and all the research you've done, what's that going to look like in three years?

Aaron: This is probably one of the hottest topics right now in the ESG space. Given the ESG area, especially ESG reporting there are no mandates right now. This is a very, very hot topic. Let me give you an interesting, or what I think is an interesting anecdote. When I used to call clients as a sales trader, major investors because Credit Suisse was one of the largest prime brokers. The response that I got from investors, the typical response was the following. "Yes, I understand that your equity analyst came about a new EPS forecast and the rating change, how are you different from a golden guy who just called me three minutes ago and effectively did the same thing as your analysis? How are you guys different?"

Now 12, 13 whatever years later you talk to an investor and their response on ESG is the following, "Oh my God, ESG is so confusing. We don't know how to make sense of it." They're everywhere. Their correlation is really low. We have no idea how to do it, but we're calling ourselves an ESG fund, and we have to charge clients. That's the state of the world that we live in, right?

Gary: Yes.

Aaron: I think where there are opportunities to follow. I also have a recent paper with my good colleague and friend George Sarah HGS titled *Stock Price Disagreement Paper*. It's titled Stock Market or-- I can't even think of the actual title right now, but anyhow, it's a disagreement paper. It takes advantage of the ESG rating disagreement. It proposes a trading strategy where you can benefit from this disagreement. I think what asset managers and investors need to think about is, in light of disagreement and ESG ratings, in light of this unregulated space, how can I uncover this value? Because at the end of the day, that's what the goal of these ratings is.

The innovation of that particular paper is that it was the first one to bother testing different ESG ratings and whether they have any predictive ability of future ESG news. To date, before that paper, no one has even bothered to test ESG rating performance on a future ESG outcome. We're obviously in a very nascent stage right now. These are, I think, very interesting areas.

Gary: You touched on this, and I'm going to talk a little bit more about this. We believe in today's world, companies have a responsibility to all stakeholders and not just-- Milton Friedman, one of his theories, said, "There's one and only social responsibility of business, to use its resources, engage activities designed to increase its profits as long as they stay within the rules of the game." He was just speaking about shareholders. The world is evolving. The world is always evolving for good or for bad or both at the same time, actually, evolving good and bad.

This whole notion around stakeholder capitalism, what are your insights to that? I know that a lot of the investment community you deal with are pretty hardcore people, but there are a lot of younger 30-somethings out there that have a whole different value set and that will be investing in or are investing today.

Aaron: Absolutely. if you look at, for example, HQR's ESG funds and their prospectus, they're very forthcoming. It's something along the lines of-- obviously, I don't have the actual prospectus in front of me, but it's something on the lines of, "Hey, we're an ESG fund." We would have to sacrifice a little bit of shareholder value to identify and then bring about impact. Where I'm trying to go with this is the following, I think Asset Management Community at the end of the day will have to cater to their clients, which could be 30-year-old millennials or maybe five-year-old millennials, in addition to everyone.

I believe that there will be products, and we're in this in-between phase of a lot of this information not being regulated. There will be more scrutiny from the regulators, there will be more scrutiny from asset allocators. It could be you and me or a pension fund, for example. I do believe that this stakeholder capitalism is a direction that is something that we cannot ignore. At the same time, I would argue that people classified Milton Friedman as, "Oh, this old person who only advocates for shareholder value."

If you read his argument, it's slightly nuanced in the sense that what he's arguing and what I believe that he's arguing and what I think that ought to be done is you need to first be able to create shareholder value, whether it is short term or long term, in order to create value for stakeholders. In my interactions with C Suisse, their complaint is number one, "Oh my God, how do I make sense of ESG rate?" Second, is they're thinking about-- They ask me sometimes, "Should I be divesting one of my subsidiaries because it's oil and gas heavy. I don't know whether that's the right way for firm managers to stick about." It's how do you create value using your own existing resources?

How do you prepare your stranded assets in a way to gear towards regulatory changes and then phase out in a way that is sustainable, and then it creates long-term value. A lot of things are necessary. Obviously, you need CEOs who are capable, you need board members who are willing to sacrifice short-term cash outflows with long-term value creation and remove these agency frictions and free-riding issues.

There's a lot of things that you need but at the end of the day, I think at least in the US, the goal of firms is to create shareholder value. That in turn could create stakeholder value. I do for sure think that stakeholder value creation is very important, but I think it would have to happen alongside shareholder value creation.

Gary: Alongside that, we work with a lot of corporations. We're a corporate brand agency and part of our philosophy is a company's core beliefs, values, and the behaviors, actions, decisions, and mindset associated with that sense of purpose. I know the purpose is a big word. These drive certain behaviors when done right within a corporation. I was just curious, what have you seen about a company's values and ethics and their possible influence on ESG strategies?

Aaron: My experience with my limited interaction with C Suite is that everyone that I meet claims that they are number one in ESG. They care about ESG, they have all these reports. Whenever I show this returns graph that I typically show based on my research, a lot of CEOs or CFOs jokingly say, "My group must be in that high group where you generate a lot of return or my firm rate" This is related to stakeholder capitalism in some sense. I believe that companies are able to manage their employees, for example, especially In B2C settings, companies were able to manage their supply chain and all these stakeholders.

That's a very strong signal, great ESG practice as well as ESG generating shareholder value. I just think that given that ESG is oftentimes toned from the top because it's usually-- of course, there is this grassroots movement from the lower level, junior-level employees caring about the environment and all these things but oftentimes up until this year, I think, most of ESG pressure is coming from investors when you are getting pressure from asset allocators. Asset allocators pressure asset managers and then in turn pressure companies to think about these issues.

In that sense, purpose I think is a great word because this purpose and culture and the truth within the organization and within the war room, in addition to how CEOs interact with directors, directly trickles down to how they treat their employees, how employees face customers, how customers feel about that brand. It's almost like a very positive loop, and I think that's where the long-term shareholder, stakeholder value creation happens.

Rocket: Yes, I completely agree. I think that circle when there's no alignment from the top and how their policies and procedures are in line with how they really treat employees, rubber hitting the ground is when you have that discretionary effort of anyone in the company not being there and creating value.

Aaron: I have a paper called, *Can high ability managers choose ESG projects that enhance general value.* Effectively, how I measure high-ability managers is from employee satisfaction score from Glassdoor.

Rocket: From what?

Gary: Glassdoor

Rocket: Glassdoor.

Aaron: glassdoor.com. What I find is that when firms engage in ESG, and they have employee buy-in-

Gary: Yes.

Aaron: -that's where the value creation is coming from. It's especially strong in Consumer Discretionary Sector. It makes total sense because how you treat your employees trickles all the way down to customers.

Gary: That's why we're focused so much on core beliefs. What's in your heart and soul as an individual, but as a collective. You have to have a set of beliefs, and you have to find the people, attract the people that believe in what you believe, employees, customers, and investors, and when that alignment happens, it can be very powerful.

Aaron: Absolutely.

Gary: Terrific. Wow, this has been so enlightening, so happy to be talking to you and understanding all the research and work that you've done. I think this is going to give our listeners a peek behind the curtain and a different point of view and perspective on this.

Aaron: Thanks for picking on me. I appreciate you doing this.

Gary: Great, Aaron. [crosstalk] Thank you so much for your time.

Aaron: Thank you. Stay safe.

[music]

Rocket: Hey, thanks for listening. Just a reminder to follow *sustainable minds*, wherever you get your podcasts, and please do leave a review if you like what we're doing.

Gary: It helps others discover the show and of course, we want more listeners. If you want to find out more about how we can help you evolve your corporate brand, culture, and ESG, head to bakerbrand.com.

Rocket: See you on the next episode of *Sustainable Minds*, exploring the interplay of the corporate brand, core beliefs, and ESG.

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