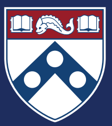

ESG Initiative

Engine No. 1: An ESG Upstart Challenges Fund-Industry Assumptions About Organizing An ETF and Everyone's Assumptions About Proxy Fights

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ESG INITIATIVE CASE STUDY SERIES

Engine No. 1: An ESG Upstart Challenges Fund-Industry Assumptions About Organizing An ETF and Everyone's Assumptions About Proxy Fights

When Jennifer Grancio heard Chris James's idea for a new exchange traded fund (ETF), she thought it was — to put her reaction politely — naïve.

As a former managing director of BlackRock, the multi-trillion-dollar asset management company, Grancio had helped build out the largest family of ETFs in the U.S. She knew the biggest players in that business — BlackRock, Vanguard, and State Street Global Advisors — had an enormous competitive advantage, thanks to their vast scale. It's why she called them "the Big Three."

James was a successful hedge-fund manager and was willing to invest his own money on the vision for a new sort of ETF — one that, like an index fund, would own all of the companies in the S&P 500 or U.S. "large caps", but whose ownership wouldn't be passive. His fund would push companies to improve their environmental, social and governance (ESG) performance — and to improve their multiples because of it. Its holdings would be indexed and therefore passively managed, but its engagement with the companies in its portfolio would range from constructive to activist. Investors, even big ones, typically sold stocks that disappointed them. James instead wanted to stay invested and push for improvement. "I just didn't see how divestment was going to drive change," he said.[1] "If you want change, you have to engage."

Grancio knew his idea ran afoul of two of the orthodoxies of the fund-management business: Low fees, enabled by scale, were crucial, and active management was pricey. Though James envisioned an index fund, engaging with companies and pursuing proxy fights can be even more people-intensive and costly than stock-picking.

BlackRock, State Street and Vanguard had solved these problems by vacuuming up assets and rarely voting against the managements of the stocks in their funds. Each one offered dozens of mutual funds and ETFs. Together, they controlled more than $4.5 trillion of ETF assets — a sum larger than the GDP of Germany.[2]

Their heft created economies of scale. The retail shares of Vanguard's S&P 500 ETF, for example, carried an expense ratio of 0.03 percent. That meant its shareholders paid $3 in expenses for every $1,000 they invested.

Grancio knew the details of those companies and their ETFs far better than most people. She had spent 20 years at BlackRock, helping create the very ETFs that James aimed to usurp.

The crux of his pitch to her was that he saw a vulnerability that a new kind of ETF — one that

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prioritized engagement with the companies in its portfolio — could exploit: the big fund companies had conflicts of interest embedded in their business models they couldn't overcome. Those conflicts prevented them from pressuring companies to improve their ESG performance. James was convinced that more investors wanted public companies to improve on that score.

What he didn't have was expertise in creating, marketing and distributing ETFs. For that, he needed someone like Grancio — someone who not only had that expertise but shared his conviction that capitalism could be an engine for environmental and social progress. That meant persuading her to agree to join his new investment firm, Engine No. 1, named after the first firehouse in San Francisco. Engine No. 1 had already created a private fund, which was pursuing a strategy of holding a small group of stocks that showed both financial and ESG promise.

James's persuasion of Grancio required her to believe something that seemed like hubris coming even from a hedge fund manager with James' record of success: that he could beat ExxonMobil, one of the world's largest energy companies, in a proxy contest. The proxy fight would be Engine No. 1's declaration that it aimed to force the world's biggest companies to take environmental and social performance as seriously as they took financial returns. What James wanted to do versus Exxon, one writer quipped, was like "making a name for yourself by punching the biggest bully in the yard in the nose."[3]

Grancio had to decide whether she wanted to be at James's side in that scrap and whether his idea for a new kind of ETF could really work.

An Unlikely Evangelist

Chris James was an unlikely evangelist for ESG investing. He'd once owned a coal mine, and no fuel was dirtier than coal. He had been a rancher. He'd made a fortune for his investors in the internet boom, investing early in such companies as Broadcom, Cisco, Yahoo and Amazon. The tech funds at Pequot had three years (1998, 1999 and 2000) where he and the team put up triple digits-even through the downturn and correction in 2000.

He had entered the investment business in 1991, out of undergrad at Tulane University in New Orleans. He had read Michael Lewis's tale of working on Wall Street, *Liar's Poker*, and been inspired. He had decided, in the unforgettable parlance of one of Lewis's characters, he wanted to come to work every day ready to "bite the ass off a bear." Wall Streeters, in the era of *Liar's Poker*, didn't talk about their commitment to conservation; they bragged about their bonuses.

James started out in New York, working as an analyst at several hedge funds. In 1995, he uprooted himself after he met Marc Andreessen, founder of Netscape Communications Corp. Andreessen had created the first web browser to become popular beyond the computer cognoscenti. Talking to the Andreessen and studying Netscape, James realized the web was one of those rare innovations to which the hackneyed term "revolutionary" really applied. It would change how business was done. The vanguard of that that revolution was in California's Bay Area. That was where James needed to be.

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After moving to the West Coast, he became managing director of Pequot Capital before co-founding a hedge fund named Andor Capital Management and later founding another named Partners Fund Management. James also involved himself in Bay Area philanthropy, volunteering his time to efforts to address environmental harm and poverty. He became a board member of a nonprofit called Tipping Point. Tipping Point's grants had helped more than 500,000 Bay Area residents satisfy basic needs like housing, childcare and job training.

James's investment interests, like his philanthropy, weren't easy to pigeonhole.

A Hard Lesson in a Dirty Business

Recall that coal mine. He had started it in the mid-2000s. It was located near his hometown in the far southern tip of Illinois, closer to Paducah, Kentucky, than Chicago. He hoped to bring jobs to an economically ailing region — because he wanted to build a business that could also give back to the community.

Mining is a tough and dirty business. It taught a hard lesson to someone accustomed to seeing his investments pay off.

Thanks to a new form of oil-and-gas drilling called horizontal fracturing — fracking — natural gas prices had fallen, sapping demand for coal. (Both fuels are heavily used to generate electricity.) James realized his mine was likely doomed, and so he ended up selling it to Alliance Resource Partners in 2015.[4] The experience taught him that innovation — or t he lack of it — mattered just as much in old-line industries like energy as it did in cutting-edge ones like information technology. He realized that the environmental damage caused by coal made it vulnerable to competition from an upstart technology. That insight would inform his decision to start Engine No. 1 and to launch his proxy fight against ExxonMobil.

But before that came a chat over dinner with his family in which he found himself struggling to defend himself. One of his children asked how he could consider himself an environmentalist — he was on the board of National Fish and Wildlife Foundation and contributed to a raft of environmental nonprofits — if he invested in energy companies.

James started in on a lengthy explanation of how companies and nonprofits had different missions. As he later said in an interview, "As I was listening to myself talk, I thought, 'I am really splitting hairs on this.'"[5] As he continued, his kid scrunched up an eyebrow in a look of skepticism. The truth, James realized then, was something he and everyone else had learned as teenagers: You need to "clean up your mess — it's insane that people don't take responsibility for their [environmental and social] impacts."

James decided he wanted to better align his business ventures and personal values. As he was pondering how, he was interviewed by Michael O'Leary, for a book titled *Accountable*, which argues that shareholders should use their voting power to save capitalism from itself. O'Leary, who would later join Engine No. 1, had worked for Bain Capital and social impact funds but been frustrated by the inability to achieve the social impact he desired. His book's thesis was built around a paper he had read in graduate school by two well-known economists, Oliver Hart of Harvard University and Luigi Zingales of the University of Chicago.[6] Though written in understated academese, the paper had a radical message: companies should care *not only* about maximizing their share prices but about "pursuing policies consistent with the preferences of their investors," even those pertaining to environmental and social matters.[7]

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The radicalism stemmed not just from the message but also the messengers. The authors' employers — Harvard's economics department and Chicago's finance department — were better known for defending the status quo than upending it. Yet Hart and Zingales were attacking the dictum of Milton Friedman, perhaps the best-known champion of laissez-faire economics since Adam Smith, that public companies' sole aim should be to maximize their share values.

Hart and Zingales argued that Friedman and his acolytes ignored what shareholders demonstrated every day with their actions and money. Their argument went as follows:

The ultimate shareholders of a company (in the case of institutional investors, those who invest in the institutions) are ordinary people who in their daily lives are concerned about money but not just about money. They have ethical and social concerns. … For example, someone might buy an electric car rather than a gas guzzler because he or she is concerned about pollution or global warming. … If consumers and owners of private companies take social factors into account, ... why would they not want the public companies they invest in to do the same?"[8]

Critics of ESG investing typically argued that corporate shareholders could use the gains from their investments to support environmental and social groups they favored. But Hart and Zingales pointed out that large companies often created serious negative externalities, like greenhouse gases, that weren't easily reversed and that charities often didn't have the economic heft and political influence to neutralize. The two scholars also noted that ESG critics typically claimed companies couldn't easily discern their shareholders' values — shareholders were too numerous and dispersed. In the age of the internet and online polling, that was simply false, they said. Besides, companies weren't the only way for this kind of information to reach the market. Investment managers had ways of identifying people's values and helping them invest accordingly. For this purpose, the economists suggested a new kind of investment fund.

Imagine an index fund, identical in every respect to all other mutual funds, with the exception that it votes [its proxies] against any sale of assault weapons and ammunition to ordinary citizens. Prosocial investors should rush to such a product, ensuring its success in the market. In fact, the idea is so simple that one might wonder why we do not already see such products in the marketplace."[9]

As O'Leary recounted this argument, James realized that the two economists were, in effect, suggesting the solution to his personal dilemma. A fund like that would enable him to combine his investing expertise and environmental and social beliefs and do it in a way that tapped into his knowledge of innovation. Instead of voting its proxies against assault weapons, a fund might just as easily vote against, say, corporate failures to address climate change or wage inequality. And in doing that, James believed it would be voting for better management: "If you take social and environmental impacts into account when you're allocating capital, you're going to make better decisions, because those impacts affect the durability of the business." And if you could achieve this at large scale, you could do what James believed was possible: improve society by making companies and therefore capitalism work better.

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In the Footsteps of a "Folly"

Oddly, no such fund existed. A few investment boutiques offered actively-managed mutual funds that included ESG assessments as part of their investment processes. The managers of these funds voted their proxies in favor of ESG measures and even participated in proxy fights over high-profile questions like whether products contributed to rainforest destruction or boardrooms were diverse enough. But because the funds were actively managed and often small, they were expensive, imposing high fees on shareholders. That was a problem because investment analysts had shown that high fees predicted low returns and vice versa.[10] Even when active managers managed to beat the market, their fees could sap their advantage.

The best way for a fund company to economize on fees was to gather up assets, spread its fixed costs across a bigger asset base and *not* invest in activism — just as BlackRock, State Street and Vanguard had done. And the best way for an individual mutual fund or ETF to economize was to manage its holdings passively via indexing. An index fund held all of the securities in a market index and then matched that index's return minus the sliver of money subtracted for administration. Vanguard had pioneered this method with its Vanguard 500 Fund, built upon the S&P 500 stock market index. When the fund debuted in the 1970s, it was nicknamed "Bogle's folly" — a poke at its creator, Jack Bogle, then Vanguard's chief executive.[11]

Over time, investors became convinced of Bogle's folly was a path to fortune. Many active managers didn't outperform the market, after fees, much of the time, so indexing made sense. By the 2010s, new investor money was gushing into index funds.[12]

BlackRock, State Street and Vanguard had positioned themselves to exploit this trend, and BlackRock and Vanguard, in particular, had parlayed their foresight into commanding competitive positions. By the late 2010s, about 80 percent of the new money flowing into mutual funds and ETFs was ending up with those two companies.[13] A writer for Morningstar.com, the investment analysis website, noted that that created a virtuous circle: "As Vanguard and BlackRock get bigger, they can lower fees further and offer more services to investors. This only increases their competitive advantage."[14]

One way BlackRock, in particular, aimed to redouble its advantage was by building out its suite of ESG ETFs. Its iShares MSCI USA ESG Select ETF dated back to 2005. That ETF held about 200 stocks and screened out companies with substantial sales of alcohol, civilian firearms, weapons, gambling, nuclear power, and tobacco. "Screening" was the original means of winnowing ESG portfolios. It entailed barring companies in harmful businesses. It didn't involve detailed assessments of ESG performance, nor engaging publicly with corporate management, via proxy voting, to improve practices. ESG screening cost more than basic indexing. iShares MSCI USA ESG Select ETF, for example, charged an expense ratios of 0.25 percent.[15]

Screening was typically based on simple metrics created by ESG data providers, such as MSCI and Sustainalytics. If a stock cleared whatever the numeric threshold was — say, tons of greenhouse gases emitted or percentage of women on the board — it could be included in the index and thus an ETF built upon that index.

James believed the current metrics were mostly a patchwork of activities and risks that data providers *could* capture through regulatory filings or voluntary company reports, not what they *should* be capturing to estimate the true value of companies. He thought Engine No. 1

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could devise better metrics and analytics for identifying ESG performance and potential. If he was right, that would be a selling point for his new ETF and, eventually, for additional thematic ETFs. He envisioned using better data — one of the lessons of being a tech investor was the power of data — to quantify ESG risks and then feed that information into valuation models. Properly understood, precise information on ESG performance was just "a dataset for making better decisions," he said.

In his view, many companies had large ESG assets and liabilities that weren't being reflected on their financial statements and thus weren't fully understood or correctly priced by other investors. An example was the risk of Exxon's business being disrupted by climate change, either through new technologies or new regulation. That risk was substantial, existential even, but you would find it nowhere on Exxon's balance sheet.

The Augusta Effect

If the Big Three, to borrow Grancio's term, had a weakness in their handling of ESG matters, it was their reluctance to use their huge size to influence corporate conduct: they seldom voted in favor of shareholder resolutions intended to advance environmental or social goals.[16] Instead they tended to vote with the managements of companies in their funds' portfolios. They avoided proxy fights over tough ESG questions like, say, how companies could better stem their greenhouse gas emissions or prepare for a warming world.

Why they behaved that way was a matter of debate. The fund companies claimed they evaluated the pros and cons of each shareholder proposal and voted accordingly. Critics, including James, said their business models created conflicts of interest: A key part of any big investment firm's business is running corporate retirement plans. The fund companies didn't want to annoy the big firms whose pensions and 401(k) plans they managed. An academic study had found that fund companies with more business ties with public companies tended to vote more often with corporate management.[17] A similar conflict of interest emerged when a corporate CEO sat on the board of a mutual fund company.

One report singled out BlackRock's handling of the retirement plan of BP, the oil giant. The report's author, the 50/50 Climate Project, laid out the facts as follows.

BP posted a $6.5 billion net loss for its FY 2015, including a $10 billion charge for its liabilities from the Deepwater Horizon disaster. However, BP's proposed executive compensation plan for 2016 would have awarded the CEO a 20 percent pay increase. … While a majority of BP's shares were voted against this plan, BlackRock voted in favor of it.[18]

James had a pet theory for why fund companies favored corporate management in proxy votes: he blamed the "Augusta effect." Fund company CEOs were the sorts of people who got invited to be members of perhaps the most prestigious golf club in the U.S. — Augusta National, host of the Masters Tournament. Waging a proxy fight against a CEO who was a member of Augusta National might get you blackballed. Wrapped within James's wry observation was a truth about human nature: CEOs of the big investment companies and the Fortune 500 socialized in the same circles, and no one likes to attack their friends. Even the nongolfers ran into each at corporate conclaves like Davos, Switzerland, and the Sun Valley, Idaho, tech-and-media conference that had been nicknamed "summer camp for billionaires."[19]

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"It's like crony capitalism, and to think it doesn't exist is naïve," James said. "It's remarkable how CEOs and board members will support other CEOs and board members because they see them socially."

Going after a Straggler

When James began to organize Engine No. 1, the idea to challenge Exxon Mobil in a proxy fight had already crystallized, and he and Edward Sun, portfolio manager of the Perennial Value Fund, had already built out the hedge fund's portfolio, using ESG data and analysis. The decision to launch an ETF took longer. He knew that Exxon was a straggler, even among oil companies, in efforts to prepare for climate change and that its stock performance had lagged for years. For the decade that ended Feb. 19, 2020 — that is, right before the COVID pandemic — Exxon's shares had returned 28 percent, compared to 85 percent for its average peer and 275 percent for the S&P 500.[20] The company's earnings had been similarly anemic, falling annually from 2018 through 2020. In 2020, Exxon would report a net loss of $13 billion or $5.25 a share.

Yet the company's CEO, Darren Woods, kept insisting on his strategy of developing new oil fields and leaving the climate transition to other firms — Woods wanted to pump out 1 million *more* barrels of oil and gas a day by 2025.[21] That was perhaps no surprise, given that one of his predecessors had mocked climate models and dismissed stock analysts who disagreed with him as "Mickey Mouse."[22,23] Exxon's own scientists had privately concluded as early as the 1970s the climate change was real, though the company would go on to help bankroll an oil-industry effort to discredit climate science.[24]

Exxon's financial underperformance underscored one of James's core beliefs: that forward-looking executives created value for shareholders and that, in the long run, the market punished companies that didn't prepare for industry transitions and changes in consumer tastes and regulation. He likewise believed that firms that anticipated change thrived. So, he wanted to challenge the all-too-common belief that good returns and ESG performance conflicted. "Climate risk is business risk," he said.[25]

Given Exxon's weak returns, a proxy contest with Exxon's management wouldn't depend on rallying only investors concerned about climate change. It could appeal to anyone who wanted better returns. In James's turn of phrase, it would be about economics, not ideology.

A key weakness of Exxon that James had noticed was the lack of energy expertise on its board of directors. The board was full of luminaries, such as Ursula Burns, former CEO of Xerox, and Kenneth Frazier, former CEO of Merck, but no members had worked in the energy industry.

Still, even if investors agreed with James that Exxon was mismanaged and ill-governed, defeating one of the most storied companies in the U.S. in a proxy contest would be a challenge. James's forte was understanding industries and companies and weighing investment risks. A proxy contest resembled a political campaign. It depended not so much on numbers and spreadsheets as it did on rhetoric and persuasion. James was a stock-picker; he needed a storyteller and seasoned impact activist.

He had a sense of where he could find such a person. In 2018, Apple had lost a proxy vote over its willingness to provide means for parents to limit their children's time on mobile devices. That campaign was organized by a lawyer named Charlie Penner, of Jana Partners in New York. James approached him, and the two men began to talk about the possibility of working together

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on an Exxon proxy contest — something Penner, too, had been considering. Eventually Penner joined Engine No. 1.

From early on, James and Penner agreed they had to push for changes in the membership of Exxon's board. "Most activist campaigns are transactional," Penner said. "You want a share repurchase or improved capital allocation. [With] the Apple campaign, we wanted a software change. But Exxon had a board that had gone along with a failing strategy, and they let the CEO get away with things like viewing emissions reduction targets as a beauty competition. The kinds of changes we envisioned weren't going to happen without changes to the board."

Even with Penner leading the proxy campaign, Engine No. 1 had a scant chance of success in a fight with Exxon. Activists rarely won proxy contests, especially those pertaining to ESG concerns. A study by the Conference Board, a nonprofit research group, had found that, from 2015 through 2018, shareholder proposals relating to social and environmental matters received just a quarter of the votes cast. "This finding indicates that shareholders of U.S. public companies continue to believe that the board of directors and senior management are better suited to determine the business viability of certain sustainability activities," a board staffer wrote.[26]

Shareholder democracy doesn't work like citizen democracy — it isn't one person/one vote; it's one share/one vote. Institutional investors, like pensions and investment companies, have enormous influence. The larger they are, the more power they wield.

That meant BlackRock, State Street and Vanguard loomed large here, too, as an obstacle to James's ambitions. Together, they owned about 20 percent of the Exxon's shares. Even if their CEOs weren't interested in joining Augusta National, they seldom supported shareholder proposals related to climate change. A Morningstar analysis of the voting practices of index-fund sponsors found that BlackRock and Vanguard were among the least supportive when it came to environmental and social proposals. They voted for less than one in 10 in 2019.[27]

What about the Gatekeepers?

Jennifer Grancio, of course, knew of the habits of BlackRock and its closest competitors. She had spent 20 years at BlackRock and a predecessor company before leaving in 2018 to advise startups. She didn't doubt James's diagnosis of the conflicts the big fund companies faced: they were giant financial supermarkets with varying lines of business that sometimes conflicted. "BlackRock, Vanguard and State Street, they didn't mean to build a business where they locked up their votes," she said. "They just accidentally did it, and they now can't untangle it."

Where she hesitated was on whether Engine No. 1 could compete with them. All Chris James really had was a strong conviction that he could do their business better than they could, that he could see more clearly where the market was headed and what investors wanted.

Over the course of a series of conversations with James, Grancio found herself to returning to what she saw as two critical questions. The first was how was Engine No. 1's new ETF going to make money. Would James have the patience to subsidize it with the returns from the hedge fund until it could turn a profit? After all, ETFs didn't typically do that until they had several hundred million or even several billion in assets. The Big Three subsidized their funds until they could stand on their own. That way, high expense ratios didn't scare away potential investors.

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The second question was how Engine No. 1 would deal with that she called "the gatekeepers."

"You don't just walk out into the market and sell an ETF," she said. "You have to wangle your way through financial advisers and other gatekeepers," like the staffers at big retirement plans who decide which funds will be allowed into their menus of investment options. The gatekeepers were afflicted by inertia bias. They wanted the market return and feared making changes, especially those that could lead to underperformance against their peers. A well-known brand, like BlackRock or Vanguard, helped allay those fears.

Grancio did share James's values. She, too, wanted to see America's biggest companies step up their ESG performance and believed that capital, not charity, would be the impetus for that change. But could Engine No. 1 really combine a new ETF that met an unmet need in the market for active ownership and satisfied the gatekeepers with a hedge fund that occasionally pursued activist campaigns that needed the support of the Big Three to succeed?

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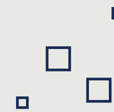
ABOUT THE: *ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INITIATIVE*



The *Environmental, Social and Governance Initiative* conducts academically rigorous and practically relevant research with industry partners and across all Wharton departments that investigates when, where, and how ESG factors impact business value. Informed by research, we offer 30+ courses that MBA and undergraduate students can assemble into a major or concentration, over a dozen co-curricular experiences, and three Executive certificate programs. Led by Vice Dean Witold Henisz, the ESG Initiative advances Wharton's best-in-class education of current and future leaders, enabling them to serve a world undergoing tremendous change.

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ENDNOTES

[1]Unless otherwise noted quotations from the protagonists of his case have been taken from the authors' conversations with them or from their interactions with students at the University of Pennsylvania's Wharton School. The protagonists also provided the background of their thinking at various junctures in the case.

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