

Do ESG Mutual Funds Deliver on Their Promises?

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Capitalism Revisited – ECGI

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Background

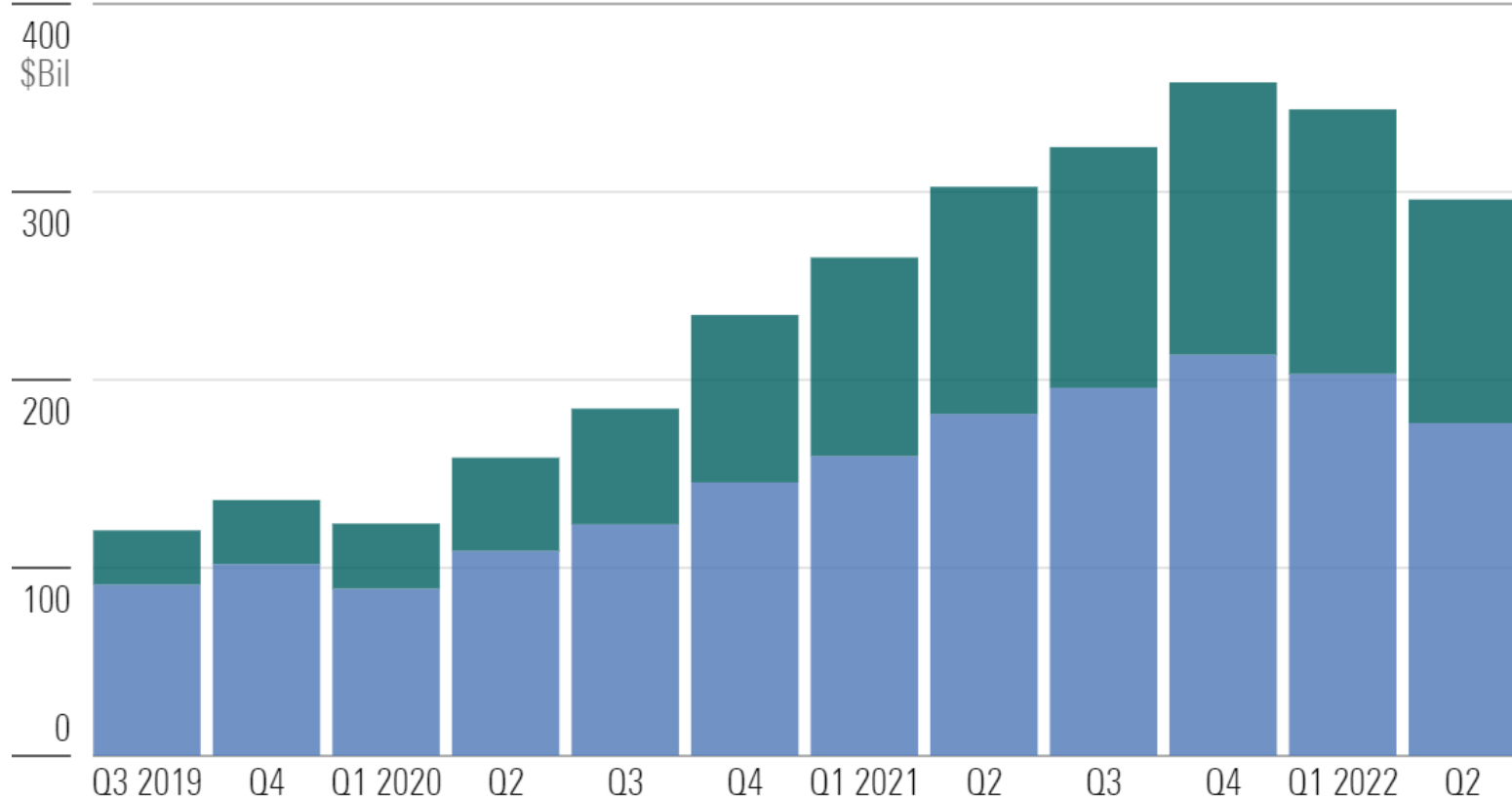
Market Context

- ▶ Exploding supply and demand for ESG mutual funds
- ▶ An evolving market in fund options and strategies

The Rise of ESG Investing

U.S. Sustainable Fund Assets

■ Passive ■ Active

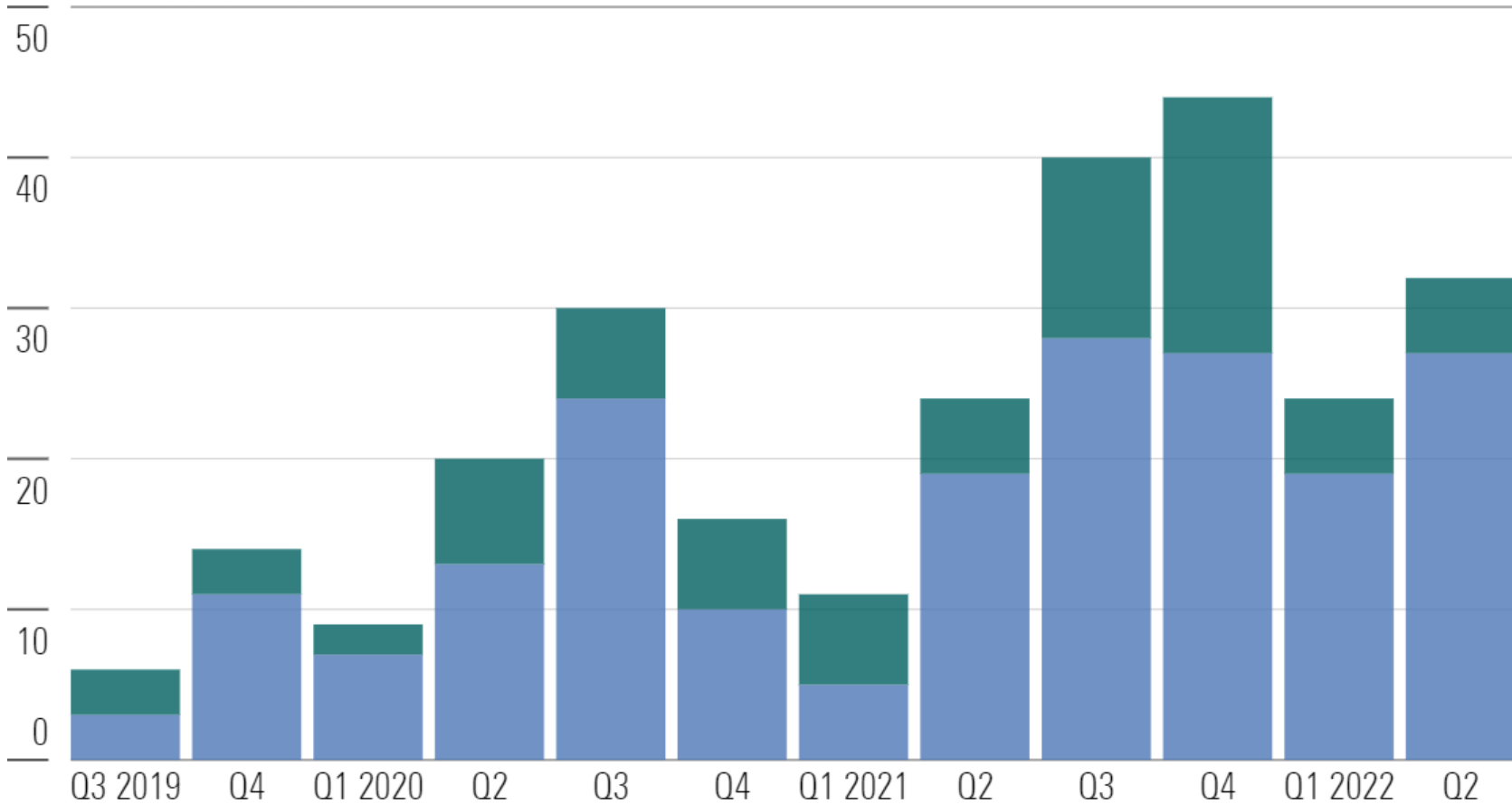


Source: Morningstar Direct, Manager Research. Data as of June 2022.

The Rise of ESG Investing

U.S. Sustainable Fund Launches

■ Passive ■ Active



Source: Morningstar Direct, Manager Research. Data as of June 2022.

Background

Concerns about ESG Funds:

- ▶ What are investors *getting* for their ESG dollars?
- ▶ What are investors *giving up* when they invest in ESG funds?

Politicization of ESG investing

- ▶ Greenwashing challenges from the left
- ▶ Anti-ESG efforts from the right
- ▶ Public pension funds

ESG is a Major Focus of Regulators



SEC Chair Gary Gensler

Sept. 1, 2021

Many funds these days brand themselves as “green,” “sustainable,” “low-carbon,” and so on.

I’ve directed staff to review current practices and consider recommendations about whether fund managers should disclose the criteria and underlying data they use to market themselves as such.

Critiques of ESG Investing

Greenwashing

An excuse to charge higher fees

ESG funds sacrifice returns (and don't tell investors that they are doing so)

ESG funds are riskier

Regulatory Developments

Since the publication of our paper, regulatory and media focus on ESG has intensified

SEC Regulatory Initiatives

- ▶ March 2022 - Proposed rule on climate risk disclosure
- ▶ May 2022 – Proposal to amend the Names Rule of the Investment Company Act (broadens the 80% policy)
- ▶ May 2022 – Proposal to enhance disclosures by Investment Advisers (ESG fund buckets & disclosure of weighted average carbon emissions)

DOL Regulatory Initiatives

- ▶ Fall 2021 proposed rule – Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights
- ▶ Feb. 2022 - Request for Information on Possible Agency Actions to Protect Life Savings and Pensions from Threats of Climate-Related Financial Risk

Various congressional initiatives

What we did

We examined whether ESG funds differ from non-ESG funds along four dimensions:

- ▶ Portfolio composition
- ▶ Voting behavior
- ▶ Costs
- ▶ Performance

We found:

- ▶ significant differences in portfolio composition and voting behavior
- ▶ no evidence that ESG funds cost more or underperform non-ESG funds

Caveats

What is ESG?

- ▶ Reasonable minds can disagree
- ▶ Climate change, human capital management, private prisons
- ▶ Tesla?
- ▶ We do not adopt our own definition

What is an ESG strategy?

- ▶ Screening and exclusion
- ▶ Invest in the “better” companies in an industry or sector
- ▶ Impact investing
- ▶ Potential breadth – other values funds, anti-ESG funds

Criticism of ESG ratings

- ▶ We are agnostic here and use four different ratings providers
- ▶ We do not purport to analyze how much ESG is “enough”

Caveats

Our analysis was focused on a specific moment in time:

- ▶ Substantial recent growth in number and size of ESG funds
- ▶ Funds continue to refine their investment strategies and disclosures
- ▶ Increasing fund variety on both the left and the right
- ▶ Non-ESG funds are increasingly considering ESG issues
- ▶ Performance numbers may also be a function of general market conditions

Empirical Analysis

Sample of Funds

ESG Names

- ▶ Does the fund name suggest that it is ESG focused? (ex., sustainable; responsible; ESG; green; etc)

Morningstar-identified

- ▶ Does Morningstar identify it as an ESG fund?

Separately, we study funds Morningstar identifies as ESG Consideration funds

- ▶ “Consider” ESG in their decisionmaking

Data

Holdings and Performance Data \Rightarrow CRSP ESG Ratings from four

different providers:

- ▶ Sustainalytics
- ▶ S&P
- ▶ ISS
- ▶ TruValue Labs

Sample Period: 2018-2019

What are Investors Getting?

The SEC's primary concern is that investors are not being misled

We ask: Is there evidence that ESG funds are **systematically failing to differentiate themselves** with respect to

- ▶ Their portfolio tilt?
- ▶ Their voting behavior?

Do ESG Funds have “more ESG” Portfolios?

We construct ESG tilt of each fund \times quarter

$$Tilt_{(j,t,k)} = \sum_i w_{i,j,t} \times r_{i,t,k}$$

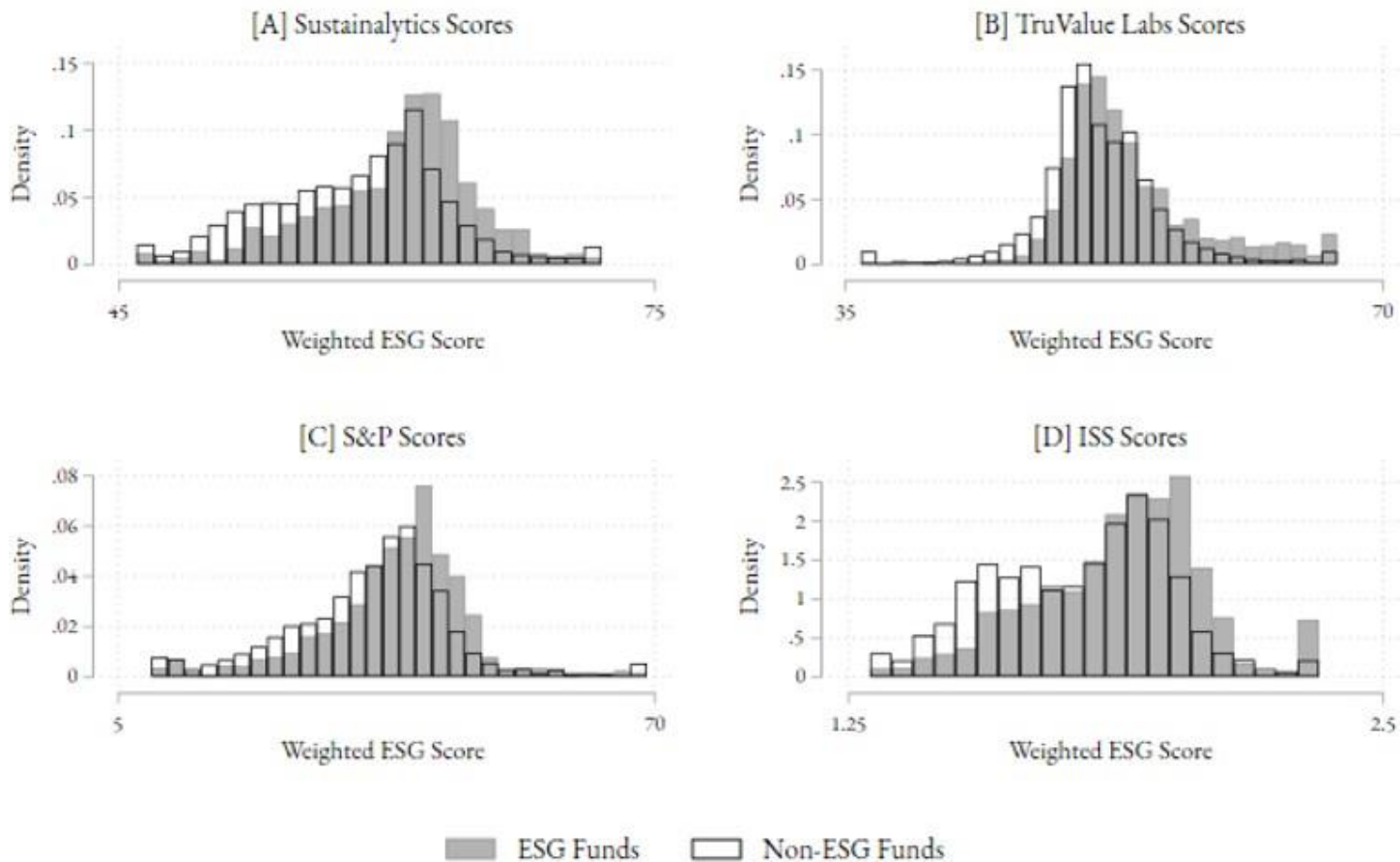
Where

- ▶ $w_{i,j,t}$ is the weight of security i in fund j 's portfolio in quarter t
- ▶ $r_{i,t,k}$ is the ESG rating of security i in period t , as rated by entity k

We also construct percentile scores using these ratings

For the Most Part, Yes

Figure 1: ESG Tilt of Mutual Fund Portfolios: Weighted ESG Scores



On Average, Yes

Table 2: ESG Portfolio Tilts- ESG/Non-ESG Funds

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	ESG Name	1.775*** (7.01)		2.223*** (7.03)		3.048*** (5.38)		0.101*** (7.96)
Morningstar		1.212*** (3.97)		1.539*** (6.56)		2.515*** (4.22)		0.051*** (4.61)
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46,432	46,432	50,658	50,658	41,778	41,778	48,304	48,304
adj. R-sq	0.071	0.071	-0.002	-0.002	-0.002	-0.002	0.046	0.046
Number of ESG Funds	174	200	189	218	164	186	182	211

Voting Analysis

Do ESG funds vote differently?

- ▶ Look at propensity to oppose management
- ▶ Try to isolate ESG funds vs ESG families
Shareholder proposals
- ▶ Essentially all ESG relevant

Environmental shareholder proposals and “E” funds:

- ▶ Easier to identify

Uncontested director elections:

- ▶ General propensity to oppose management

Voting - Results

Table 5: Likelihood of Voting Against Management Recommendation (LPM)- ESG/Non-ESG Funds

	Shareholder Props.		Unopposed Director Elections	Shareholder Props.		Unopposed Director Elections
	(1)	(2)	(3)	(4)	(5)	(6)
ESG Fund Indicator	0.126*** (4.16)		0.020*** (3.29)	0.117*** (5.55)		0.019*** (4.71)
Enviro Fund Indicator		-0.036 (-1.02)			0.063 (1.25)	
Enviro Issue Indicator		-0.064*** (-18.63)			-0.064*** (-17.50)	
Enviro Fund x Enviro Issue		0.126** (3.07)			0.137* (2.51)	
ESG Family Indicator	0.271*** (7.95)	0.387*** (17.75)	0.238*** (6.16)			
Constant	0.460	0.469	0.060	0.463***	0.471***	0.061***
Firm x Year FE	Yes	Yes	Yes	No	No	No
Fund Fam. X Firm X Yr. FE	No	No	No	Yes	Yes	Yes
Observations	788,913	788,913	14,438,612	788,913	788,913	14,438,612
R-squared	0.283	0.282	0.205	0.653	0.652	0.515

What are Investors Giving Up?

The DOL's primary concern is that ESG funds are sacrificing pecuniary performance for non-pecuniary goals

We ask: Is there evidence that ESG funds are **systematically underperforming** with respect to

- ▶ Their expenses?
- ▶ Their performance?

Higher Fees?

Table 6: Expense Ratios - ESG/Non-ESG Funds

	(1)	(2)	(3)
ESG Name	-0.00049 (-1.47)		
Morningstar		0.00017 (0.70)	
Morningstar Consideration			0.00079*** (4.31)
Observations	52,592	52,592	52,592
Adjusted R-squared	0.340	0.340	0.341
Number of ESG Funds	178	218	249

All models include: manager, fund, and class size controls; objective x year fixed effects and index fund fixed effects

Note: We are not showing (or claiming) that ESG funds are as cheap as the ultra-low-cost index funds

Worse (Pecuniary) Performance?

Table 7: Returns and Sharpe Ratios - ESG/Non-ESG Funds

	(1)	(2)	(3)	(4)	(5)	(6)
ESG Name	0.00214*			0.04917*		
	(2.62)			(2.80)		
Morningstar		0.00090			0.01647	
		(1.86)			(1.62)	
Morningstar Consideration			0.00127**			0.02667**
			(3.43)			(3.06)
Observations	721305	721305	721305	721186	721186	721186
Adjusted R- squared	0.651	0.651	0.651	0.780	0.780	0.780
Number of ESG Funds	202	234	260	201	233	259

All models include: manager, fund, and class size controls; objective x month fixed effects and index fund fixed effects

Regulatory Implications

What does this mean for the SEC?

The moral panic about ESG funds may be overblown

- ▶ At the portfolio level, ESG ratings may not be so problematic
- ▶ ESG funds do tend to have portfolios with more ESG tilt
- ▶ ESG funds do seem to vote more independently

Investors may not understand exactly how the ESG evaluation is done, or exactly how the fund is run, but that's true of all mutual fund strategies!

Bottom line: Our analysis does not demonstrate a need to treat ESG funds differently from other mutual funds

Current SEC rule proposals that introduce distinctive compliance obligations on ESG funds may limit innovation

What does this mean for the DOL?

No obvious reason to discourage ESG considerations by pension fund trustees

No obvious reason to discourage ESG funds in participant-directed retirement plan menus

No obvious reason to *require* the consideration of ESG factors by fiduciaries

The End

Tilt - Regression (Percentiles)

Table 2: ESG Portfolio Tilts- ESG/Non-ESG Funds

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	ESG Name	12.377*** (7.90)		14.899*** (8.23)		11.873*** (6.60)		13.273*** (9.01)
Morningstar		9.018*** (5.41)		12.355*** (8.49)		9.105*** (4.86)		7.498*** (4.88)
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46,432	46,432	50,658	50,658	41,778	41,778	48,304	48,304
adj. R-sq	0.381	0.380	0.247	0.246	0.263	0.261	0.402	0.399
Number of ESG Funds	174	200	189	218	164	186	182	211