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The ESG Backlash and the Demand for ESG Mutual Funds

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Abstract

The backlash to ESG investing is in full swing, with dozens of states enacting measures aimed at curtailing the consideration of environmental, social, and governance factors in their pension funds. Meanwhile, ESG mutual funds are experiencing net outflows after a period of lagging performance. Is this the end for ESG funds? This paper draws on the literature on mutual fund flows to study how the demand for ESG funds has changed over time and how that demand interacts with the political and legal backlash to ESG. It finds that ESG funds received significant positive flows, controlling for conventional predictors of fund flow, starting in 2017. This effect peaked in late 2019, much earlier than the publicly perceived decline of ESG. Abnormal investor preference for ESG funds disappeared in 2020, around the time of the Trump Department of Labor rule targeting ESG and then reappeared in 2021 before declining again. The excess demand for ESG was driven largely by institutional share classes, particularly pre-2021. While the positive effect of ESG branding on flows has disappeared, demand for ESG funds (controlling for past performance) has generally remained non-negative up to 2024. Most of the decline in excess demand for ESG funds predates the political backlash and state anti-ESG laws. Tests for a causal relationship between ESG fund flows and the political backlash, as measured by mentions of ESG in conservative media and state laws restricting ESG, show no statistical connection.

Keywords: ESG, Investing, Finance, Pension, financial regulation, mutual funds

JEL Classifications:

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The ESG Backlash and the Demand for ESG Mutual Funds

ABSTRACT: The backlash to ESG investing is in full swing, with dozens of states enacting measures aimed at curtailing the consideration of environmental, social, and governance factors in their pension funds. Meanwhile, ESG mutual funds are experiencing net outflows after a period of lagging performance. Is this the end for ESG funds? This paper draws on the literature on mutual fund flows to study how the demand for ESG funds has changed over time and how that demand interacts with the political and legal backlash to ESG. It finds that ESG funds received significant positive flows, controlling for conventional predictors of fund flow, starting in 2017. This effect peaked in late 2019, much earlier than the publicly perceived decline of ESG. Abnormal investor preference for ESG funds disappeared in 2020, around the time of the Trump Department of Labor rule targeting ESG and then reappeared in 2021 before declining again. The excess demand for ESG was driven largely by institutional share classes, particularly pre-2021. While the positive effect of ESG branding on flows has disappeared, demand for ESG funds (controlling for past performance) has generally remained non-negative up to 2024. Most of the decline in excess demand for ESG funds predates the political backlash and state anti-ESG laws. Tests for a causal relationship between ESG fund flows and the political backlash, as measured by mentions of ESG in conservative media and state laws restricting ESG, show no statistical connection.

I. Introduction

The backlash against attention to environmental, social, and governance ("ESG") factors in asset management is in full swing. More than twenty states have adopted at least some type of anti-ESG measure, flows into ESG funds are declining, and the performance of many ESG funds lagged the broader market in 2022. For the first time since investor interest turned to ESG around 2017, assets under management in ESG funds have declined. This slowdown has led commentators, with varying degrees of relish, to proclaim that ESG is "fading" (Shifflett, 2023), "dying" (Goodkind, 2023), or "beyond redemption" (Damodaran, 2023). ESG has been one of the most important movements in corporate governance and investing in the last decade, but commentators are now asking: Is the end near for ESG?

To understand the current state of the market for ESG funds and its potential link to the ESG backlash, this paper draws on the literature on mutual fund flows to measure whether funds with ESG-indicating names draw more assets than similarly performing conventional funds with similar styles. Repeating this measurement monthly, we build a time-varying measure of the demand for ESG funds. This measure, which is new to the ESG literature, provides helpful insight into the key questions around ESG funds:

Have ESG funds attracted higher flows than other funds? At certain points in time, yes. From late 2017 to early 2020 and again, albeit at lower levels, in 2021 inflows to ESG funds were higher than other funds controlling for past performance and other factors. Looking at the average effect over the entire time period analyzed here, ESG funds have not received higher inflows on average.

Has this effect declined? Yes. Being an ESG fund is no longer a positive predictor of fund flows.

Are investors fleeing ESG funds? In general, no. While market observers began to proclaim the decline of ESG as early as 2022, ESG naming is only associated with negative flows during two months in 2024. This net effect reflects outflows for institutional share classes, and continued inflows for retail share classes. For most months since 2020, ESF funds' flows performed much like other funds when past returns are considered.

Is the ESG backlash having an effect? That is a more challenging question. This paper investigates the ESG backlash along two dimensions. The first dimension is legal. At the federal level, the Trump DOL engaged in rulemaking aimed at ESG investing in ERISA plans that, correlated with a reduction in demands for ESG, particularly among institutional share classes. At the state level, many red states have sought to directly reign in ESG through a variety of legal initiatives. Some of these legal interventions have aligned in time with retrenchment in ESG investing. The political backlash took off in 2022 with a number of states adopting laws, and assets under management in ESG funds declined in 2023, but flows adjusted for performance remained steady over that period. An important question, whether any of these state interventions are sufficiently binding to materially affect the decisions of asset managers. This paper analyzes various ESG statutes against the backdrop of the original DOL ESG rule proposed under the Trump administration. It concludes that the vast majority of state anti-ESG bills are likely to have limited-to-no effect on ESG investing, but some states have adopted anti-ESG measures that could conceivably have a material effect.

Legally binding constraints are not the only way that the ESG backlash could matter for fund flows. The second dimension this paper investigates is the general political environment around ESG. Declining demand can be a threat to ESG even if the law is not. While there is reason for skepticism that political interventions are directly constraining decision-making, the political pushback to ESG might nevertheless tarnish its brand in a sharply divided political environment. Exploring the connection between state laws, mentions of ESG in conservative media, and fund flows, there is little evidence of a causal effect on the demand for ESG.

To empirically investigate the recent history of ESG investing and shed light on its future, this paper examines the flow of investment assets into ESG mutual funds over the last eight years. An extensive literature in finance, beginning with Sirri & Tufano (1998) has investigated the relationship between mutual fund flow and performance. While "past performance is not a guarantee of future returns" investors nevertheless consistently chase funds with strong past performance records. Replicating the methodology of this literature and adding an indicator for funds with ESG-associated names, this paper analyzes fund flows for ESG and non-ESG funds, isolating the differential flow to ESG funds over time while controlling for standard flow-affecting characteristics and returns. This paper also gathers data on the ESG backlash, including key legislative developments and the number of mentions of the term "ESG" on Fox Business Channel by month. Taken together, these measures provide a useful overview of the ESG backlash and insight to the conservative media approach to ESG.

While drawing strong causal claims from multiple time series is a fraught exercise, putting the shifting demand for ESG funds and the changing political environment on a common timeline permits an evaluation of the order in which events occurred. Studying flows to ESG funds this way leads to several interesting conclusions.

First, over two distinct time periods, there has indeed been demand for ESG funds in excess of what would be expected in light of their past returns. The first period ran from the end of 2017 through early 2020. The second period was during most of 2021. During these times, flows to ESG funds were higher than what would be predicted by their performance characteristics, suggesting that investors were attracted to the ESG branding of ESG funds in particular. That ESG funds have been a hot sector will not come as a surprise, but this confirms investor interest in these funds specifically and validates the general approach.

Second, this excess demand came largely from the institutional share classes of these funds, not the retail shares. Because institutional and retail share classes of mutual funds are distinct (and carry distinct costs), it is possible to look separately at the flows from these two groups of investors. During the primary period of excess ESG demand pre-pandemic, retail share classes of ESG funds almost never showed significantly positive flows relative to other funds. Retail investors started to gravitate to ESG only in 2021, well after the peak of the institutional share classes, and retail excess demand has generally been less dramatic.

Third, the fund flow data shows that current investor demand for ESG funds is below peak levels, even when controlling for the returns of ESG funds. This, again, is no surprise to those who have been following this market. This analysis, though, demonstrates that this decline in flows is not purely a returns effect. Something about the ESG "brand" has shifted in investors' minds. It would be premature, though, to write off ESG funds completely. While demand for ESG mutual funds is clearly undergoing a retrenchment, there have been only two of negative performance-adjusted flows for ESG funds since 2017.

Fourth, the decline in relative demand for ESG funds began well before the most intense phase of the backlash. Excess investor demand peaked early in 2020, around the time of the COVID-19 pandemic, and declined dramatically around the adoption of the Trump DOL rule in November 2020. This is well before the conservative backlash against ESG became a mainstream phenomenon. Mentions of ESG on the conservative Fox Business channel were rare at that point, and state legislative activity didn't pick up until two years later. Money continued to flow into ESG funds during this period, but these flows were in line with the typical response of flows to past fund performance. While it is impossible to rule out that political opposition to ESG has had a negative effect on the market, it is clear that investor interest in ESG was declining before the backlashed picked up steam.

Fifth, examining the rising number of state anti-ESG statutes, mentions of ESG on Fox Business News as a proxy for political salience, and the shifting demand for ESG on a common timeline, it is possible to test for correlated lags that might suggest causality. Running a test for Granger causality shows no strong evidence that either dimension of the backlash is responsible for declining investor demand.

This paper has several limitations. First, it is a study of a relatively small subset of mutual funds that explicitly brand themselves as embracing ESG in their names. Investment in ESG mutual funds is one aspect of ESG investing, but not its entirety. All of the largest asset managers globally, with assets exceeding $100 trillion, signed the Principles for Responsible Investment, (PRI, 2023), committing to consider ESG principles in their asset management decisions. ESG mutual funds represent only a small slice of these assets but nevertheless bear study because they are a channel through which investors can easily and explicitly elect to follow an ESG-oriented strategy, rather than merely have such considerations "integrated" in a non-specific way into portfolio decisions. As such, they are a useful yardstick for investigating the changing demand for ESG strategies. Second, there is an absence of obvious exogenous shocks that might lead to strong causal inferences in this context. As such, this paper is aimed primarily at measuring both the demand for ESG and the backlash to ESG to allow the side-by-side comparison of these trends. Third, the demand for ESG funds imperfectly measures the demand for ESG investing generally. ESG funds are relatively uncommon in 401(k) menus, meaning that ESG funds are not readily available through the primary channel for ordinary investors. ESG funds also face competition from large asset managers like BlackRock and State Street who, for much of the period under study, foregrounded ESG considerations in their approach to their conventional portfolios during this period. (Barzuza et al., 2021). Despite these limitations, ESG mutual funds provide a promising empirical window into the market for ESG asset management. They make an explicit, transparent commitment to ESG, and their flows are easily measurable. Finally, we rely on fund name to identify ESG funds. While the vast majority of ESG funds indicate their approach in their name, and investors are likely to rely on names when seeking out ESG options, there is likely to be some over- and underinclusiveness in this approach.[1] Given the high salience of fund name, to the extent our goal is to measure investor demand for ESG, fund name is a sound basis for identification.

The rest of this paper proceeds as follows. Section II presents background on ESG investing and the backlash. Section III reviews data and methodology. Section IV presents results and

[1] This limitation is discussed further below.

discussion. Section V concludes.

II. Background

While a vast literature discusses the meaning and implications of ESG investing and related concepts, work on the ESG backlash is less common. Some academic work as well as law-firm analysis has tracked the rising tide of state anti-ESG bills. (Behbin et al., 2023; Lichtenstein et al., 2024; Morrison Foerster, 2023; Padfield, 2022). A recent paper has looked at the financial impact of state bills that blacklist particular banks from underwriting bond offerings on the cost of bond issuances. (Garrett & Ivanov, 2022) Other work has suggested that retail investors have little interest in ESG disclosures, (Mahoney & Mahoney, 2021; Moss et al., 2020), or that the premise of at least some ESG investing is unrealistic. (Berk & Van Binsbergen, 2021). At least one paper has looked directly at ESG fund flows, examining how those flows might affect the prices of stocks with strong ESG scores. (van der Beck, 2021).

This paper seeks to fill a gap in the literature by taking ESG fund flows themselves as the object of study. The demand for ESG investing as a general matter is not observable, in part because the meaning of ESG investing is contested and not always clear. (Pollman, 2022). ESG funds, while not comprising the entirety of ESG investing, give one window into understanding this demand. Casual observation of the mutual fund market suggests that the demand for ESG has shifted over time, and so attempting to gain insight into these shifts provides valuable information about investor preferences, the impact of politics and law, and—one might hope—the future direction of the market.

a. Characterizing the Market for ESG Funds

A threshold consideration is the identification of ESG funds. Identifying ESG funds with reference to particular terms in the fund name[2] is sensible, as fund names are understood to be one of the most important features signaling information about funds to investors. (Cooper et al., 2005; Fisch &

[2] See note 28, *infra* for a list of terms used to identify ESG funds.

Robertson, 2023). While ESG mutual funds have drawn the eye of regulators for potential greenwashing, prior works have shown that ESG mutual funds exhibit measurable differences in their portfolio allocations such that ESG funds have portfolios tilted toward securities with better ESG scores. (Curtis, Fisch and Robertson, 2021). Such funds therefore reflect the actual implementation of ESG strategies.

[Insert Figures 1 and 2 Here]

ESG funds have undergone remarkable growth in recent years. Figure 1 shows the increasing number of ESG funds, as identified by ESG terminology in the fund name, with the number of funds tripling from 2018 to 2023 and net assets in ESG funds more than tripling over the same period. Also evident from Figure 1 is that the growth of ESG funds has recently stalled, with the number of funds topping out in 2023 and the net assets reaching its peak well before that. Assets have flowed out of ESG funds recently. This slowdown has led commentators to wonder about the future of ESG funds and the ESG movement generally.

The recent decline in ESG flows comes amid two other trends. First, the outflows follow recent underperformance in ESG funds. Figure 2 presents equally-weighted raw returns averages for ESG and non-ESG funds. The figure shows that, while ESG funds enjoyed a performance edge over conventional funds for much of recent history, in 2021 and 2022 their performance lagged other funds. Moreover, the market was down across the board during that period, perhaps souring investors on ESG strategies. Second, ESG has met considerable political resistance, particularly in red states, where the leftward-lean of many ESG considerations has not gone unnoticed.

There are several questions that warrant investigation. First, what is the nature of the decline in ESG investment? In particular, it is well known that mutual fund flows and returns are related. If ESG funds have lagged in returns, a decline in flows is to be expected, but are ESG labels *per se* turning off investors, or are ESG funds behaving as any other fund would be expected to? Second, what is the effect of the political backlash? Has the fact that ESG is now a locus of intense political contestation caused some investors to flee the sector? Or perhaps the state laws designed to restrict investing have sufficient bite to reduce asset allocations to ESG. The next section characterizes the legislative interventions aimed at curtailing ESG.

b. Anatomy of the ESG Backlash

The apparent declining interest in ESG is not happening in a vacuum. ESG has been subject to a vigorous political backlash. At the federal level, the Trump administration in its final year adopted several initiatives aimed at curtailing ESG investing. At the state level, "as of September 4, 2023, there are 20 states with effective 'anti-ESG' rules…. More than 75 additional anti- or pro-ESG bills are pending in current state legislative sessions across the United States. In all, forty-one states have either effective or pending ESG investing rules." (Behbin et al., 2023). This backlash reflects the political valence of many ESG initiatives, which tend to focus on left-leaning issues like climate change and diversity. As a result, red states have moved to curtail ESG initiatives, and ESG has become something of a bête noir in conservative media. (Kolhatkar, 2022)

This section presents a brief review of the legislative and regulatory interventions that have targeted ESG investing with the goal of restricting the consideration of ESG factors. As will be outlined below, these measures are likely to be limited in their potential impact on ESG investing. It is certainly possible that, by making ESG investing into a politically fraught issue, the appetite of politically sensitive institutions, including asset managers, to embrace ESG will be dampened, but the discussion below concludes that only a handful of state rules have substantial bite when it comes to actual asset allocations.

i. The Status Quo Ante: ERISA Regulation of Social Investments

While the concept of ESG is relatively new (Pollman 2022), the debate over considerations of social issues in investing is not. That debate has played out largely with respect to the regulation of retirement plans—both defined contribution and defined benefit—by the Department of Labor under

ERISA. ERISA creates duties of prudence and loyalty for the fiduciaries of retirement plans.[3] Under this duty, plan sponsors are required to act "solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to their participants and beneficiaries."[4]

In 1994, the Clinton DOL issued an Interpretive Bulletin[5] with respect to "Economically Targeted Investments (ETIs)" designed to create collateral social benefits, an early form of ESG investing. The Bulletin noted that "a perception exists within the investment community that investments in ETIs are incompatible with ERISA's fiduciary obligations" and sought to "eliminate this misperception."[6] In the DOL's view, fiduciaries could consider the collateral (i.e., social) benefits of such investments, provided that "such collateral benefits may be decisive in evaluating an investment only if the fiduciary determines that the investment … is expected to provide an investment return to the plan commensurate to alternative investments having similar risk."[7] Thus, the baseline rule is that social factors can be considered, but not at the expense of risk-adjusted returns. This baseline has never been changed by subsequent legal interventions.

In 2008, the Bush DOL revisited the issue. In the 2008 Interpretive Bulletin,[8] the DOL wrote "Given the significance of ERISA's requirement that fiduciaries act 'solely in the interest of participants and beneficiaries,' the Department believes that, before selecting an economically targeted investment, fiduciaries must have first concluded that the alternative options are truly equal, taking into account a quantitative and qualitative analysis of the economic impact on the plan…the Department believes that fiduciaries who rely on factors outside the economic interests of the plan in making investment choices … will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a

[3] ERISA §§ 403-404 (codified at 29 U.S.C.A. § 1104(a)(1)(A-C) (2019)).
[4] Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 32606, 32607 (1994).
[5] *Id* at 32,607.
[6] *Id.*
[7] *Id* at 32,607.
[8] Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 73 Fed. Reg. 61,734 (2008).

contemporaneous economic analysis showed that the investment alternatives were of equal value."[9] This interpretation did not substantively change the requirement, but suggested that instances of plan sponsors facing truly equivalent investments would be rare and must be documented.

The Obama DOL's rejoinder came in 2015, in the form of yet another Interpretive Bulletin. The guidance provided that "in the seven years since its publication, IB 2008–01 has unduly discouraged fiduciaries from considering ETIs and ESG factors. In particular, the Department is concerned that the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent."[10] The guidance also explicitly acknowledged, for the first time, that ESG issues might have financial significance and therefore be part of the consideration of risk and return and not ancillary to that consideration.[11]

In 2018, the Trump DOL weighed in on the back-and-forth with a Field Assistant Bulletin (an explicitly enforcement-oriented document) that stated "Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors."[12] While the substance of the Bulletin was—once again—not a significant change from past practice, that the Bulletin was addressed to the DOL Director of Enforcement sent a message about the DOL's intentions with respect to ESG investments.

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[9] *Id* at 61,735-36.
[10] Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 73 Fed. Reg. 61,734 (2015).
[11] *Id.*
[12] John J. Canary, US Department of Labor, "Interpretive Bulletins 2016-01 and 2015-01" Field Assistance Bulletin No. 201801 (2018).

ii. The 2020 Department of Labor Rule

The back-and-forth over ESG factors in retirement plans prior to 2020 was, in many ways, marginal. No one disputed that plans could not sacrifice returns to pursue social goals, nor was it disputed that economically material ESG considerations were a legitimate factor for plan fiduciaries to consider. The competing approaches amounted only to slight changes of emphasis playing out in sub-regulatory guidance.

This changed in 2020 with a proposed rule that sought to constrain the use of ESG factors in plans covered by ERISA. ("Financial Factors in Selecting Plan Investments," 2020). The rule was published on June 30, 2020, in the final year of the Trump administration and was proposed as an interpretation of Sections 404(a)(1)(A) and (B) of ERISA, characterizing the fiduciary duties of sponsors of 401(k) and ERISA-covered pensions plans. Importantly, this duty is understood to be enforceable by a private right of action, and lawsuits alleging a breach of this duty are commonplace. (Mellman & Sanzenbacher, 2018). The DOL's characterization of these duties therefore carried not just threat of public enforcement, but private litigation by plaintiffs' attorneys as well.

The proposed rule singled out ESG investments for heightened scrutiny, stating:

> A fiduciary's evaluation of an investment must be focused only on pecuniary factors. Plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals. Environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The weight given to those factors should appropriately reflect a prudent assessment of their impact on risk and return. Fiduciaries considering environmental, social, corporate governance, or other similarly oriented factors as pecuniary factors are also required to examine the level of diversification, degree of liquidity, and the potential risk-return in comparison with other available alternative investments that would play a similar role in their plans' portfolios.[13]

[13] 2550.404a-1(c)(1).

Under this proposal, ESG investment options could be included in in 401(k) plan menus only if they were selected without regard to their ESG characteristics[14] and the plan sponsor's conclusion supporting the selection had to be documented.[15] Even if these requirements were met, such an ESG fund could not be a Qualified Default Investment Alternative to which investor assets were assigned by default.[16]

Had the proposed rule been adopted in its original form, it would have considerably heighted the legal risk associated with including any fund that considered ESG factors in a plan menu, much less a fund—like the ones studied here—that commit to ESG goals in their names. It is uncommon for ESG funds to explicitly state that their strategies sacrifice returns. At most, such funds will state that their strategy *might* result in lower returns, but one can find similar disclaimers in the prospectuses of conventional funds: If growth stocks do poorly, then a growth fund will too. In fact, many ESG funds frame their ESG objectives as aligned with long term value, "sustainable" firms—one might think—ought to do well if one anticipates a future where emitting carbon is costly and public pressure on companies to behave in responsible ways increases. Whatever one thinks of that as an investment strategy, the DOL proposal would have subjected ESG strategies, and only ESG strategies, to an explicit requirement to justify themselves with reference "material economic considerations under generally accepted investment theories." The expression "generally accepted investment theories" was not further defined in the rule.

The adoption of such a rule, and its subsequent enforcement in private litigation, would have all but eliminated funds that explicitly consider ESG factors from retirement plans.[17] This effect may well have extended to funds that even "consider" ESG factors alongside conventional financial metrics without an explicit ESG branding. Arguably, the rule might have even called into question the conventional funds of BlackRock, State Street, and Vanguard, all of whom state that they consider ESG factors.

[14] 2550.404a-1(c)(3)(i).
[15] 2550.404a-1(c)(3)(ii).
[16] 2550.404a-1(c)(3)(iii).
[17] As noted below, such funds are already rarely included in these plans due to perceived legal risk even under the existing standards.

The proposal met furious pushback from the financial services industry and plan sponsors and garnered more than 20,000 comments. The final rule, adopted in November 2020, ultimately held to the requirement that plans consider only pecuniary factors, but did not single out ESG funds for special scrutiny or require documented substantial with reference to generally accepted theories. (Financial Factors in Selecting Plan Investments--Final Rule, 2020). The rule did require, in line with the 1994 guidance, that economically indistinguishable options be documented, and also restricted the use of ESG funds as default investments. The final rule was, at most a modest change to the status quo as a matter of law, but nevertheless emphasized that plan sponsors must be committed to financial rather than social goals in asset selection.

Similarly modest was the Biden administration's response: yet another rule interpreting ERISA. While maintaining the core limitation that returns cannot be sacrificed to yield social benefits, the 2022 rule made explicit that "the economic effects of climate change and other ESG considerations"[18] could be permissibly weighted by plan sponsors. The rule also rescinded default investment limitation and documentation requirements of the 2020 rule.[19] While the rule likely did little to change asset manager behavior, it was nevertheless overturned by a Senate vote, which was subsequently vetoed by President Biden. ("Biden Uses First Veto to Defend Rule on ESG Investing," 2023) The lawsuit attempting to have the rule thrown out subsequently failed in the 5th Circuit. *Louisiana v. Biden,* 64 F.4th 674 (5th Cir. 2023).

The back and forth over ESG investing under ERISA represents a substantial (and bipartisan) allocation of regulatory attention across four presidential administrations against an unchanging legislative baseline that plans cannot sacrifice returns for social goals but can consider financially relevant ESG considerations.

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[18] US Department of Labor, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 FR 73822 (2022)

[19] *Id.*

iii. State-Level ESG Rules

After the 2020 election, those looking to constrain ESG looked to red states. (Padfield, 2022). While states have no power to regulate investment funds, defined contribution retirement plans, or private pensions, there are nevertheless levers states could use to get traction on ESG issues: namely, their control over state pension funds and their need to underwrite municipal bond offerings. The American Legislative Exchange Council circulated anti-ESG bills, (Aronoff et al., 2021), versions of which were adopted in a number of states. According to data assembled by law firm Ropes & Gray, there have been 49 legislative enactments aimed at limiting the consideration of ESG factors. (Lichtenstein et al., 2024). Dozens of ESG-restricting bills have been proposed at the federal level as well. This section discusses the potential impact of these laws on demand for ESG funds.

Anti-ESG laws can be divided into several categories. (Lichtenstein et al., 2024). So-called "boycott bills" which allowed states to blacklist banks from underwriting state bond offerings or other transactions if the bank, in turn, boycotted fossil fuels or gun manufacturers in view of state officials. Other bills restrict proxy voting activity and require that proxy voting decisions consider only pecuniary factors. While these laws are indicative of a growing backlash to ESG, we focus our in this section on state laws aimed at pension plans because they are likely to have the most direct impact on demand for ESG funds.

Public pension plans are creatures of state law, and economically important in their own right. As of 2023, public pension funds held about $5.7 trillion in assets. (National Association of State Retirement Administrators, 2023). Eleven states have adopted bills to eliminate the consideration of ESG from state-run pension plans. Three more have done so through revisions to investment policy statements. Notably, "none of the currently enacted 'anti-ESG' regulations prohibit or seek to discourage ESG-related investment where such investment is made strictly as a result of financial considerations and analysis of the investment" (Behbin et al., 2023), though some provisions do declare certain ESG considerations off-limits as financially relevant. These statutes mirror the DOL rule insofar as they seek to focus plan fiduciaries on risk and return, but the bills take slightly different approaches to limiting ESG that may have material consequences on how asset management decisions are made.

In order to have an impact on asset allocation decisions, and therefore on investments in ESG funds, restrictions on pension fund investments must be capable of limiting the discretion of an investment manager who would otherwise be inclined to elect to invest using ESG criteria. As the debate over the DOL rule illustrates, the precise language of an ESG restriction matters, because the debate over ESG rules is, in part, a debate over whether ESG factors count as "pecuniary." Most ESG investors see ESG factors as a matter of risk and return. Some state enactments are more effective than others in constraining discretion to consider ESG. The analysis below identifies four approaches taken up in state law.

Four states have adopted legislation purporting to restrict ESG investing that simply aligns with the long-standing ERISA rules. Consider the language of one of the earlier-adopted anti-ESG pension bills from North Dakota (An Act Relating to Social Investments, 2021).

> 1. As used in this section, "social investment" means the consideration of socially responsible criteria in the investment or commitment of public funds for the purpose of obtaining an effect other than a maximized return to the state.
>
> 2. Except as otherwise provided in a state investment policy relating to the investment of the legacy fund and unless the state investment board can demonstrate a social investment would provide an equivalent or superior rate of return compared to a similar investment that is not a social investment and has a similar time horizon and risk, the state investment board may not invest state funds for the purpose of social investment.

In this bill, ESG investments are problematic only to the extent that they are undertaken to achieve "an effect other than a maximized return to the state." As noted above, most ESG funds position themselves in pecuniary terms. Moreover, the tie-breaker consideration in paragraph two of the bill parallels ERISA regulations prior to the DOL rule of 2020. This bill does nothing more than align North Dakota pension plans with prior ERISA guidance. Kentucky, Ohio, and Utah have adopted similar rules (though without the tiebreaker provision.)

Since ERISA does not apply to state pensions plans but does—in practice—deter investment in ESG funds, it is not impossible that these bills might affect the choices made by pension plans in these states. But unlike ERISA plans, no private right of action lurks with respect to these state plans to create open ended liability. To be sure, fiduciaries might conclude that caution is warranted, but these bills do not directly constrain pension managers from pursuing ESG strategies insofar as they see pecuniary value in those strategies. They simply implement the long-standing ERISA approach without a private right of action.

Other states have gone farther to restrict ESG investing. Arkansas, Montana, and North Carolina have adopted anti-ESG rules that explicitly refer to "generally accepted investment methodologies" mirroring the language of the proposed, but not adopted, 2020 DOL rule. These states can be reasonably understood to go farther than the current DOL approach in restricting the consideration of ESG factors. While an enthusiastic pension investment committee might defend the pecuniary value of some ESG strategies, it would be more challenging—given the novelty of such strategies—to argue that such strategies are generally accepted.

Another approach adopted in seven states[20] is to explicitly state that certain ESG factors do not count as pecuniary. In 2022, Florida's State Board of Administrators adopted language for the Florida Retirement System as follows:

> (a) The evaluation by the Board of an investment decision must be based only on pecuniary factors. As used in this section, "pecuniary factor" means a factor that the board prudently determines is expected to have a material effect on the risk and return of an investment based on appropriate investment horizons consistent with the fund's investment objectives and funding policy. *Pecuniary factors do not include the consideration of the furtherance of social, political, or ideological interests.*

[20] Florida, Arizona, Arkansa, Kansas, Indiana, Montana, and Wyoming.

> (b) The board may not subordinate the interests of the participants and beneficiaries to other objectives and may not sacrifice investment return or take on additional investment risk to promote any non-pecuniary factors. The weight given to any pecuniary factor by the board should appropriately reflect a prudent assessment of its impact on risk and returns.[21]

Here, the investment policy statement not only requires that investments be made for pecuniary reasons, but explicitly lists certain reasons as not pecuniary, including "social…interests." The result is to foreclose the argument that considerations of social goals are connected to business outcomes. This limitation, thought is less than meets the eye. It would seem permissible to consider, for example, climate disclosure as a pecuniary factor so long as the reason for doing so was not "social, political, or ideological," but is instead related to the financial consequences of climate change. This is an argument ESG investors frequently make, so a sufficiently motivated investment board might feel unrestrained by Forida's enumeration of non-pecuniary factors. (In Florida, at least, this seems unlikely as the State Board of Administrators consists of the governor, the attorney general, and a CFO.)

Arkansas's anti-ESG law is even more explicit:

> (4)(A) "Pecuniary factor" means a factor that has a material effect on the financial risk or financial return, or both, of an investment based on appropriate investment horizons consistent with the pension benefit plan's investment objectives and the funding policy.
>
> (B) "Pecuniary factor" does not include a nonpecuniary factor; and
>
> (5) "Nonpecuniary" means any action taken or factor considered by a fiduciary with any purpose to further *environmental, social, political, or ideological goals*.[22]

Here, environmental goals are explicitly identified as non-pecuniary. A fiduciary subject to this limitation would be restricted, therefore, from considering a carbon reduction plan as a pecuniary factor. This approach goes beyond the restrictions of the proposed DOL by identifying particular factors that are sometimes part of ESG strategies and placing those strategies outside of list of pecuniary factors as a matter of law.

[21] (emphasis added).

[22] Arkansas House Bill 1253, A Arkansas House Bill 1253, Act 498 (2023) (emphasis added).

A second term making some state statutes particularly effective is a clause singling out funds and asset managers based on their investment policies. This term has been adopted in Kansas, Idaho, Indiana, and New Hampshire. New Hampshire's statute, for example—while not banning ESG fund specifically—does create a requirement to "maximize…financial benefits for the state"[23] and requires the treasurer to "note the existence of any investment funds that may have mixed, rather than pure, fiduciary interest investment motivations."[24] This approach puts the emphasis on the policies of specific funds rather than addressing the decisions of the pension board directly.

Indiana's approach is striking. Under the Indiana anti-ESG law,[25] the pension system is barred from holding any investment with a service provider that has made an "ESG commitment" as evidenced by any "public statements," "reports," "letters to clients," or "participation in an…industry initiative."[26] An "ESG commitment" in turn, is defined as follows:

> Sec. 2. (a) As used in this chapter, "ESG commitment" means an action taken or a factor considered by a service provider:
>
> … (2) with the nonfinancial purpose to further social, political, or ideological interests based on evidence indicating the purpose.
>
> (b)The term defined in subsection (a) includes … any of the following for nonfinancial purposes beyond the applicable law requirements:
>
> (1) Eliminating, reducing, offsetting, or disclosing greenhouse gas emissions.
>
> (2) Instituting or assessing:
>
> (A) corporate board; (B) employment; (C) composition; (D) compensation; or (E) disclosure; criteria that incorporate characteristics protected under IC 22-9.
>
> (3) Divesting from, limiting investment in, or limiting the activities or investments of a company that does any of the following:
>
> (A) Fails to meet or does not commit to environmental standards or disclosures.

[23] New Hampshire House Bill 457 (2023)
[24] *Id.*
[25] Indiana Public Law 206 (2023)
[26] *Id* at § 6.

> (B) Engages in, facilitates, or supports the manufacture, import, distribution, marketing or advertising, sale, or lawful use of firearms, ammunition, or component parts and accessories of firearms or ammunition…

> (b) Except as otherwise provided by law, the system is prohibited from making an ESG commitment with respect to system assets, including without limitation in the selection of investments, selection of investment managers, management or oversight of investments, proxy voting, or shareholder engagement.

The Indiana approach is uniquely aggressive among currently enacted legislation. It restricts ESG strategies directly, enumerates in law what those strategies are in broad terms, and allows extrinsic evidence form asset managers' marketing and communications.

The Indiana bill is sufficiently broad that it would sweep in most conventional asset managers. Vanguard, for example, states that it is "likely to support" in its proxy voting, shareholder proposals that "Request[] disclosure related to the company's Scope 1 and Scope 2 emissions data, and Scope 3 emissions data in categories where climate-related risks are deemed material by the board." (Vanguard, 2023). Section 2(a) of the Indiana bill states that using proxy authority to "disclos[e] greenhouse gas emissions," is a per se "non-financial purpose" and therefore a prohibited "ESG commitment" within the meaning of the statute. This provision would, apparently, put all Vanguard funds at risk of exclusion from the Indiana retirement system. The Indiana Legislative Services Agency apparently agreed with this interpretation, arguing in a report that the bill would cut the pension plan off from most large asset managers and reduce plan returns. (Muñiz, 2023). The enacted bill does include a safety-valve provision if no suitable alternative asset manager is available, permitting the plan to use an asset manager that would otherwise be disqualified.

[Insert Table 1 and Figure 3 here.]

Table 1 presents a summary of state pension anti-ESG provisions in the order in which they were adopted, as well as a coding of the three provisions outlined above: a reference to generally accepted investment practices, an explicit list of non-pecuniary factors, and a clause singling out funds with pro-ESG policies. The presence of any one of these clauses suggests a measure that goes beyond current DOL regulations. There is no strong time trend evident from this limited number of bills; many weaker bills were adopted after relatively strong ones. All the bills lacked a private right of action, though they perhaps carried a more significant threat of enforcement by public officers given the heightened political salience of ESG. A critical limitation, of course, is that these bills could only affect the assets managed by the state pension funds in question.

Figure 3 shows the number of anti-ESG pension laws in effect over time as well as the percentage of total pension assets covered by such laws as a total of all pension assets nationally. Anti-ESG laws currently cover about 16% of US state pension assets.[27]

All told, these "ESG Consideration" bills did less to restrict ESG investment for state plans than ERISA did for federally regulated plans. The bills also lacked any private right of action, and—of course—affected only the pension plans of the states in question. Whether these bills, and the attendant backlash to ESG, are capable of affecting the demand for ESG investments is an open question, and one that the balance of this paper seeks to answer.

III. Data and Methodology

To measure demand for ESG funds over time, we use data from the CRSP Survivor-Bias Free Mutual Fund Database between 2015 and September 2023. The database includes monthly information on performance, assets under management, expense ratios, fees, and the fund objective classification. We identify ESG funds as those with some ESG-related terminology in the fund name[28] following Curtis, Fisch and Robertson (2021) and Fisch and Robertson (2023). Using fund names to identify ESG funds is likely to be somewhat under- and overinclusive, as not all funds ESG funds adopt these naming conventions while other funds might engage in greenwashing. To the extent identification of ESG funds is

[27] The data for pension assets is taken from the Federal Reserve Enhanced Financial Accounts statements. Balances for 2022 and 2023 are note currently published, so the percentages are based on 2021 asset balances. (Federal Reserve, 2023).

[28] Specifically, we code funds as ESG funds if they have one of the following in their name: "ESG", "Sustain*", "Green", "Envir*", "Social", "Carbon", "Climate", "Women", "Engagement", "Responsib*", "Impact", and "Diversity." We also include funds from Calvert and Domini Social Impact.

imperfect, our results will be somewhat attenuated. Nevertheless, ESG naming is a reasonable proxy for funds pursuing ESG strategies. Curtis, Fisch and Robertson (2021) show that funds with ESG names demonstrate measurable portfolio tilt to companies with strong ESG scores. Moreover, mutual fund names are particularly important to investors, (Cooper et al., 2005), so focusing on funds with ESG names is a useful way to measure demand for ESG funds since we are measuring the most salient feature to investors.

Table 2 presents summary statistics by year for the most important covariates, split by ESG and non-ESG funds.

[Insert Table 2 here.]

In analyzing the political backlash, we use data scraped from the Internet Archive, which gathers transcripts from the Fox Business Channel shows. (Rossi, 2023). Fox Business is described as “lean right” and slightly more conservative than Fox News. (AllSides, 2022). A casual review of mentions of the term “ESG” on Fox Business suggests that the concept is usually mentioned in a negative context.

Mutual fund flows are measured monthly by comparing returns and net assets per the formula below:

$$Flow_{i,t} = \frac{Assets_{i,t} - Assets_{i,t-1}(1 + Return_{i,t})}{Assets_{i,t-1}}$$

In the graphs and regressions below, flows are expressed as a percentage. Because very small funds occasionally have very large changes in assets around the time they are newly offered, we winsorize flow at the 99% level to avoid excessive influence from outliers.

In order to measure the effect of ESG on flows, we draw on the literature on fund flows, including Sirri & Tufano (1998) and Ferreira et al. (2012) among many others. This literature suggests that mutual fund flows are a function of past performance, as well as other variables, and that this flow-performance relationship is different for high-performing and low-performing funds. While new assets flood into high-performing funds, low-performing funds do not see a symmetrical effect.

To capture the differential flow-performance relationship, we use a piecewise regression of flow on performance that allows funds with different performance levels to have different flow-performance sensitivity. We begin by calculating for each month, the fraction of funds in the same Lipper Objective Code that each fund outperformed over the prior twelve months, the *Rank*. We then break the funds into quintiles by *Rank*, with the highest performing 20% of funds considered high performing, the lowest 20% considered law performing, and the middle 60% assigned to the middle group. Following (Ferreira et al., 2012), for the piecewise regression we construct the variables *Low*, *Middle.* and *High* for fund *i* at time *t* in objective class *c,* as follows:

$$Low_{i,c,t-1} = \min(0.2, Rank_{i,c,t-1})$$

$$Mid_{i,c,t-1} = \min\left(0.2, Rank_{i,c,t-1} - Low_{i,c,t-1}\right)$$

$$High_{i,c,t-1} = \min(0.2, Rank_{i,c,t-1} - (Mid_{i,c,t-1} + Low_{i,c,t-1}))$$

To capture the demand for ESG funds, controlling for conventional predictors of fund flow, we run piecewise regressions of *Flow* on *Low*, *Middle.* and *High* as well as a set of control variables. Controls include flows into other funds in the same objective class, the lagged log of assets under management in the fund, the log of the age of the fund, the expense ratio, and 12b-1 fees. While the primary interest of this paper is how demand for ESG funds, as expressed by flows, varies overtime, Table 3 presents an overview of the relationship by estimating a pooled OLS model weighted by fund size and including date dummies. Model 1 in Table 3 shows the relationship between flows and performance without controls, confirming that high performing funds have a stronger flow response to performance than lower performing funds. Model 2 adds standard control variables from the literature.

[Insert Table 3 here.]

To estimate the effect of being an ESG fund on flows, Model 3 includes standard control variables as well as an indicator variable for whether the fund is an ESG fund. Interestingly, in the pooled regressions, which include all time periods, ESG funds do not attract additional flows compared to conventional funds to a statistically significant degree. As will be seen in the next section, though, this relationship is heavily time-dependent, so this table is included as a benchmark and to give a sense of the covariates.

IV. Results

This section investigates the changing demand for ESG funds and the potential impact of legal interventions on the demand for ESG funds.

a. Are Investors Losing Interest in ESG?

The recent decline in flows to ESG funds suggests a market shift, but it is unclear whether shifting demand for ESG reflects investor aversion to ESG specifically, or simply a market response to lower ESG-fund returns in 2022 in line with the normal flow-performance relationship. It is notable that in Table 3, Model 3, ESG funds do not actually show heightened flows after controlling for standard covariates in the fund flow literature. To investigate shifting ESG demand, we estimate the piecewise regression in Table 3, Model 3, including an ESG fund indicator, monthly from 2015 to 2023. The coefficient on the ESG fund indicator in each regression is a measure of the demand for ESG funds beyond what might be expected based on typical predictors of mutual fund flows. For this reason, we label the quantity *Excess ESG Flow*.[29]

[Insert Figure 5 here.]

Figure 5 plots Excess ESG flow, as well as a 90% confidence interval, for each month. To highlight shifting demand, bars are colored green when the confidence interval is above zero and red

[29] We do not intend, by this naming convention, to suggest that flows to ESG funds were excessive, merely that they are in excess of what would have been expected for a comparable conventional fund.

when it is below zero, suggesting statistical significance in the positive or negative direction, respectively. Thus, Figure 5 shows, month by month, how flows to ESG funds differed from funds that had comparable returns, size, age, and similarly popular investment styles, but lacked a name indicating an ESG objective.

During the peak of ESG demand, the effect of being an ESG fund was quite strong. Figure 5 shows that the abnormal flow for institutional ESG share classes are about 4% of net assets at the peak. This is roughly equivalent to a high-performing fund moving from the bottom to the top quartile in fund performance. This dramatic demand for ESG is consistent with the observed increased in ESG funds and the overall flow of assets into the ESG sector.

Several interesting dynamics are evident from Figure 5. First, demand for ESG funds began to rise above conventional funds in 2017. This is consistent with the general impression that the growth of ESG as an investment phenomenon started around that time. 2017 was, for example, the year of the Fearless Girl statute on Wall Street. Demand for ESG funds rose quickly and was consistently statistically positive by 2019.

The second dynamic evident from the figure is, perhaps, more surprising. Figure 5 shows that the strongest period of investor demand for ESG funds is pre-pandemic. For most of 2019 and the first half of 2020, ESG flows were significantly stronger than other funds, but this positive effect for ESG funds disappears shortly after the start of the COVID pandemic. A partial explanation for the lower *excess* interest in ESG funds is that ESG fund were performing particularly well during the pandemic. Recall that the regression controls for past performance, which was strong for ESG during this period. See Table 2. Figure 5 suggests that—relative to the pre-pandemic months—investors allocated less money to ESG funds conditional on their performance, but since performance was strong, absolute interest was still high. Investors, if anything, were being somewhat cautious relative to the pre-pandemic timeframe, perhaps in recognition that the benefits of underweighting fossil fuels would not go on indefinitely as the lockdowns eased. Positive relative flows to ESG funds then reappear in the second half of 2021 before disappearing again by 2022.

Finally, while interest in ESG funds is no longer abnormally positive, fund flow was on par with mutual funds generally when controlling for past returns and other covariates until very recently: When retail and institutional shares are considered together, as in Figure 5, there was not a month in which ESG flows were significantly below predicted levels since 2017 until early 2024.

To what extent is interest in ESG funds a retail phenomenon and to what extent is it driven by institutional investors? Since mutual funds offer different share classes to retail and institutional investors, it is possible to observe flows for these groups of investors separately.

[Insert Figure 6 here.]

Figure 6 disaggregates Figure 5 by mutual fund share class. Separating out retail and institutional shares shows that flows to ESG funds in excess of what would be expected based on conventional predictors was more prominent in institutional shares. Only in late 2021 do retail shares string together consecutive months of statistically significant positive flows. Moreover, retail share classes of ESG fund have continued to exhibit occasional positive demand and no months of negative demand during the backlash period. Institutional shares on the other hand, show more dramatic swings in demand. Peaking higher in 2019 and then showing outflows in 2023 and 2024.

Table 4 presents regression evidence on the differential demand for ESG funds. In model 2, with the full set of controls for performance as well as date dummies, demand for institutional shares of ESG funds is significantly stronger than ESG funds or institutional shares individually.

It is notable that, while institutional shares are commonly available to investors through 401(k) plans, ESG funds are not thought to be popular options in 401(k) plans due to risk associated with ERISA liability. (Hallez, 2023; NEPC, 2023). On the other hand, the changing demand for ESG funds does point to evidence that such funds were finding their way into 401(k) plans. Two below-trend months for institutional shares August 2020 and November 2020. The former is about a month after the Trump DOL published its proposed rule on ESG investing[30] in ERISA plans and the latter is the month the revised rule was adopted.[31] It is possible that these drops in demand (from which institutional demand never quite recovered), reflect ERISA retirement plan sponsors eliminating ESG funds from plans in response to the heightened legal risk (or at least heightened scrutiny) associated with the DOL rule. This, in turn suggests, that the presence of ESG funds in such plans was significant to the market for ESG funds, if still a small part of the retirement plan market as a whole.

Is demand for ESG funds waning? The answer is more complicated than headlines suggest. There is no doubt that the appetite for ESG funds is off its peak—that has been true for four years—but claims that investors are fleeing the market en masse appear overstated. Until 2024, investors have not been abnormally averse to ESG funds. Much of the reduced flows to ESG funds over the last two years are attributable to a period of lagging performance in 2022. On the other hand, it does appear that institutional investors are less attracted to ESG funds than in the 2019-2020 timeframe and have now begun to move away from the sector. What is intriguing about this effect, though, is that peak institutional demand occurs well ahead of most of the ESG backlash. In the next section, we consider how changing interest in ESG aligns in time with the shifting political terrain.

b. Is the Political Backlash Having an Effect?

As noted above, it seems likely that DOL rulemaking reduced the presence of ESG funds in ERISA-regulated plans, but this rule predates ESG as a popular political issue. Has the broader, state-level backlash to ESG had an effect? There are two channels through which the political backlash might affect demand for ESG funds. First, as detailed above, some states have adopted rules that restrict the ability of public pension funds to consider ESG. Since much of the demand for ESG funds is from institutional investors, these rules might have a direct effect in reducing that demand. Second, the political

[30] See section II.b.ii *supra* for a discussion of the rules.
[31] I am grateful to Max Shanzenbach for noting this timing.

backlash might reduce the demand by airing objections to ESG investing even if the specific legal rules lack bite. That is, the states laws are a sort of negative publicity that might reduce demand.

At the outset, it is important to note that this is not a promising context for causal inference. Fund flows are ultimately a single time series, the political environment around ESG is confounded with numerous other factors and seems likely to be endogenous to historical performance. There are no obvious exploitable shocks that might help tease apart the effect of politics from other potential sources of shifting ESG fund flows. Nevertheless, it is worth investigating whether the ESG backlash is even correlated with changing demand for ESG. Such a correlation would be hard to use as the foundation of a causal claim, but the absence of any correlation might leave us skeptical of a causal link.

We draw on two time series to measure the political backlash. The first is state-level legislative activity. Focusing on the state bills that restrict the consideration of ESG investments by state pension funds, it is possible to identify a period of highly active legislative activity as occurring between March 2021 (North Dakota) and August 2022 (Arizona). The state initiatives to restrict ESG investing were mostly adopted over this time period. We track the cumulative number of such laws in effect.

What about the broader political backlash? In order to get insight into the intensity of the overall conservative backlash to ESG, we scrape transcripts of shows broadcast on the Fox Business channel and count the number of mentions of "ESG" during all shows on the channel each month. These mentions are a reasonable proxy for the coverage of ESG in conservative media, which might shift public perception of ESG investing. Figure 7 shows the Fox News Business data along with the total number of anti-ESG state pension laws in effect.

[Insert Figure 7 here.]

To get a sense of the interaction of these various political trends, Figure 8 has two panels. The first panel replicates Figure 5 and the second panel overlays a smoothed plot of the average excess demand for ESG by month with the Fox Business News Data. Both panels have two shaded regions. The smaller blue region is the period of time between the COVID crash in the S&P 500 and its eventual recovery to pre-COVID levels. The larger orange region is the period of time of intense state legislative activity.

Figure 8 shows that the most dramatic decline in demand for ESG funds occurred not during the political backlash period, but during the COVID recession of 2020. Prior to this period, demand for ESG funds was substantially higher than other funds, but this affect disappears over the course of the COVID recession and only partially recovers after. Notably, this decline in investor interest in ESG funds, controlling for other flow-predicting characteristics, was not—as far as we can tell—publicly known. The post-COVID recession era seemed, if anything, to be a time of heighted attention to ESG issues and enthusiasm for ESG investing. In absolute terms, flows to ESG funds continued to be higher than flows to conventional funds until late 2022, as seen in Figure 4.

[Insert Figure 8 here.]

Is the state-level political backlash having an effect? While Figure 8 shows that the largest decline largely pre-dates the backlash, it is not possible to draw the conclusion that an effect is absent simply by looking at the figures. To test the possibility that political backlash is affecting the demand for ESG, we run a vector autoregression on the three timeseries of excess demand for ESG, Fox Business mentions, and state pension anti-ESG laws in effect at time *t*, with twelve monthly lags and then test for Granger causality. The results of these tests are presented in Table 5.

[Insert Table 5 here.]

The results show that, while conservative media coverage of ESG and the adoption of restrictive ESG bills are tightly linked, there is not statistical evidence of a link to the excess demand for ESG funds. The data therefore do not provide support for the hypothesis that the political backlash is dampening interest in ESG funds. Indeed, the most dramatic decline in excess interested in ESG seems to precede the backlash. Of course, this is not conclusive evidence that the backlash is not having an effect, but it is inconsistent with the hypothesis that the political response to ESG is have a strong negative impact on market demand.

V. Conclusion

The data present a picture that is not entirely consistent with the popular perception of ESG. It's easy to perceive ESG as a phenomenon that took hold pre-pandemic, and then exploded after the COVID-19 pandemic only to deliver sub-par returns and then wither in the face of a conservative backlash. A careful analysis of the flow data, though, points to a more nuanced story, in which demand for ESG funds from institutional investors, peaked pre-pandemic. By the time the backlash gained significant momentum, institutional investors were already treating ESG funds like other asset classes. And retail investors never did anything else. State laws requiring that fiduciaries not give differential consideration to ESG factors not justified by their risk and return are addressing a market that is already behaving as such and having no measurable effect.

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Figure 1: Number of ESG Funds

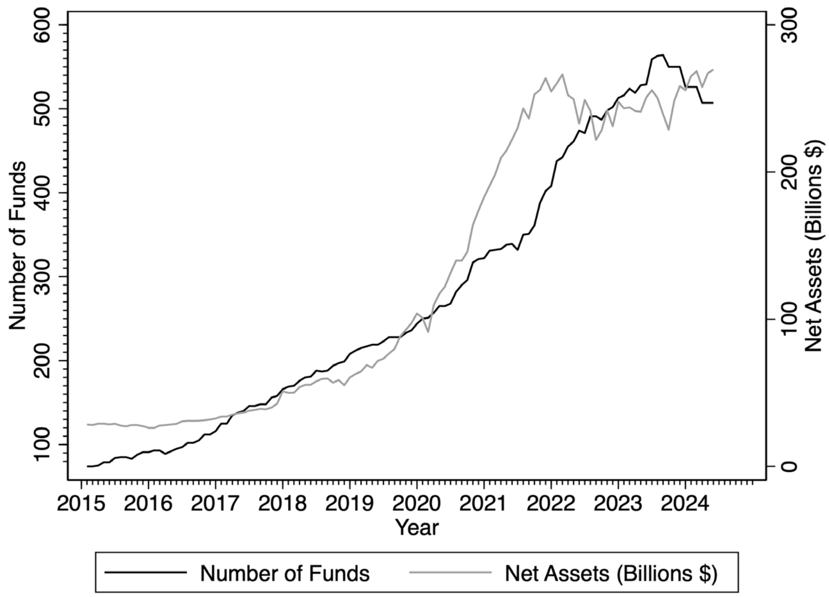


Figure 2: Returns (Monthly) of ESG and non-ESG Funds (Asset Weighted)

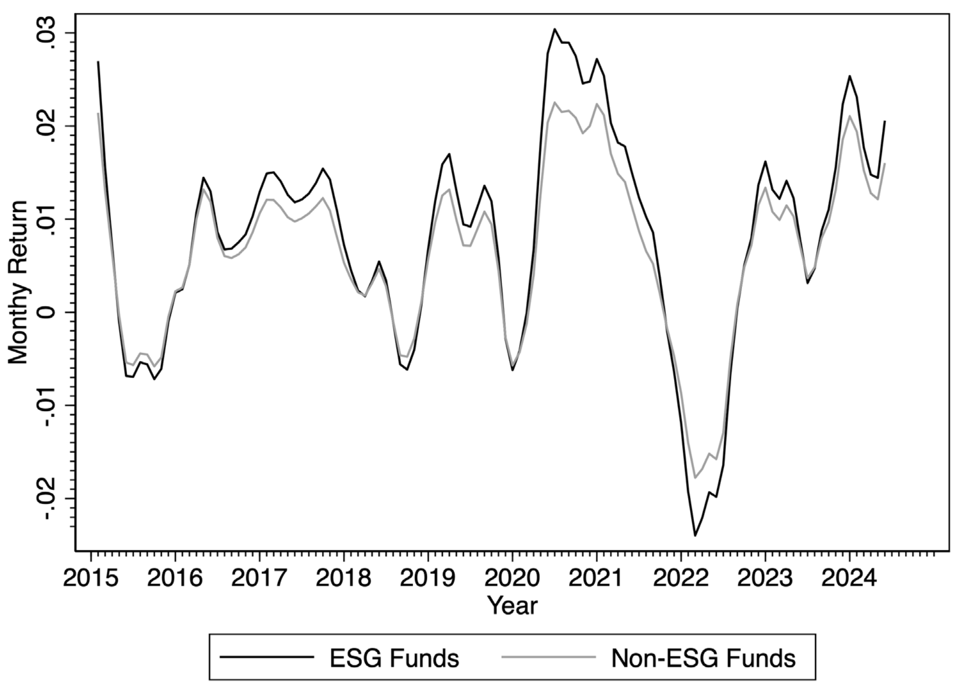


Figure 3: State Anti-ESG Pension Laws and Assets Covered

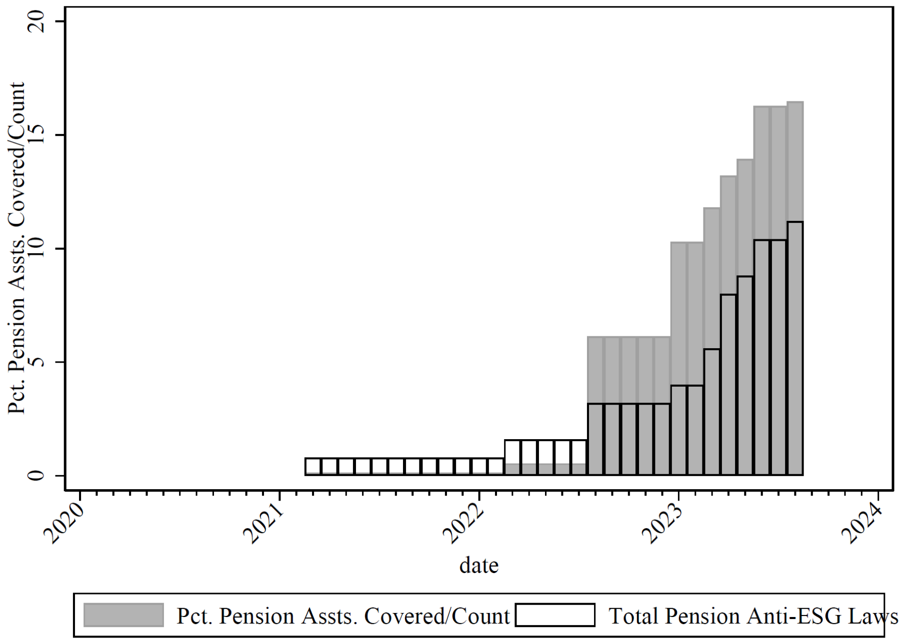


Figure 4: Flow (Monthly) into ESG and non-ESG Funds

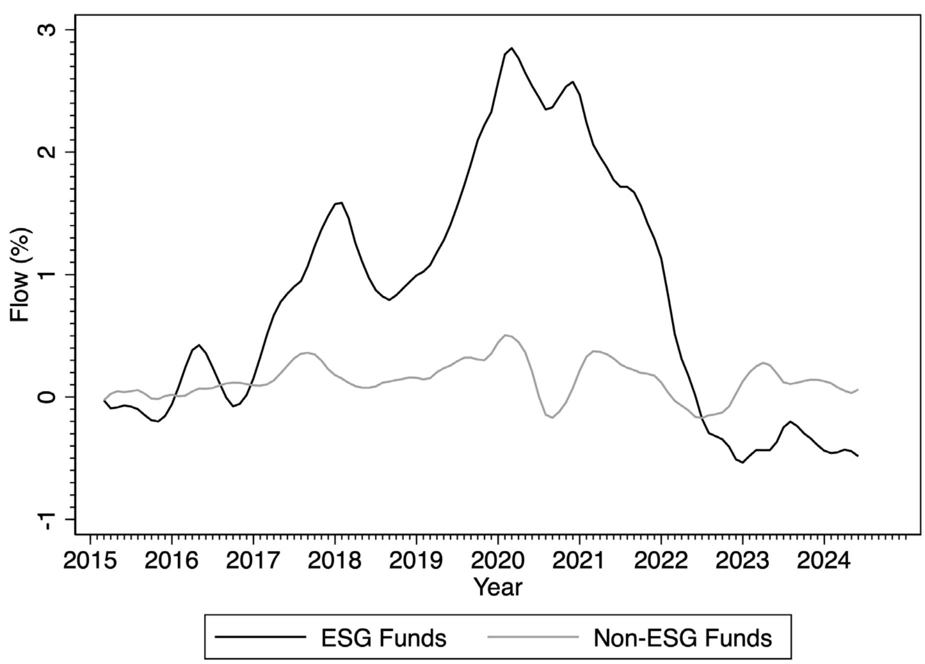


Figure 5: Excess ESG Demand by Month

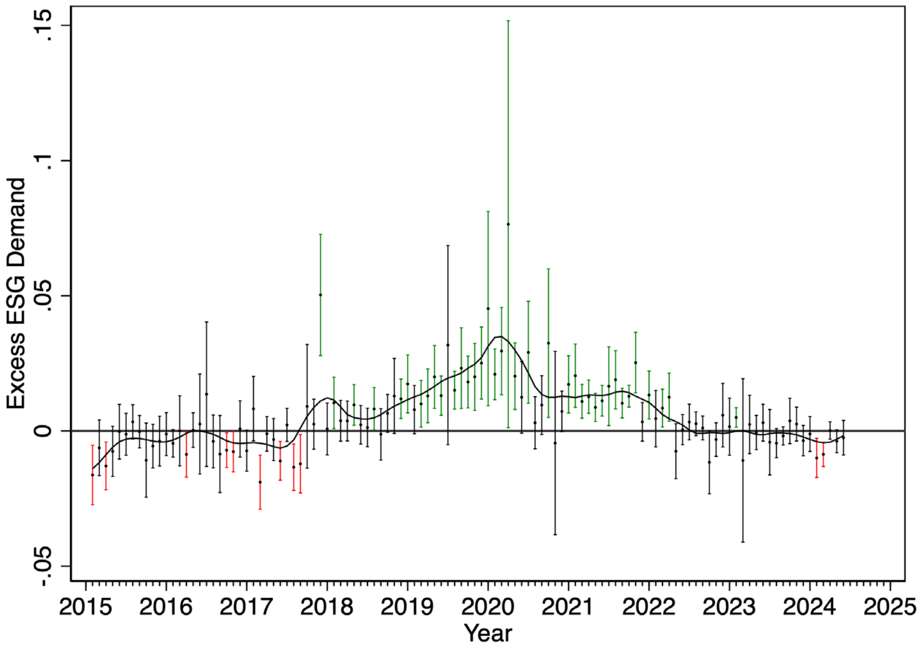
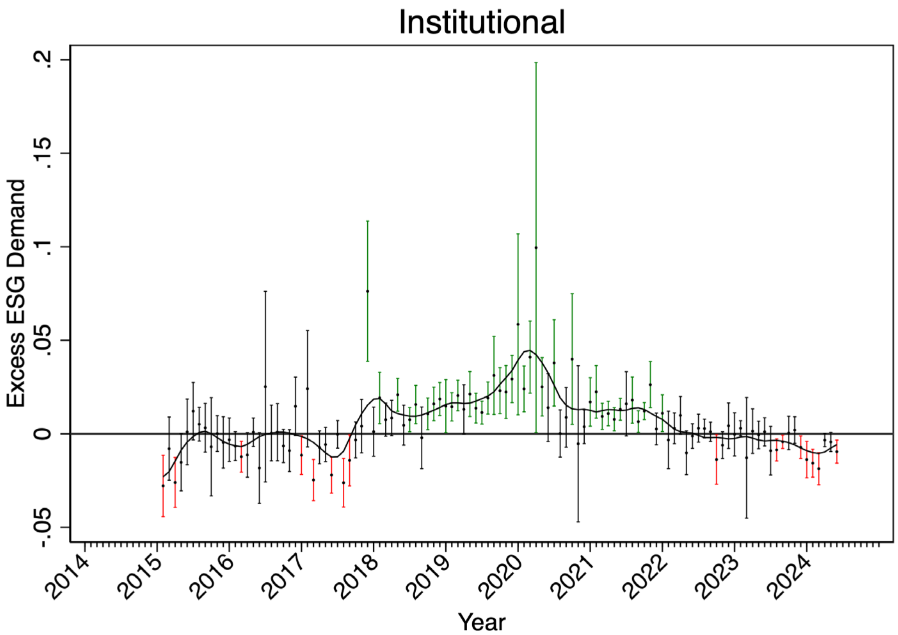


Figure 6: Excess ESG Demand Institutional Relative to Retail



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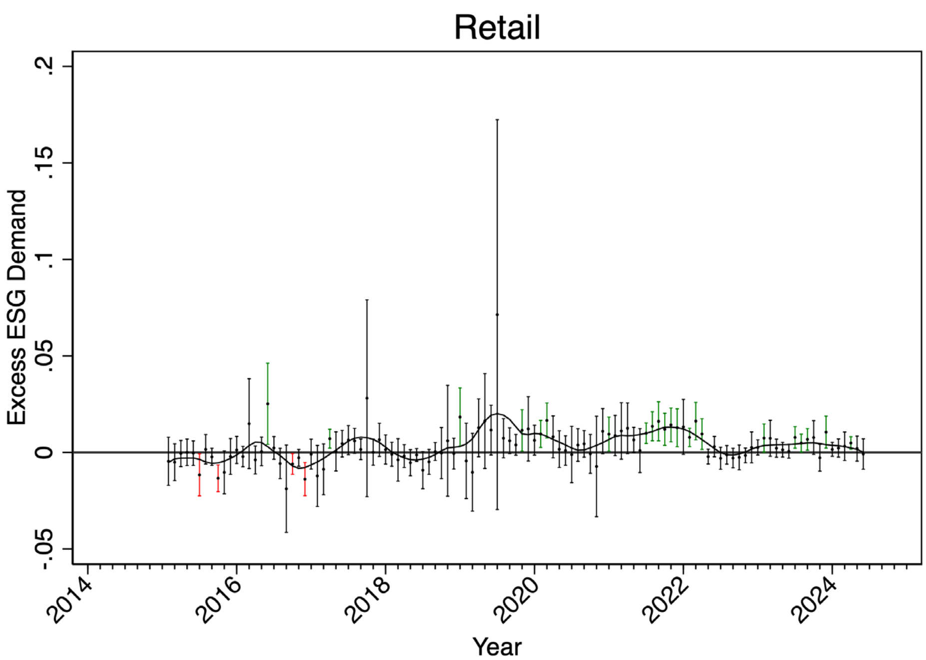


Figure 7: Mentions of ESG on Fox News Business and State Anti-ESG Pension Laws

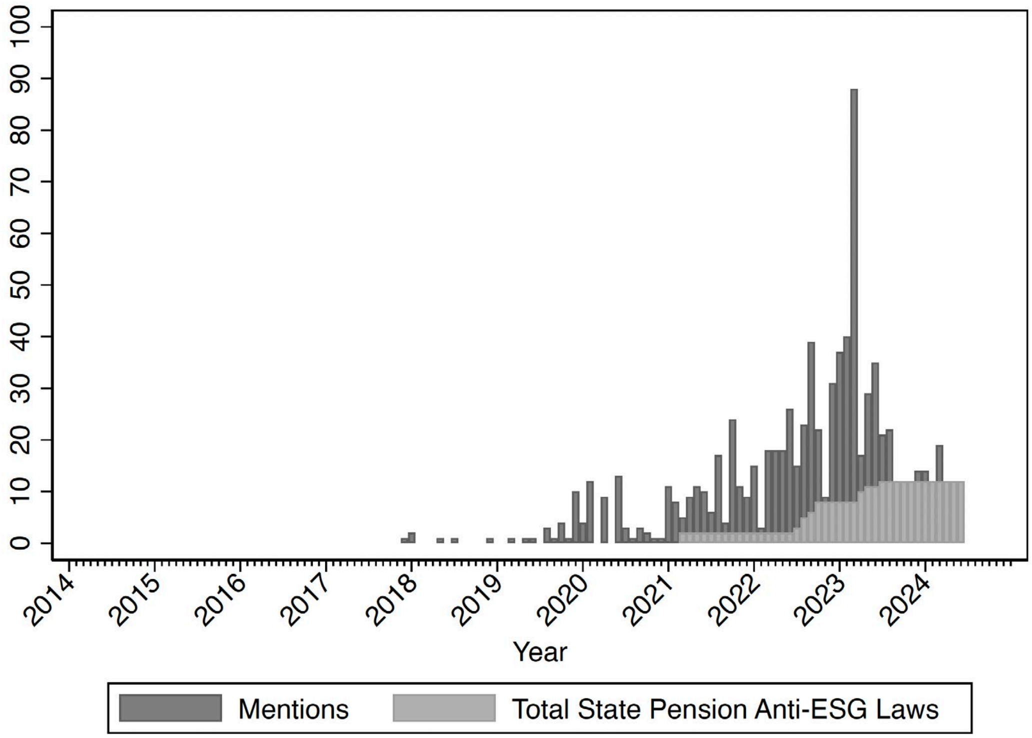
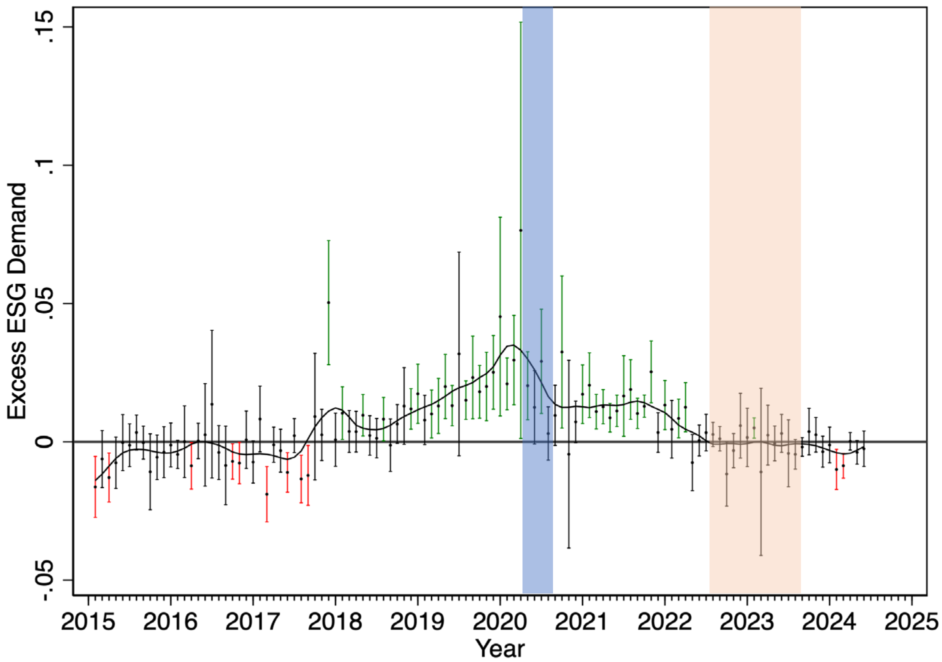


Figure 8: Average Excess ESG Demand and Fox News Business Mentions of "ESG"



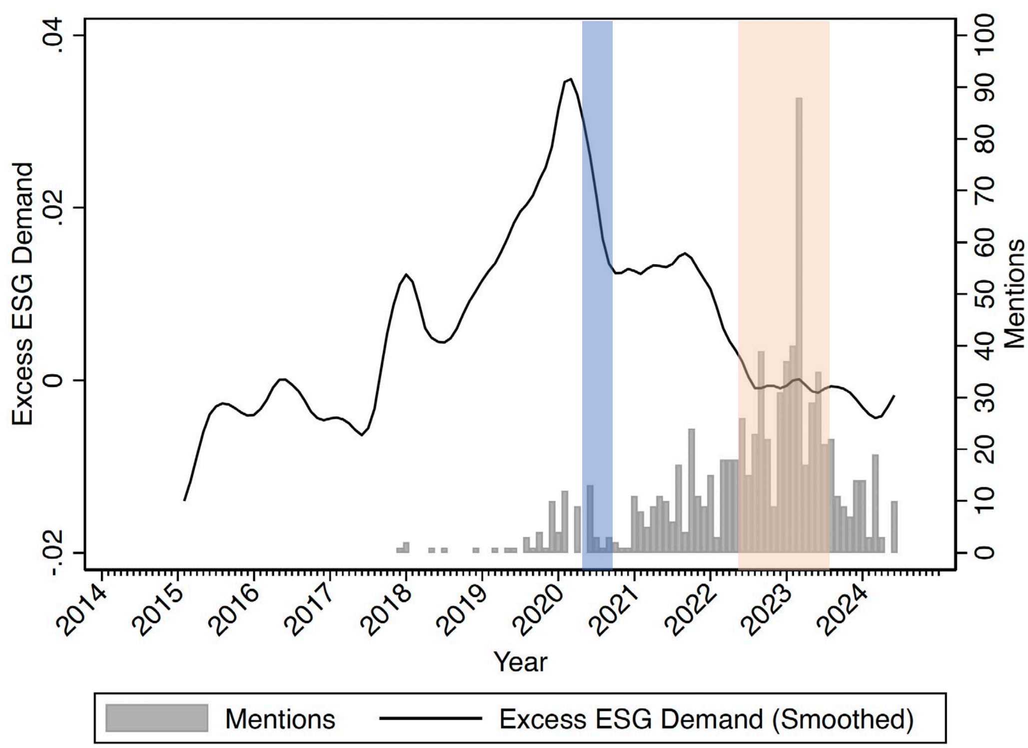


Table 1: State Anti-ESG Pension Measures[32]

STATE	TITLE	DATE	ESTABLISHED PRACTICE CLAUSE	EXPLICIT NON-PECUNIARY FACTOR CLAUSE	FUND ESG POLICY CLAUSE
ND	SB2291: Social Investment—Prohibition	3/22/2021	No	No	No
ID	S1405: Disfavored State Investments	3/25/2022	No	No	Yes
FL	Governor Ron DeSantis Eliminates ESG Considerations from State Pension Investments	8/23/2022	No	Yes	No
AZ	Arizona Treasury Kimberly Yee Announced Newly Adopted Investment Policy Statement That Protects Taxpayer Dollars from ESG Policies	8/30/2022	No	Yes	No
OH	SB6: Regarding Certain Public Entities' Governance Policies	1/17/2023	No	No	No
KY	HB236: An Act relating to the fiduciary duties owed to the state-administered retirement systems	3/13/2023	No	No	No
UT	SB96: Addressing Fiduciary Duties for Management of Government Funds	3/14/2023	No	No	No
AR	HB1253: To Create The State Government Employee Retirement Protection Act	4/10/2023	Yes	Yes	No
KS	HB2100: Updating the version of risk-based capital instructions in effect	4/14/2023	No	Yes	Yes
MT	HB228: Prohibits Consideration of Nonpecuniary Factors in Investing	4/19/2023	Yes	Yes	No
IN	HB1008: Pension investments	5/1/2023	No	Yes	Yes
NC	HB750: Address ESG Factors	6/13/2023	Yes	No	No
NH	HB457: Prohibiting ESG Investments by State Treasurer and the Retirement System	6/21/2023	No	No	Yes
WY	The State Loan and Investment Board Unanimously Adopts a New Investment Policy that Condemns the use of ESG Investment Criteria	8/3/2023	No	Yes	No

[32] This table is based on the anti-ESG law database maintained by Ropes & Gray (Lichtenstein et al., 2024). The classification of clauses is original to this study.

Table 2: Summary Statistics by Year for ESG and Non-ESG Funds

	N	Total Net Assets (Billions) Total	Retail	Inst.	Flow (%)	Flow (S.D.)
2015						
Non-ESG Funds	9,464	17,448.7	8,212.58	9,236.12	0.50%	2.87
ESG Funds	88	28.7502	14.8696	13.8805	0.55%	2.94
Total	9,552	17,477.4	8,227.45	9,250	0.50%	2.87
2016						
Non-ESG Funds	9,819	17,771.2	8,154.88	9,616.32	0.59%	3.44
ESG Funds	113	30.8082	14.7933	16.0149	1.16%	3.16
Total	9,932	17,802	8,169.67	9,632.33	0.59%	3.44
2017						
Non-ESG Funds	9,761	20,345.7	8,706.49	11,639.2	0.89%	2.56
ESG Funds	164	40.3261	16.8606	23.4655	1.36%	3.12
Total	9,925	20,386	8,723.35	11,662.7	0.89%	2.56
2018						
Non-ESG Funds	9,772	22,136.9	8,998.06	13,138.8	0.61%	2.49
ESG Funds	195	56.6842	22.4587	34.2255	1.50%	3.62
Total	9,967	22,193.5	9,020.52	13,173	0.61%	2.50
2019						
Non-ESG Funds	9,709	23,640.1	9,332.59	14,307.5	0.36%	1.94
ESG Funds	230	82.286	26.0836	56.2023	1.96%	3.24
Total	9,939	23,722.3	9,358.67	14,363.7	0.37%	1.95
2020						
Non-ESG Funds	9,599	26,716	9,742.27	16,973.7	0.36%	2.41
ESG Funds	319	135.375	34.9335	100.441	3.54%	5.39
Total	9,918	26,851.4	9,777.21	17,074.2	0.38%	2.44
2021						
Non-ESG Funds	9,918	35,306.4	11,804	23,502.4	0.48%	2.24
ESG Funds	443	260.256	51.0335	209.223	2.01%	3.09
Total	10,361	35,566.6	11,855	23,711.6	0.49%	2.25
2022						
Non-ESG Funds	8,464	30,332	10,001	20,331	0.24%	2.02
ESG Funds	488	257.232	50.4047	206.827	0.45%	2.25
Total	8,952	30,589.2	10,051.4	20,537.8	0.25%	2.02
2023						
Non-ESG Funds	8,182	34,224.3	11,777.2	22,447.1	0.37%	1.87
ESG Funds	534	257.31	51.8397	205.47	-0.02%	1.93
Total	8,716	34,481.6	11,829.1	22,652.5	0.37%	1.87
2024						
Non-ESG Funds	5,874	36,237.6	11,733	24,504.6	0.32%	1.44
ESG Funds	371	278.182	56.0081	222.174	0.16%	1.70
Total	6,245	36,515.8	11,789	24,726.8	0.32%	1.44

Table 3: Fund Flows and Performance

This table presents pooled piecewise regressions of fund flows on performance (divided into Low, Middle and High groups to permit differential response as is typical in the flow literature. Controls include flow to the funds' objective class, excluding the fund itself, log of lagged net assets, log of fund age, the expense ratio and 12b-1 fees as report by CRSP, an ESG fund indicator, and date dummies. Flow and the performance groups are constructed as outlined in the text. Regressions are weighted by lagged total net assets. Standard errors are clustered by date and fund.

	(1) Fund Flow	(2) Fund Flow	(3) Fund Flow
Low Performing	0.034***	0.035***	0.035***
	(4.25)	(4.69)	(4.69)
Middle	0.008**	0.006***	0.006***
	(2.32)	(2.61)	(4.88)
High Performing	0.048***	0.058***	0.058***
	(3.07	(4.74)	(4.74)
Flow to Fund Objective Class		0.976***	0.976***
		(6.93)	(6.93)
log(Net Assets)		-0.003***	-0.003***
		(-4.81)	(-4.81)
log(Fund Age)		-0.007***	-0.007***
		(-11.16)	(-11.16)
Exp. Ratio		-1.459***	-1.458***
		(-8.18)	(-8.18)
12b-1 Fee		-0.127	-0.127
		(-0.65)	(-0.65)
ESG Fund			0.002
			(0.99)
Constant	-0.044***	-0.044***	-0.044***
	(-3.62)	(-3.62)	(-3.62)
Observations	2958593	2958593	2958593
Adjusted R^2	0.012	0.107	0.107

t statistics in parentheses * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table 4: Institutional vs. Retail Flows to ESG Funds

This table presents pooled piecewise regressions of fund flows on performance (divided into Low, Middle and High groups to permit differential response as is typical in the flow literature. Controls include flow to the funds' objective class, excluding the fund itself, log of lagged net assets, log of fund age, the expense ratio and 12b-1 fees as report by CRSP, an ESG fund indicator, and date dummies. Flow and the performance groups are constructed as outlined in the text. Regressions are weighted by lagged total net assets. Standard errors are clustered by date and fund.

	(1)	(2)
	Fund Flow	Fund Flow
Low Performing	0.034***	0.035***
	(5.01)	(5.23)
Middle	0.008***	0.006***
	(4.88)	(4.43)
High Performing	0.048***	0.058***
	(4.76)	(6.98)
ESG Fund	-0.002	-0.001
	(-0.80)	(-0.44)
Institutional Share Class X ESG Fund	0.013***	0.003*
	(5.99)	(1.73)
Flow to Fund Objective Class		0.976***
		(21.54)
log(Net Assets)		-0.003***
		(-7.59)
log(Fund Age)		-0.007***
		(-15.83)
Exp. Ratio		-1.458***
		(-11.59)
12b-1 Fee		-0.125
		(-0.75)
Constant	-0.044***	0.030***
	(1)	(2)
Date Dummies	Yes	Yes
Observations	2958593	2958593
Adjusted R^2	0.013	0.107

t statistics in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table 5: Granger Causality Tests for ESG Demand, Fox Business Mentions, and State Laws

This table presents Granger causality Wald test based on a 12 lag VAR of ESG excess demand, calculated monthly as per Model 3 in Table 3 with 2, Fox Business channel mentions of "ESG," and the cumulative number of state laws targeting ESG in pensions enacted.

Dep. Var.	Excluded	F	Prob > F
ESG Demand	Fox Mentions	0.69428	0.7526
	ESG Laws	0.60172	0.8328
Fox Mentions	ESG Demand	0.77045	0.6779
	ESG Laws	11.322***	0.0000
ESG Laws	ESG Demand	2.3028**	0.0156
	Fox Mentions	4.4123***	0.0000

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

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