Episode 9

Do Investors Value Sustainability?

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Samuel Hartzmark explains his and Abigail Sussman's findings on investors' perception of the sustainability ratings of US mutual funds and the resulting investment implications.

This Conversation is based on

Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows
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Samuel Hartzmark and Abigail Sussman

Read Paper

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Conversations

Feifei

Hi Sam, congratulations to you and Abigail Sussman on winning the RAFI Best Paper Award for ESG for "Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows." Could you start by explaining what you mean by sustainability and how investors might think of it as a positive or negative attribute?

Sam

Thank you so much for the award. We define sustainability in our paper in the way Morningstar defines sustainability and we investigate what investors think when they hear that a fund is more sustainable. We ran a survey as part of the experiment and found that most investors think sustainability has something to do with the environment, but there is broad disagreement about other things it could be related to. In terms of our paper, we look at the impact of the Morningstar sustainability rating, a rating Morningstar developed based on the underlying holdings of a mutual fund's portfolio

Feifei

Can you talk more about the introduction of the Morningstar ratings and how they might impact fund flows?

Sam

Absolutely. In March 2016, Morningstar published a rating system that ranks US mutual funds on sustainability. Each fund is rated from one globe to five, with five being the highest rating (i.e., lowest rating of ESG risk). Using Sustainalytics scores,[1] Morningstar looked at the underlying holdings of funds and devised a simple, easy-to-understand system. The new rating system was a natural shock to the market, because all of the information used in the ratings was publicly known before. Morningstar found that investors paid attention to this rating. High-sustainability funds received large inflows, about 5%, of a fund's size over the next year. Low-sustainability funds received big outflows, again about 5%, over the next year.

Feifei

We see mutual funds that rate high in sustainability tend to gather more assets. Some people think that these asset flows can influence companies, leading those that lose assets to take a different business approach or to change their economic activities. Do you consider this channel important?

Sam

I think it's a broadly important question and it's one our paper doesn't directly address. It seems to be a question of magnitude. If investors' actions hinder a firm from raising capital, this of course, might change behavior. In our setting, we're looking at well-diversified mutual funds. My guess is that if a single mutual fund shifts away from low-sustainability companies these low-sustainability companies will find other sources of capital and it won't influence behavior. This is a hugely important question for the sustainability literature in general. I think it could have an impact, but it's ultimately an empirical question as to whether it does so, and how much money would have to flow away for a lower-sustainability-rated fund to shift the behavior of the underlying companies with low sustainability.

Feifei

You documented roughly US$36 billion[2] in flow difference between high-sustainability funds and low-sustainability funds. It's statistically significant, but still just a drop in the bucket relative to the entire size of the equity market. Do you have an estimate of how large this flow has to be in order to make a meaningful impact?

[1] Sustainalytics is an independent global provider of environmental, social, and governance (ESG) and corporate governance research and ratings to investors.

[2] US$12 billion net outflows from low-sustainability funds and US$24 billion net inflows into high-sustainability funds.

Sam

No. I think there absolutely is some threshold at which it would have an impact, both in terms of what action funds take and in terms of returns moving forward. Maybe the most relevant data point here would be something like index inclusion. In joining the S&P 500, a company typically gets a big bump in return. It seems that many investors do flow in and buy those stocks. I don't necessarily think we are at that point yet in the ESG funds, but I do think we're on pace for continued growth in that area, and we're definitely moving toward a magnitude of flows where it seems plausible. This could change how mutual funds form portfolios, and if valuations are driven up because of it, possibly impact returns moving forward.

Feifei

Another interesting observation from your empirical test is that the one-globe funds, the lower-ranked funds with higher ESG risk, tend to outperform slightly over the high-sustainability funds. Over an 11-month sample period (March 1, 2016–January 30, 2017) perhaps this is not very significant, but what do you think about it? Is it a bad sign for the future of ESG investing? Do you think investors only care about superior returns or are they allocating based on other motives?

Sam

If you are an investor in ESG, it's important to be clear about why you are investing in the strategy. Absolutely some investors view the ESG rating as a performance signal. In our paper, we run an experiment that suggests the presence of the ESG rating leads participants to think that high-sustainability funds are better investments. If an investor considers high sustainability purely as a performance driver, then it's no different from value, no different from momentum. If performance seeking is where most of the flows are coming from, then I think it does speak to perhaps some downside in ESG investing moving forward to the extent that the market is mispricing ESG characteristics; as more money comes in to these funds, we'd expect that to correct.

We also find evidence in our experiment for nonpecuniary motives. More-charitably oriented investors are getting involved in ESG. If these investors view themselves as receiving a benefit from socially responsible investing, it's not the worst thing in the world if a fund underperforms by a little bit. The important thing for an investor is to be clear about why they're choosing ESG investing. If they have a charitable motive, they should not conflate that with a return-based motive, and if the motive is performance, they should treat ESG no different from any other performance driver.

Feifei

We have observed the ESG conversation move forward at a pretty rapid pace, yet the ESG definition remains very heterogeneous, with a lot of noise and confusion still in the market place. Do you have any recommendations for investors as to which ESG aspects they should be focusing on?

Sam

To answer your question I will focus just on those who are involved in ESG investing with a charitable motive. More charitably motivated folks should be clear about what they are buying to make sure it achieves their goals. Maybe they want to reduce carbon emissions; they should make sure the fund they want to invest in is doing that. Not every ESG fund may deliver on that goal. A lot of the ESG funds are fairly broad in their holdings. Someone who is interested in the environmental aspect of ESG may not see a company's board structure as relevant, whereas someone who is interested in the governance aspect of ESG may not be so interested in carbon emissions. An investor should make sure that the ESG metric they care about is being addressed by the fund. They shouldn't assume that's the case.

Feifei Thank you Sam. Would you like to give a quick summary of the key takeaway of your research?

Sam *Sure. The key takeaway of our paper is that the net flow into funds that had Morningstar globe ratings of high sustainability was positive. That means that the market overall values sustainability and that mutual fund investors in the United States think sustainability is a good characteristic. We examined a variety of explanations to understand what investors cared about and why we were observing these flows.*

We did not find evidence of outperformance, which is what we might expect as a rational explanation of these flows. We are looking at 11 months of data so it's very difficult to say anything definitive in terms of performance. In our experiment, we found evidence of people viewing the globe ratings as performance drivers, in that they thought high-sustainability funds would have higher performance and lower risk, and people viewing the globe ratings as indicative of a charitable orientation. It looked like people allocated more money in our experiments to high-sustainability funds than could be explained purely by performance metrics.

Feifei Thank you very much.

Sam *Thank you.*

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