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Why Do People Invest in ESG Funds?

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ESG investing has been developed primarily by and for large institutional investors (pension funds, sovereign wealth funds, endowments, etc.). The American tradition of socially responsible investing (SRI) that had started in the 1970s, and was instead focused on retail investors, had remained indeed very marginal. Instead, in the last five yeas, we have finally seen some interest in ESG investing among retail investors (individuals and families) both in Europe and the United States. By 2020, retail investors had reached 25% of the total global ESG market, soaring from 11% in 2012. But what is the evidence behind this shift? And what explains this behavior?

The evidence on mutual funds flows is a good starting point to address these questions. One study leveraged the launch of the Morningstar Sustainability rating for mutual funds on March 1, 2016, and showed that when mutual funds are categorized as low sustainability, they suffer net outflows of more than $12 billion, while being categorized as high sustainability led to net inflows of more than $24 billion.

Various surveys and some experimental evidence also confirmed that people would hold a preference for sustainable investing funds. Yet, this evidence is problematic as it might not necessarily translate into actual investment behavior. This problem is common in research on sustainable consumption, where consumer state preferences but are not necessarily consistent in their actual purchase behavior.

One study that overcomes some of these challenges leveraged data provided by the largest mutual fund providers in the Netherlands, including data on 3,382 investors in ESG funds (the study referred to these funds as socially responsible investing funds but here I use the ESG label), and 35,000 investors in non-ESG funds. The authors invited these investors to the study, and thus enabled a more reliable measure of why investors actually hold ESG mutual funds. In addition to gathering personal information and beliefs, the study elicited the participants' social preferences through version of the "trust game," and measured the extent to which they might use their investments to signal virtue, by asking how much they talk about their investments.

The results shatter some often held assumptions about the motivations behind investing in ESG funds:

1. Most surprisingly perhaps is the fact that investors did not hold ESG funds because they expected to financially outperform conventional funds, or because they would be exposed to lower risk. Instead, negative perception on their expected returns and riskiness were mentioned by investors who shunned ESG funds.

2. The most interesting result is probably the fact that the main driver of the likelihood to hold ESG funds is the intrinsic social preference of the investor. Thus, it seems that ESG retail investors are driven more by their social preference than risk-return expectations in their decisions.

3. Not surprisingly, signaling also plays a role, and investors who talk more about their investments are more likely to hold ESG funds.

4. ESG investors have a longer investment horizon. Investors who hold their funds one year longer are 2.76 percentage points more likely to hold an ESG equity fund.

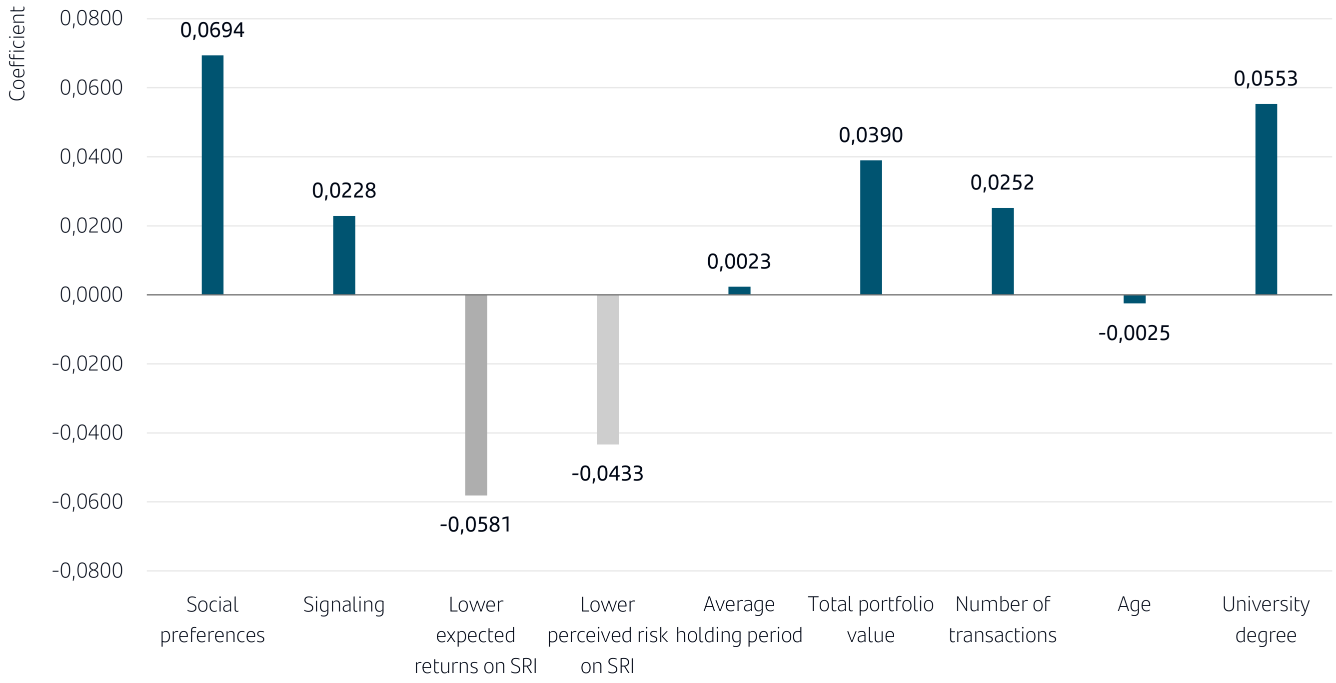
5. ESG investors also have a larger portfolio and are more active. For instance, a doubling of the portfolio size is associated with a 3.9 percentage point increase in the likelihood of investing in a socially responsible manner ($p = 0.002$).

6. In terms of demographics, more educated investors (with a university degree) and younger ones are more likely to hold ESG funds.

Drivers of Holding Socially Responsible Mutual Funds

Source: Author, based on Riedl and Smeets (2017).

*Patterned bars report non-statistically significant results.

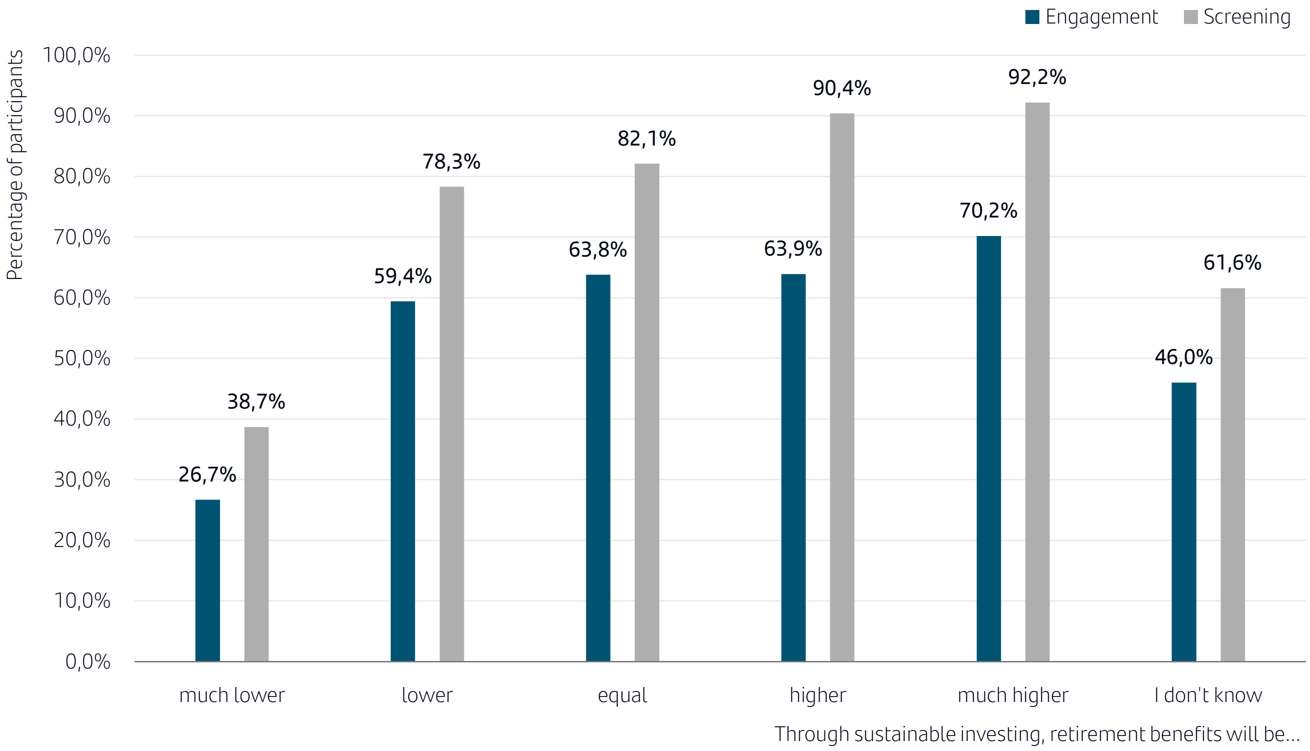


Another study in the Netherlands took advantage of a unique policy of a local pension fund, who gave its members the possibililty of voting on its sustainable investment policies, and then implemented their choices.

The pension fund members were asked if they wanted to increase the fund's investment focus on the UN's Sustainable Development Goals (SDG) through engagement and screening policies; 67,9% of participants favored more sustainable investing policies by including a fourth SDG "Responsible Consumption" in the fund engagement policies; and 74,4% of respondents also favored portfolio screening based on four SDGs. What drove these decisions? Once again, the study finds that pension beneficiaries were driven primarily by social preferences rather than risk-return expectations. Even when respondents expected their retirement benefits to be negatively affected, they directed their fund to do more sustainable investing.

Percentage of Participants choosing sustainable investing per belief category

Source: Author, based on Bauer, Ruof, and Smeets (2021).



The study also showed that respondents were not influenced by their political beliefs, as with the exception of those who voted for far-right, populist, and anti-Europe party, the majority of voters in all parties wanted to increase the SDG focus of the fund.

Bringing these studies together we can conclude that retail investors are indeed in favor of ESG investing, but not because they expect a better risk-return profile but primarily as a result of their social preferences. The risk-return profile matters as it seems that relatively unfounded beliefs on the supposed underperformance of ESG might keep many retail investors from following their values.

The results of these studies cannot simply be generalized to the preferences of individuals and families across different countries. Similar studies should explore the distribution of actual preferences in different countries. Yet, as the Netherlands has been a pioneer in the field of responsible investing in Europe, it is reasonable to expect that investors in other countries might follow a similar path.

To Learn More

- Bauer, R., Ruof, T., & Smeets, P. (2021). Get Real! Individuals Prefer More Sustainable Investments. The Review of Financial Studies, 34(8), 3976-4043. Read more

Available at: Read more

- Hartzmark, S. M., & Sussman, A. B. (2019). Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows. Journal of Finance, 74(6), 2789–2837. Read more

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- Riedl, A., & Smeets, P. (2017). Why Do Investors Hold Mutual Social Funds? The Journal of Finance, 72(6), 2505-2550. Read more

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Other Interesting Resources:

- Siemroth, C., & Hornuf, L.(2021). Do Retail Investors Value Environmental Impact? A Lab-in-The-Field Experiment Read more

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