Do mutual funds walk the talk after ESG-renaming?

This research was financially supported by CFA Society Netherlands through its dedicated VBA reserves. We are proud of the recognition this research has received.

The Society allocates funding for projects that advance knowledge and interest in areas such as investment analysis, financial issues, assessment of investment vehicles, financing structures, and portfolio management. To apply for funding or check eligibility, please reach out to us at info@cfasociety.nl.

ESG investments exhibited a remarkable growth over the last decade. As an illustration, a sizeable number of fund managers have now rebranded their mutual funds to signal ESG commitments, and they changed their funds' names accordingly. A prominent concern raised in recent years is that funds cosmetically change to ESG-related names merely to attract capital when ESG investing is 'hot'. Indeed, studies in the early 2000s reported that U.S. mutual funds changed their names to portray investment styles that were 'hot' in the market, without actually changing the styles of their portfolios subsequently. In addition, recent studies suggest that funds which signed the Principles for Responsible Investing enjoyed larger money flows without subsequently exhibiting stronger ESG tilts. Not surprisingly, regulators and policy makers are increasingly considering guidelines and policies to ensure that ESG-labeled investments are meaningfully distinctive.

To shed more light on mutual fund renaming towards ESG-labels, Gibbon et al. (2023) studied mutual funds' flows, equity portfolios, and expenses both before and after their name included an ESG-related term. Based on a textual analysis of global mutual fund names, 740 funds were identified that renamed from a name that did not include ESG-related words towards one that did (e.g., ESG, sustainable, green). The data confirm a clear increase in the number of funds that have changed their names to include ESG-related words during our 2016-2022 sample period. The analysis yields three main results:

Kayshani Gibbon, PhD. student at the Utrecht University School of Economics

The first finding is that, compared to non-renaming mutual funds, the average renamed fund exhibits a higher monthly flow of nearly one percentage point after it has renamed to include an ESG-related term. While this result could imply that attracting capital is a plausible financial motive for mutual funds to rename, the effects of ESG-renaming on fund flows appears region-specific. In particular, the study reports that positive flow effects are significant mainly for mutual funds domiciled in Europe but not for U.S. funds that rename. Although this result seems intuitive considering that ESG investing is more developed in Europe, it contrasts with previous studies suggesting that U.S. funds are able to attract additional capital by signaling an ESG commitment, possibly even without 'walking the talk'.

Second, addressing the question whether funds that rename do in fact walk the talk, the study analysed the ESG profiles of mutual funds' underlying holdings both before and after renaming. An analysis of a wide range of different portfolio-level ESG scores from MSCI ESG fund metrics and Morningstar points into a consistent direction: After ESG renaming, a mutual fund's portfolio tends to exhibit a higher overall ESG score, less exposure to controversial sectors, lower levels of carbon intensity, and lower scores on sustainability risk. Despite these improvements for the average ESG-renaming fund, the study documents differences between the U.S. and Europe. Improvements in portfolio-level ESG scores after renaming appear to be larger for the average U.S. mutual fund compared to European funds. Because European funds already exhibited a stronger ESG orientation than their U.S. counterparts regardless of renaming decisions, it is conceivable that European funds are simply more restricted in further increasing their ESG-tilts after renaming.

Third, the final section of the study touches upon another subject of debate:
Do funds use ESG profiling to charge higher expense ratios? The evidence in the study indicates that funds' expense ratios are generally not materially higher (if not lower) after ESG-related renaming, except for a subset of European mutual funds that exhibit on average a modest 4.5 bp higher annual TER after renaming.

Gibbon et al. (2023) provides implications for fund managers, investors, and regulators. For fund managers, the study shows that flows can increase after ESG-renaming, however, this effect appears region-specific for Europe only. For policy makers and regulators with concerns about ESG-washing through renaming, the study shows that ESG-renaming leads to improved ESG profiles with improvements mainly taking place among U.S. funds. For investors, the study shows that renamed funds provide more positive EGS-exposure for the same (U.S.) or only slightly higher fees (Europe). To conclude, the study shows that funds' ESG profiles improve after ESG renaming, and casts doubts on the idea that ESG renaming is merely a cosmetic event motivated by fund flows or fees.

Reference

- Gibbon, K., Derwall, J., Gerritsen, D., & Koedijk, K. (2024). Renaming with Purpose: Investor Response and Fund Manager Behavior after ESG Renaming. CEPR Discussion Papers, 19291.