Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows

Giovanna Nicodano
Collegio Carlo Alberto, University of Turin

GCGC, Harvard
June 2018

Summary

1. Morningstar issues monthly rankings of 20000 funds based on Sustainalytics rating since March 2016.
   - March 16– Jan 17: investors flow into (out from) the highest (lowest) ranked funds.
   - Controlling for prior (12, 24) month returns, log size, log age, expense ratio, prior star rating, and fixed effects
   - Before the publication, (close to) no pattern.

=> **Rankings cause investor flows**

Summary

- Institutional shares funds are similar to all funds; globes do not predict future risk adjusted performance (small sample)
- Lab: people interested in sustainability invest more (less) in higher (lower) ranking funds, controlling for expected risk and return.

=> **Flows reflect affection to sustainability**

- Investors focus on extremes; on discrete rather than continuous scores; expect higher performance and lower risk..

- => **Evidence supports behavioral theories**

This discussion

1. Relevance
2. Is it affection to sustainability?
   - 2016 is a special year
     - A non-behavioral story for extremes
   - Risk
3. Do Rankings help Sustainability?
   - Tax and Public Social Spending Corrections
   - Distortions and feedback effects
4. Other points

1. Relevance

- Timely and relevant: Green Parties, Paris Agreement, Consumers' Boycotts and more:
  - "The UN-supported Principles for Responsible Investment (PRI) initiative is a network of over 1500 institutions, **with US$ 62 trillion AUM.**"

  - The PRI reflect the view that (ESG) issues can affect the performance of portfolios. "They therefore **must be given** appropriate consideration by investors if they are to **fulfill their fiduciary duty.**"

2. 2016 is a special year

- Prior to 2016 little interest for fund sustainability: only 2% of funds had ESG mandates

- In 2016, PRI conducts a consultation on strengthening signatory accountability:
  - responsible investment must cover >50% of AUM; the policy sets out their approach to responsible investment (RI) OR has formalised guidelines on E or S or G.

2016 is a special year

- Final Regulations for Tax Exemptions
  - https://www.federalregister.gov/articles/2016/04/25/2016-09396/examples-of-program-related-investments)
- “When a private foundation makes a particular investment in a for-profit, can the foundation justify that such investment was made primarily to advance the foundation’s specific exempt purpose?»
- **=>Tax-driven demand for certification may cause both rankings and flows**

2016: A Tax Exemption Motive?

- Heterogeneity blurs institutional shares dummy
  - Only some institutions are «borderline» tax exempt foundation
  - Smaller foundations likely need globe certification for tax exemptions (and invest in retail segment)?

- To gain insight on tax exemption motive
  - Did Globe rankings appear outside the US?
  - Did they also cause fund flows?

Extremes and Tax Exemption

- If I need for a long-term certification
  - I face costs associated with portfolio adjustments

- Then I divest from lowest and invest in highest, so as to minimize the chances of reaching the lowest percentiles again

Panel D: Transition Probability

Current Month Rating	Next Month Rating: 1 Globe	2 Globes	3 Globes	4 Globes	5 Globes
1 Globe	2297	539	37	8	0
	(79.73%)	(18.71%)	(1.28%)	(0.28%)	(0.00%)
2 Globes	436	4869	1170	29	6
	(6.70%)	(74.79%)	(17.97%)	(0.45%)	(0.09%)
3 Globes	64	983	8753	1185	28
	(0.58%)	(8.93%)	(79.48%)	(10.76%)	(0.25%)
4 Globes	18	93	1032	5415	512
	(0.25%)	(1.32%)	(14.60%)	(76.59%)	(7.24%)
5 Globes	4	14	61	467	2837
	(0.12%)	(0.41%)	(1.80%)	(13.80%)	(83.86%)

A Risk Motive?

- Globes do not predict risk-adjusted returns
- Lab people: 5G has lower risk and better performance.
  - Fama-French factors do not reflect regulatory risk
  - 1G-5G long-short portfolio captures such risk, and commands a positive excess return

  - Higher future cash flows and less downside risk lead to lower expected returns

  - **In this light, rankings complete the market**

Rankings and Sustainability +

- Corporate ESG scores, that drive globe ranking, spur corporate action

  - 2018: Apple ranks in upper 72 percentile according to Sustainalytics (Barron's)

  - 2012: on a scale of A through E, both Apple, and Google manage a 'D' in EIRIS' sustainability ratings
  - http://www.sustainablebrands.com/

Rankings and Sustainability –

- Scores (and rankings) do not control for

1. variation in the tax bill across companies
2. share of public spending devoted to ESG
   - If company A avoids 50 billion$ tax bill
   - And public social spending is 50% of tax receipts
   - Then A’s ESG investing should be reduced by 25 billions (and fund rating accordingly)

- Problem may dissolve within country, since PRI (2018) is promoting corporate tax transaparency

- **Investors recognise that corporate taxes support society's tangible (i.e. infrastructure) and intangible (i.e. education, governance/legal, etc.) needs**. Investors recognise that strong government institutions create a solid foundation for competition, growth and other factors that enable long-term business sustainability at investee companies. Corporate income taxes are an important part of most governments' revenue base, and, as such, help to support this.

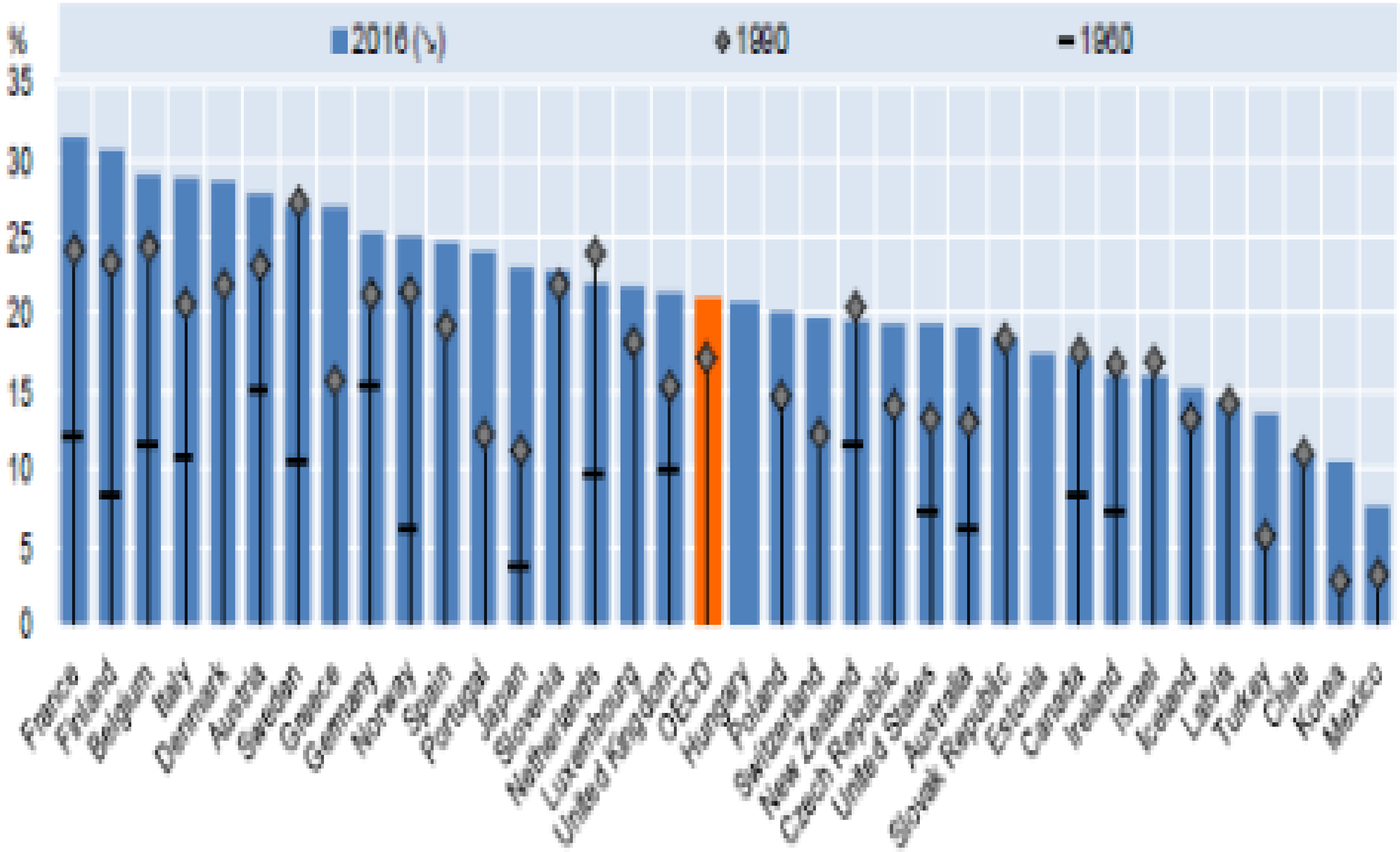
Rankings and Sustainability –

- However, distortion grows in cross-country differences in tax rates and public social spending, which are not accounted for in ESG scores

- Also an indirect effects distort ESG scores
  - Higher tax rates/social spending may reduce firm competitiveness in a given country, reducing corporate ESG spending

Figure 1. Public social spending is worth 21% of GDP on average across the OEC

Public social expenditure as a percent of GDP, 1960, 1990 and 2016



Ranking and welfare?

- Rankings reflect quality of fund; but when investors rely on them, rankings affect the quality of the fund and its portfolio. EG, a downgrade may lead to higher cost of capital (Manso, 2013).
- ➔Self-fulfilling distortions in rankings
  - Agencies should set scores that
  - A. correct cross-country distortions
  - B. modify scores only if they are really accurate, taking into account feedback

Other points

1. «Investors responded on preconceived notions of sustainability» p. 8
   - Count access to Morningstar Explanatory Page and Sustainalytics
2. «Investors largely ignore sustainability information» p.16
   - Continuous metrics are unreliable due to within-industry scores and other distortions

- Outflows are larger than inflows in the market, while they are equal in the lab. Why?

Conclusion

- A thought provoking paper establishing that investors value sustainability rankings
  - Tax exemption and regulatory risk motives
  - Focus on extremes is transaction cost minimizing
  - Investors' reaction to rankings may reduce sustainability due to unaccounted (cross-country) differences in taxation and public social spending