

# Sustainability or Performance? Ratings and Fund Managers’ Incentives

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Nickolay Gantchev

University of Warwick, CEPR and ECGI

Mariassunta Giannetti

Stockholm School of Economics, CEPR, Swedish  
House of Finance and ECGI

Rachel Li

University of Alabama

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## Abstract

We show that following the introduction of Morningstar's sustainability ratings (the "globe" ratings), mutual funds attempt to improve their globe ratings by increasing their demand for sustainable stocks. This trading behavior creates buying pressure, making stocks with high sustainability ratings overvalued. As a consequence, a tradeoff between sustainability and performance arises and the performance of funds improving their globe ratings deteriorates. Since performance appears to be more important in attracting flows than sustainability, a new equilibrium emerges in which the globe ratings stop affecting investor flows and funds no longer trade to improve their globe ratings. Our results highlight the issues arising when funds are evaluated along two different dimensions that create conflicting incentives for fund managers competing for flows

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Keywords: Sustainability; ESG; Mutual Funds; Fund Flows; Ratings

JEL Classifications: G11, G12, G23, G24

Nickolay Gantchev\*

Professor of Finance  
University of Warwick, Warwick Business School  
Scarman Road  
Coventry, CV4 7AL, United Kingdom  
e-mail: Nickolay.Gantchev@wbs.ac.uk

Mariassunta Giannetti

Professor of Finance  
Stockholm School of Economics, Department of Finance  
Sveavagen 65  
113 83 Stockholm, Sweden  
phone: +46 873 696 07  
e-mail: mariassunta.giannetti@hhs.se

Rachel Li

Assistant Professor of Finance  
University of Alabama, Culverhouse College of Business  
236 Alston Hall, 361 Stadium Dr  
Tuscaloosa, AL 35487, United States  
phone: + 1 205 348 7858  
e-mail: qli@culverhouse.ua.edu

\*Corresponding Author

# **Sustainability or Performance? Ratings and Fund Managers' Incentives**

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We show that following the introduction of Morningstar's sustainability ratings (the "globe" ratings), mutual funds attempt to improve their globe ratings by increasing their demand for sustainable stocks. This trading behavior creates buying pressure, making stocks with high sustainability ratings overvalued. As a consequence, a tradeoff between sustainability and performance arises and the performance of funds improving their globe ratings deteriorates. Since performance appears to be more important in attracting flows than sustainability, a new equilibrium emerges in which the globe ratings stop affecting investor flows and funds no longer trade to improve their globe ratings. Our results highlight the issues arising when funds are evaluated along two different dimensions that create conflicting incentives for fund managers competing for flows.

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\* Gantchev ([nickolay.gantchev@wbs.ac.uk](mailto:nickolay.gantchev@wbs.ac.uk)) is with the Warwick Business School at the University of Warwick, CEPR, and ECGI; Giannetti ([mariassunta.giannetti@hhs.se](mailto:mariassunta.giannetti@hhs.se)) is with the Stockholm School of Economics, CEPR, and ECGI; Rachel Li ([qli@cba.ua.edu](mailto:qli@cba.ua.edu)) is with the Culverhouse College of Business at the University of Alabama. We thank Chotibhak (Pab) Jotikasthira for helpful discussions and seminar participants at American University, Baylor University, the Stockholm School of Economics, the University of Kansas, and the University of Liverpool. Giannetti acknowledges financial support from the Nasdaq Nordic Foundation and the Jan Wallander and Tom Hedelius Foundation.

In their efforts to increase financial flows to sustainable investments, policymakers often advocate higher transparency about the sustainability of mutual fund portfolios. To this end, in March 2016, Morningstar introduced the globe ratings to rank the sustainability of funds' portfolios. Hartzmark and Sussmann (2019) show that in the aftermath of their introduction, these easy-to-process and attention-grabbing signals significantly increased flows to the funds that received the highest sustainability ratings; in contrast, the funds with the lowest ratings experienced outflows.<sup>1</sup>

This paper asks whether portfolio sustainability ratings can have long-lasting effects on the cost and allocation of capital in a world in which funds compete for flows based not only on their portfolios' sustainability, but also on performance. This concern arises from the fact that precisely because they affect flows, portfolio ratings are expected to alter stock demand. In particular, we expect funds to take into consideration the stocks' sustainability ratings to a larger extent after the introduction of the Morningstar globe ratings because a higher portfolio sustainability rating can positively impact flows. This behavior could improve the funds' performance if sustainability is positively related to the stocks' future performance and most market participants do not take it into account (Pedersen, Fitzgibbons, and Pomorski, 2019).

However, in an attempt to improve their globe ratings, mutual funds may increase their demand for stocks with high sustainability ratings above and beyond what would be warranted by the stocks' expected returns. This behavior is likely to increase the valuation of stocks with high sustainability ratings and negatively affect their future returns (Heinkel, Kraus, and Zechner, 2001;

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<sup>1</sup> Ammann, Bauer, Fischer, and Müller (2019) and Ceccarelli, Ramelli, and Wagner (2020) also show that flows to funds with high sustainability ratings increase in the aftermath of the ratings' introduction.

Pastor, Stambaugh, and Taylor, 2019; Pedersen, Fitzgibbons, and Pomorski, 2019). Under these conditions, a trade-off may arise between the rankings of a fund's portfolio along the sustainability and the performance dimensions. Even in sustainable funds, managerial compensation depends on assets under management and performance (Geczy et al., 2021). Therefore, the relative weight that investors put on performance versus sustainability is likely to affect fund managers' incentives to pursue different objectives. As a consequence, an equilibrium may arise in which some funds pursue high sustainability ratings, while others aim for better performance. However, if most investors primarily value performance, the trade-off between sustainability and performance may motivate all funds to pursue performance as their main objective. In this case, the globe ratings may have limited effects on the funds' portfolio allocation.

Exploiting the introduction of the globe ratings, we investigate how the mutual fund industry transitions to a new equilibrium, and whether the sustainability ratings affect the funds' allocation of capital. We show that after the introduction of the globe ratings, mutual funds with stronger incentives to achieve higher globe ratings change their investment policies in an attempt to improve the sustainability rankings of their portfolios. This generated buying (selling) pressure and stocks with high (low) sustainability ratings became overvalued (undervalued) as a result of the mutual funds' trading behavior.

Funds that were attempting to improve their star ratings, another popular Morningstar metric that ranks mutual funds on performance, purchased (sold) stocks that became undervalued (overvalued) because of the trading of funds pursuing better sustainability ratings. This behavior was more pronounced for funds with stronger incentives to improve their star ratings, for instance because they were closer to the cutoff for a higher rating and competed with fewer peers to be upgraded. As a consequence, funds improving their globe ratings were more likely to experience

a downgrade of their star rating. In contrast, funds purchasing (selling) stocks with low (high) sustainability ratings, which were sold (bought) by the funds attempting to improve their globe ratings, achieved better performance and improved their star ratings.

We show that in the aftermath of the introduction of the globe ratings, both high (low) globe and star ratings have positive (negative) effects on flows. However, the magnitude of the effect is larger for the star ratings. More importantly, we find that the effect of the globe ratings on flows is not persistent. In particular, starting nine months after the introduction of the globe ratings, we no longer observe any effects of these ratings, and their changes, on flows. Consistent with a new equilibrium in which globe ratings no longer affect flows, funds nearly stop trading in a way to improve their globe ratings.

A growing literature explores how sustainability affects investors' strategies and performance. Socially responsible investors are generally believed to put sustainability before performance (Riedl and Smeets, 2017; Barber, Morse, and Yasuda, 2021). Arguably for this reason, socially responsible mutual funds have been shown to have a lower flow-performance sensitivity (Bollen, 2007; Pastor and Vorsatz, 2020). Another strand of the mutual fund literature studies how investor flows respond to attention-grabbing and easy-to-process signals, such as external rankings of the funds' performance (see, e.g., Del Guercio and Tkac, 2008; Ben-David, Li, Rossi, and Song, 2019) or of the sustainability of the funds' portfolios (Hartzmark and Sussman, 2019; Ammann, Bauer, Fischer and Müller, 2019). To the best of our knowledge, our paper is the first to highlight the tensions arising when funds are rated along two different dimensions that may create opposing incentives for fund managers aiming to improve their funds' ratings. We show that in the long run, only ratings on the dimension that is followed by a larger proportion of investors contribute to higher flows.

In this respect, our paper also adds to a vast literature, mostly developed in the debt markets, on the consequences of ratings. Existing literature shows that corporations and financial intermediaries have strong incentives to improve and manipulate their ratings (e.g., Rajan, Seru, and Vig, 2015; Kisgen, 2006). Another strand of the literature explores corporate ESG ratings and raises concerns about their informativeness (see, e.g., Serafeim, Park, Freiberg, and Zochowski, 2020; Cohen, Gurun, and Nguyen, 2020). We study how mutual funds strive to improve their performance and sustainability ratings and how incentives arising from fund flows may make some ratings irrelevant in the presence of trade-offs between different types of ratings.

Our paper is also related to a strand of the literature exploring the consequences of investors' preferences for sustainable investments on asset prices. For instance, Chava (2014) and Bolton and Kacperczyk (2020) show that high carbon emissions result in stock undervaluation because of institutional investors' preferences against stocks with these characteristics. We exploit the introduction of the globe ratings as an exogenous shock to mutual funds affecting the valuation of stocks with different sustainability ratings. We also show how funds react to such a shock to increase their assets under management.

## **1. Institutional Background**

### *1.1 Morningstar Performance Ratings*

The Morningstar star ratings were first introduced in 1985 and represent a quantitative backward-looking measure of a fund's performance, ranging from one (low) to five (high) stars. The star rating is based on a fund's percentile rank relative to peer funds in the same Morningstar category. The fund's performance is measured using Morningstar's Risk-Adjusted Return. Morningstar computes ratings based on funds' three-, five-, and ten-year performance. The overall



Morningstar rating is based on a weighted average of all available time-period ratings. Funds must have been active and report performance for at least 36 months to obtain a star rating.<sup>2</sup>

Star ratings are updated at the end of every month and have been widely shown to be an important determinant of fund flows, above and beyond the funds' historical performance (Ben-David, Li, Rossi, and Song, 2019; Del Guercio and Tkac, 2008).

### *1.2 Morningstar Sustainability Ratings*

On March 1, 2016, Morningstar introduced ratings aimed at ranking the sustainability of the funds' portfolios. The objective was to provide a way for investors to evaluate how different funds meet environmental, social, and governance standards. These ratings were introduced side-by-side with the star ratings and are referred to as globe ratings. They range from one (low) to five (high) globes.<sup>3</sup>

The globe ratings are based on a fund's portfolio sustainability score, which has always been available to Morningstar users. It is computed as a weighted average of the company-level ESG scores, obtained from Sustainalytics, with the fund's portfolio shares as weights. The globe rating of a fund is based on the percentile rank of its portfolio sustainability score relative to other funds in the same Morningstar category. Only funds belonging to categories with at least ten funds are ranked.

Table A.1 summarizes how the star and globe ratings relate to the funds' percentile ranks.

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<sup>2</sup> An overview of the Morningstar star ratings and the detailed procedures used in calculating them is available at [https://www.morningstar.com/content/dam/marketing/shared/research/methodology/771945\\_Morningstar\\_Rating\\_f\\_or\\_Funds\\_Methodology.pdf](https://www.morningstar.com/content/dam/marketing/shared/research/methodology/771945_Morningstar_Rating_f_or_Funds_Methodology.pdf)

<sup>3</sup> Most of our tests focus on the period following the initial introduction of Morningstar's globe ratings. In late 2018, Morningstar changed the methodology to compute the sustainability ratings by switching the peer-fund category from the Morningstar category to the more comprehensive Morningstar Global category. We show that this change does not affect our conclusions.

## 2. Data and Descriptive Statistics

Our sample includes all U.S. equity funds domiciled in the U.S., which have both star and globe ratings. As is common in the literature (Chevalier and Ellison, 1997), we include funds with at least \$10 million in assets under management that are at least two years old. We also require funds to have information on their return, age, expense ratio, TNA, and Morningstar category. The final sample for our main analysis from March 2016 to December 2017 includes 1,953 unique funds.<sup>4</sup> For each fund, we aggregate fund size (TNA) and flows across share classes and calculate the fund's mean expense ratio and return. We use the star rating of the largest share class and compute the fund's age as the time from inception of the oldest share class.

## 3. Results

### *3.1 The Introduction of the Sustainability Ratings and Fund Incentives*

We explore how the introduction of the sustainability ratings affects fund incentives. Since funds with the highest (lowest) globe ratings have been shown to experience inflows (outflows), fund managers should have incentives to improve their globe ratings, thus creating buying (selling) pressure in stocks with high (low) ESG scores.

To test whether the desire to improve the globe ratings affects the funds' behavior, we consider that some funds may have stronger incentives to change their trading behavior in order to improve their globe ratings. In particular, as has been shown for firms' capital structure (Kisgen,

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<sup>4</sup> The funds belong to the following Morningstar categories, within which they are sorted to obtain the globe ratings: US Fund Large Blend; US Fund Large Growth; US Fund Large Value; US Fund Mid-Cap Blend; US Fund Mid-Cap Growth; US Fund Mid-Cap Value; US Fund Small Blend; US Fund Small Growth; US Fund Small Value. Only 30 funds in our sample market themselves as ESG, as we can infer from their names searching for ESG, sustainable, responsible and the like. Interestingly, while nearly 40% of the observations referring to funds with ESG in the name have the top ratings, we observe any of the other globe ratings also for these funds.

2005), we expect funds close to the rating cutoffs, to be more likely to achieve a better rating (or to avoid a downgrade) by rebalancing their portfolios.

We consider the bottom and top globe ratings because Hartzmark and Sussmann (2019) show that only these have an effect on fund flows. Consequently, only the funds close to the cutoffs of these ratings should have stronger incentives to improve their sustainability ratings or to avoid being downgraded.

Table 2 studies a quarterly fund-stock panel. We conjecture that funds with a sustainability rating within  $\pm 2.5\%$  of the cutoff between globes 1 and 2 or between globes 4 and 5 have stronger incentives to try to improve or maintain their globe ratings. We label these funds *Border Funds*. Controlling for stock characteristics, we find that funds with strong incentives to improve or to maintain their globe ratings indeed increase their holdings of stocks with high ESG ratings, as captured by the stock's Sustainability *Effective ESG Score*. For example, in column (2), an interquartile increase in a stock's effective ESG score is associated with a 0.36% increase in the position of funds with sustainability ratings close to the cutoff, or about 3.5 times the average change in position.<sup>5</sup> This behavior is even more pronounced for funds competing with fewer peers to be upgraded, as seen in column (4).

Importantly, this effect is driven by the first nine months after the introduction of the globe ratings, suggesting that the incentives to improve funds' sustainability scores may have subsequently weakened. As we show below, this is consistent with a new equilibrium in which the globe ratings are no longer associated with flows because fund managers and investors become aware of a tradeoff between sustainability and performance.

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<sup>5</sup> The economic magnitude is computed as  $0.033 \times (50.787 - 39.871)$ , where 50.787 is the 75th percentile of the ESG score, 39.871 is the 25th percentile, and the average change in position is 0.102.

We also consider that our sample may include index funds, whose holdings must reflect the indexes they follow. Because of their mandates, index funds have to increase their holdings in stocks that are part of the index and that appreciate without any strategic considerations. This could bias our estimates. We thus identify index funds using the corresponding Morningstar flag. Reassuringly, columns (6) and (7) show that active border funds with few peers exhibit an even larger increase in stocks with high *Effective ESG Score* during the first nine months after the introduction of the globe ratings. This indicates that our findings are driven by actively-managed funds, but that index funds may contribute to amplifying the buying pressure.

### 3.2 Stock-level Consequences

We identify the buying pressure generated by the funds' objective to obtain higher sustainability ratings ex-post, by considering the abnormal trading of funds that end up improving their globe ratings. We do so, instead of merely considering the stocks' sustainability ratings, as funds may pursue different strategies and select stocks that can contribute to improving their globe ratings within their mandate.

Specifically, we define the aggregate abnormal ESG trading experienced by stock  $i$  in quarter  $t$  as:

$$Agg\ Abnormal\ ESG\ Trading(i, t) = \sum_{f=1}^F Abnormal\ Trading(f, i, t), \text{ if } f \in G,$$

where  $G$  is the set of funds that improve their globe ratings between quarters  $t-1$  and  $t$ . The abnormal trading of fund  $f$  in stock  $i$  between quarters  $t-1$  and  $t$  is equal to the change in the fund's number of shares held in stock  $i$  as a fraction of the stock's shares outstanding –

$$Trading(f, i, t) = \frac{NumShares(f, i, t) - NumShares(f, i, t-1)}{Shares\ Outstanding(i, t-1)} - \text{minus the average change between } t-1$$

and  $t$  in the holdings of stock  $i$  by all other funds in our sample.

According to our definition, *Agg Abnormal ESG Trading*  $(i,t) > 0$  indicates that during quarter  $t$ , there is buying pressure in stock  $i$  arising from the funds' incentives to improve their portfolio sustainability ratings. In contrast, *Agg Abnormal ESG Trading*  $(i,t) < 0$  implies that there is selling pressure created by the funds that attempt to improve their globe ratings.

While this definition of trading pressure is based on the ex-post realization of the funds' globe ratings, our results are similar if we use an ex-ante definition of trading pressure. Specifically, in our ex-ante definition, we consider the aggregate buying and selling pressure generated by funds with strong incentives to improve their globe ratings, defined here as funds in a  $\pm 2.5\%$  neighborhood of the cutoffs for the bottom and top globe ratings.

Table 3 shows that according to both the ex-ante and ex-post definitions, the trading of the funds that end up improving or have stronger incentives to improve their sustainability ratings is statistically different from the trading of the average mutual fund in our sample. This suggests that funds may be actively changing their portfolios in order to improve their globe ratings. For example, based on the ex-ante definition of aggregate pressure, the average abnormal ESG trading in stock  $i$  is about 7% of the average total trading during the 18-month sample period (column 1).<sup>6</sup> This magnitude could potentially affect stock prices.

Importantly though, this pattern is driven by the first nine months after the introduction of the portfolio sustainability ratings. In the second half of the sample, the trading of the funds that are close to the ratings' cutoffs, as well as the trading of the funds that end up improving their ratings, is not statistically different from the average of the other mutual funds in the sample. This is consistent with our findings in Table 2 that after the initial period, funds stop targeting improvements in their sustainability ratings.

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<sup>6</sup> This economic magnitude is calculated as the coefficient in column 1 ( $=0.0000895$ ), divided by the average total trading as a percent of shares outstanding ( $=0.0013175$ ).

To provide more direct evidence that the abnormal trading of funds that obtain better globe ratings is indeed driven by their efforts to improve the sustainability of their portfolios, we explore whether the sign of the aggregate ESG trading pressure experienced by a given stock is positively related with the stock's ESG score. Figure 1 provides graphical evidence that this is indeed the case. A higher stock ESG rating is associated with higher abnormal trading by funds that end up improving their globe ratings, but this pattern is much more pronounced in the first half of the sample and largely absent in the second half.

Table 4 presents similar results controlling for a number of stock characteristics. We find that the influence of a stock's *Effective ESG Score* on abnormal trading is economically significant; for instance, in column 1, a one-standard-deviation increase in a stock's ESG score ( $=8.67$ ) explains about 18% of the total abnormal trading in the stock, calculated as  $(0.268 \times 8.67) / (0.0013175 \times 10000)$ . Importantly, consistent with our earlier findings in Table 2, the pattern emerges only in the first nine months after the introduction of the globe ratings. We fail to detect a significant relation between stocks' ESG scores and the funds' abnormal ESG trading afterwards.

We next explore whether the demand pressure generated by the funds that strive to improve their sustainability ratings affects stock returns, thus creating profitable trading opportunities for other funds. If the sustainability-driven funds indeed create demand pressure, we should observe that the stocks that they purchase to a larger extent than other funds become overvalued, while the contrary should be the case for the stocks that they sell.

To evaluate whether this is the case, we consider the returns on a zero-cost long-short strategy that goes long in stocks with ESG selling pressure and short in stocks with ESG buying pressure. The portfolio is rebalanced at the beginning of each quarter. Since we need the abnormal

trading pressure generated by the introduction of the globe ratings, we lose the first quarter of the sample. We estimate the Jensen's alpha of this long-short portfolio, controlling for the three Fama-French factors and the momentum factor.

Table 5 shows that such a strategy has a positive and statistically significant alpha in the first six months following the introduction of the globe ratings. This is the case regardless of whether we use equally-weighted or value-weighted returns (in columns 1 and 3, respectively). The annualized return of the strategy is 2.3% ( $=0.0093*252$ ), when considering equally-weighted portfolios (column 1). The annualized return is higher (5.4%) but less statistically significant when considering value-weighted portfolios (column 3), possibly indicating that large stocks are less affected by the trading pressure. Importantly, consistent with our earlier tests, the return of this long-short strategy declines over time, and even changes sign in the second half of the sample.

Overall, the evidence in Table 5 suggests that in the aftermath of the introduction of the globe ratings, the trading of the funds that improve their sustainability ratings provides trading opportunities for other funds that are not concerned about the sustainability of their portfolios, but aim instead to improve their performance.

### *3.3 Performance-driven Fund Trading Strategies*

To evaluate whether fund managers that do not aim to improve their sustainability ratings exploit the trading of ESG-driven funds, we consider mutual funds' position changes, defined as:

$$Position\ Change(f, i, t) = \frac{Price(i, t-1) * (NumShares(f, i, t) - NumShares(f, i, t-1))}{TNA(f, t-1)}.$$

We include in the sample only funds that do not end up improving their globe ratings. We then investigate whether other funds take the opposite trading position and whether they benefit from the price pressure generated by the sustainability-driven funds.

By considering a contemporaneous relationship, we assume that fund managers learn about the trading pressure generated by ESG-driven funds from their brokers who extrapolate the informational content in order flow, allowing their clients to anticipate future price behavior. Such an assumption is consistent with prior evidence that brokers disseminate information about profitable trading opportunities to other clients with the objective of generating broker fees (Di Maggio, Franzoni, Kermani, and Sommarvilla, 2019; Barbon, Di Maggio, Franzoni, and Landier, 2019).

Panel A of Table 6 shows that in the first nine months following the introduction of the globe ratings, that is, when this trading strategy appears relatively more profitable, other fund managers take the opposite position of sustainability-driven funds. The economic magnitude of the funds' position change is meaningful and equals -0.22% of the funds' TNA, calculated as the coefficient in column 2, multiplied by the standard deviation of the abnormal ESG trading ( $-0.675 \times 0.0032$ ).

This result is obtained controlling for the selling pressure generated by the funds' purchasing and selling behavior unrelated to ESG considerations. The aggregate change in the shares held by mutual funds as a proportion of shares outstanding also controls for flow-driven fund trading (Coval and Stafford, 2007), thus confirming that buying and selling pressure generated by ESG trading matters.

Importantly, the fact that the results do not hold in the second part of the sample suggests that the findings are not hard-wired in the definition of ESG abnormal trading, which captures the abnormal trading of globe-improving mutual funds, relative to the remaining funds whose trading we explore in Table 6.



In columns (5) and (6), we compare the trading of active funds and index funds. Once again, we should see that our results are driven by active funds if we are indeed capturing fund managers' strategic behavior. Consistent with our conjecture, we find that the tendency to trade against globe-motivated funds in the first nine months after the introduction of the globe ratings appears even more pronounced when we exclude index funds in column 6. In column 5, we still find a small but statistically significant effect for index funds, suggesting that these funds increase their holdings in stocks experiencing high ESG demand pressure to a lesser extent than ESG-motivated funds. Overall, this evidence confirms our earlier findings that the strategic behavior of active funds drives our estimates. Index funds following indexes with more or less sustainable stocks, however, contribute to amplifying the trading pressure.

To further support our interpretation of the empirical evidence, the rest of Table 6 investigates whether funds that have stronger incentives to improve their performance and to increase their star ratings are more likely to buy stocks that are experiencing trading pressure due to their ESG scores. In particular, funds close to the star rating cutoffs have strong incentives to try to be upgraded or to avoid a downgrade because better star ratings are known to lead to higher flows above and beyond the direct effect of fund performance (Del Guercio and Tkac, 2008). Therefore, funds in the neighborhood of the star rating cutoffs may be more inclined to disregard the effect of their trading on their sustainability scores. We consider all star ratings because higher star ratings have been shown to be positively associated with fund flows (Del Guercio and Tkac, 2008).

Consistent with our conjecture, Panel B shows that funds that are closer to the cutoff for improving their star ratings take larger positions in stocks with negative aggregate ESG trading pressure. The effect increases monotonically, as we consider funds further away from their rating

cutoff (column 1), funds that are within  $\pm 5\%$  of the percentile ranking cutoff (column 2), and funds that are within  $\pm 2.5\%$  of this cutoff (column 3). Once again, the effect is driven by the first nine months after the introduction of the globe ratings, as indicated by the negative coefficient on the interaction between the *First 9 months* dummy and *Abnormal ESG Trading*.

Panel C further explores to what extent the incentives to trade against funds pursuing ESG strategies are driven by the desire to improve the funds' star ratings. Because funds are ranked relative to their Morningstar category peers and different categories include different numbers of funds, the number of peers within a particular category significantly affects funds' ability to obtain higher star ratings. Since improving the ratings should be easier for funds with fewer peers, we should observe that *ceteris paribus*, funds with fewer peers take larger positions against the aggregate ESG pressure. This is indeed what the economic magnitudes and statistical significance of the coefficients in columns 3 and 5 suggest. Funds with more peers, being less likely to succeed in improving their ranking in order to obtain a better star rating, exhibit a lower propensity to exploit the aggregate ESG pressure in their trading strategies. In addition, comparing odd-numbered and even-numbered columns, we see that the effects are stronger in the first nine months after the introduction of the globe ratings.

Finally, Table 7 shows that our results are robust if we consider the ex-ante proxy for abnormal ESG trading pressure and restrict the sample to focus on the trading of sustainability-driven funds that are closer to the cutoffs between globes 4 to 5 or between globes 1 to 2, that is, funds with stronger incentives to improve their ESG ratings.

### 3.4 Trade-off between Globe and Star Ratings

In this subsection, we consider the consequences of the funds' trading strategies on their star ratings and abnormal returns. To do so, we need a proxy for the extent to which a fund has been trading to pursue an improvement in its globe or star rating. Thus, for each fund, we add up the value of the position changes in stocks that we have identified as more likely to have experienced aggregate ESG trading pressure due to the trading of funds that try to improve their globe ratings. Thus, we define:

$$ESG\ Pressure\ Trade(f, t) = \sum_{i=1}^N Pressure\ Trade(f, i, t),$$

where  $Pressure\ Trade(f, i, t)$  equals  $Position\ Change(f, i, t)$  if (1) stock  $i$  experiences abnormal ESG trading pressure in the top quintile ( $Agg\ Abnormal\ ESG\ Trading(i, t) \in Top\ Quintile$ ) and fund  $f$  increases its portfolio share in stock  $i$  ( $Position\ Change(f, i, t) > 0$ ), or (2) stock  $i$  experiences abnormal ESG trading pressure in the bottom quintile ( $Agg\ Abnormal\ ESG\ Trading(i, t) \in Bottom\ Quintile$ ) and fund  $f$  decreases its portfolio share in stock  $i$  ( $Position\ Change(f, i, t) < 0$ ).

By construction, funds that purchase stocks with aggregate abnormal ESG trading pressure (that is, the stocks bought by the funds that end up improving their sustainability scores) should improve their globe ratings. More interestingly, we explore how pursuing a strategy that aims to improve the fund's sustainability rating affects its performance rating. We also ask whether funds that trade against other funds pursuing higher sustainability ratings indeed improve their performance ratings and examine the effect on their sustainability ratings.

Panel A of Table 8 shows that funds that tilt their portfolios towards stocks that are experiencing higher aggregate abnormal ESG pressure are more likely to see a positive change of their globe ratings. Notably, these funds are also more likely to experience a downgrade of their

star ratings, indicating that there is a trade-off between sustainability and performance ratings. This trade-off is very pronounced in the first nine months after the introduction of the globe ratings, when the stocks with aggregate abnormal ESG pressure appear to have become overvalued, but is not present afterwards.

In Panel B of Table 8, the funds' performance reveals a similar pattern. In particular, we regress a fund's alpha, estimated as the fund's abnormal return in excess of its exposure to the three Fama-French factors and the Carhart's momentum factor, on *ESG Pressure Trade* ( $f, t$ ) and a number of controls. It is evident that in the first nine months after the introduction of the globe ratings, funds that trade against the pressure generated by ESG-motivated trades enjoy better performance. We find no significant effects in the subsequent period when funds' propensity to pursue ESG-driven trades subsides (column 3).

## **4. Consequences for Fund Flows**

### *4.1 Main Findings*

In this section, we explore why funds' incentives change after the period immediately following the introduction of the globe ratings. Fund managers' compensation depends on the fees they earn, which in turn are driven by the funds' net assets under management (Chevalier and Ellison, 1997). Based on these considerations, funds' trading strategies should aim to maximize net flows, which are known to be affected by the funds' performance as well as by the funds' sustainability and performance ratings.

If both strategies – aiming to improve portfolio sustainability and performance – bring flows, there might exist an equilibrium in which some funds pursue better sustainability ratings and other funds strive for better performance ratings. Table 9 explores to what extent this is the

case. It appears that during our sample period only the funds' star ratings consistently bring more flows. Such a finding emerges in Panel A, where we estimate specifications similar to those in Hartzmark and Sussman (2019), without controlling for the funds' star ratings, and in Panel B, where we consider dichotomous variables for each of the star ratings, using the middle globe/star rating as the omitted variable.

In the first nine months of the sample period, better globe ratings are associated with higher flows, as is evident from columns 2 and 5 of Panel A and column 2 of Panel B. However, a comparison of the coefficients on the globe and star ratings in column 2 of Panel B shows that the star ratings have larger effects on flows than the corresponding globe ratings. Yet, some funds may specialize in strategies that pursue the globe ratings if some investors put sustainability over performance in their fund selection, even if the magnitude of flows suggests that these investors have lower wealth to invest than performance-chasing investors. However, pursuing a better globe rating may be counterproductive if associated with a downgrade of the performance rating and if investors care more about performance. For example, having a globe rating of 5 increases fund flows by 0.2%, whereas having a star rating of 1 reduces flows by 0.6%. In contrast, having a globe rating of 1 decreases flows by 0.2%, but a star rating of 5 increases flows by 1.6%.<sup>7</sup>

Interestingly, the globe ratings appear to leave flows unaffected in the second half of the sample and when we consider the whole sample period. The findings are broadly confirmed in Panel C, where we distinguish between funds' institutional and retail share classes. While immediately after the introduction of the globe ratings retail investors appear to redeem capital from funds with the bottom globe rating and institutional investors allocate capital to funds with

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<sup>7</sup> Interactions between globe and star ratings are not statistically significant. In particular, funds that obtain a top globe rating do not attract more flows even if they have a top performance rating.

the top globe ratings, the sustainability ratings lose power in explaining the flows of both categories of investors in the second half of the sample.

Overall, our findings suggest that on average, investors learn about the trade-off between the performance and sustainability of fund portfolios and the vast majority of investors chooses to focus on performance. This in turn makes the globe ratings irrelevant and helps explain why we uncover weaker incentives to pursue sustainability ratings in the second half of the sample.

#### *4.2 Alternative Explanations*

One reason why the globe ratings lose power in attracting flows could be that all investors that wanted to hold sustainable mutual funds have already reallocated their portfolios in the aftermath of the introduction of the globe ratings. If the globe ratings are rarely changed once they are assigned, investors would not need to switch funds, and hence, we would observe little effect on flows. Such an interpretation would be consistent with an equilibrium in which both sustainability and performance matter for different investors depending on their preferences. However, Table IA.2 shows that the turnover in both globe and star ratings is only slightly lower in the second half of the sample period. If anything, upgrades/downgrades to/from the top and bottom globe ratings, which are the ones that matter for flows in the first part of the sample, become more likely in the second subperiod. Thus, funds that achieve an improvement in their globe ratings should experience net inflows if a sufficiently large proportion of investors care more about sustainability than performance; the contrary should be true for funds that are downgraded.

In Table 10, we consider the reaction of flows to globe rating upgrades and downgrades, controlling for the initial rating. We find no evidence that investors respond to upgrades and downgrades from/to the bottom and top globe ratings in the second part of the sample. Only star

ratings appear to matter. These findings support our interpretation that flows stop responding to the globe ratings after their initial disclosure, because investors become aware of the trade off with performance. Put differently, even if the assets under management of funds with the top sustainability ratings increased after the introduction of the ratings, changes in the sustainability of the funds' portfolios captured by rating upgrades and downgrades do not lead investors to reallocate their capital. This suggests that in the long-term, the globe ratings are unlikely to lead to an increase in financial flows to sustainable investments.

Another possibility is that investors consider the funds' sustainability scores as opposed to their globe ratings. The sustainability scores have the advantage to give an absolute ranking of the sustainability of the funds' portfolios, rather than relative to other funds in the same category, and may therefore be preferred by funds with pro-social preferences. In this case, the sustainability of the fund's portfolio could attract flows, even if the globe ratings stop being relevant. To evaluate this possibility, in Table 11, we substitute the fund's globe rating with its sustainability score. Consistent with our earlier findings, the sustainability score appears to be positively related to flows only in the first half of the sample period, confirming that only the fund's performance matters for flows.

## **5. Robustness**

In October 2018, Morningstar announced some changes to the criteria used to assign globe ratings, which became effective in November 2018. First, ratings are now assigned based on the fund's historical sustainability score, which considers also the sustainability of the fund's portfolio in the past, even though more recent scores are assigned higher weights. Second, Morningstar no longer ranks funds within the Morningstar category, but considers the Morningstar Global

category, a coarser classification. In this way, funds have a larger number of peers. Overall, these changes – making a fund’s globe rating less sensitive to the current portfolio and increasing the number of peers – should have decreased funds’ incentives to manipulate the globe ratings.

We ask to what extent an arguably improved methodology may have increased the efficacy of the sustainability ratings. Table 12 shows that the globe ratings are not associated with flows in the period after November 2018, mirroring our results for the latter part of our main sample period. This confirms that the globe ratings do not contribute much to the allocation of capital across different funds because investors seem to focus mostly on performance as captured by the funds’ star ratings.

## **6. Conclusion**

Rating financial intermediaries on the basis of the sustainability of their portfolios may appear to be an effective mechanism that allows investors to allocate their funds in accordance with their environmental and social preferences. We show that if most investors care to an even larger extent about performance, a tradeoff between portfolio sustainability and performance arises, which reduces the subsequent effectiveness of sustainability ratings.

The behavior of mutual funds and their investors is consistent with evidence showing that a majority of ESG proposals is not supported by shareholders, and in particular by institutional investors (He, Kahraman, and Lowry, 2020), suggesting that ultimately investors care predominantly about performance. Our findings raise concerns that market forces may lead to greenwashing, rather than to actual improvements in investment sustainability, and indicate that regulation may be necessary to direct capital to more sustainable investments.



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## Appendix: Variable Definition

Variable Name	Definition
<i>Panel A: Fund Trading</i>	
Trading	The trading in stock $i$ of fund $f$ in quarter $t$ , defined as: $Trading(f, i, t) = \frac{NumShares(f, i, t) - NumShares(f, i, t-1)}{Shares\ Outstanding(i, t-1)}$
Abnormal Trading	The abnormal stock trading in stock $i$ of fund $f$ in quarter $t$ , defined as the fund's stock trading minus the average trading in stock $i$ between quarters $t$ and $t-1$ across all funds.
Abnormal ESG Trading	<p>The aggregate abnormal ESG trading in quarter <math>t</math> is the abnormal trading across all funds in set <math>G</math> between quarters <math>t-1</math> and <math>t</math>, defined as:</p> $Agg\ Abnormal\ ESG\ Trading(i, t) = \sum_{f=1}^F Abnormal\ Trading(f, i, t),\ if\ f \in G$ <p>We consider two definitions of the set <math>G</math>. In the ex-post definition, the set <math>G</math> includes all funds that improve their globe ratings. In the ex-ante definition, the set <math>G</math> includes all funds that are within a <math>\pm 2.5\%</math> of the bottom and top rating cutoffs.</p>
Effective ESG Score	The normalized company-level ESG score minus a Sustainalytics controversy deduction. The company-level ESG score is normalized using a z-score transformation within each company's peer group. The Sustainalytics controversy deduction is based on the following calculation: Score 0: Deduction 0; Score 1: Deduction 0.2; Score 20: Deduction 4; Score 50: Deduction 10; Score 80: Deduction 16; Score 100: Deduction 20. Morningstar's Portfolio Sustainability Score is based on the weighted average of the stocks' effective scores, with the funds' portfolio shares as weights.
ESG Pressure Trading	Defined as the weighted average (using portfolio shares as weights) of a fund's positive position changes in quarter $t$ in a stock that belongs to the top quintile of Abnormal ESG Trading and the fund's negative position changes in quarter $t$ in a stock that belongs to the bottom quintile of Abnormal ESG Trading.
Position Change	<p>The position change in stock <math>i</math> of fund <math>f</math> in quarter <math>t</math>, defined as:</p> $Position\ Change(f, i, t) = \frac{Price(i, t-1) * (NumShares(f, i, t) - NumShares(f, i, t-1))}{TNA(f, t-1)}$
Total Trading (% Shares Outstanding)	The total trading in stock $i$ and quarter $t$ is the aggregate stock trading across all funds between quarters $t-1$ and $t$ , as a percentage of shares outstanding.
Total Trading (% TNA)	For fund $f$ in quarter $t$ , total trading is the aggregate position change between quarters $t-1$ and $t$ across all stock holdings.

*Panel B: Fund Characteristics*

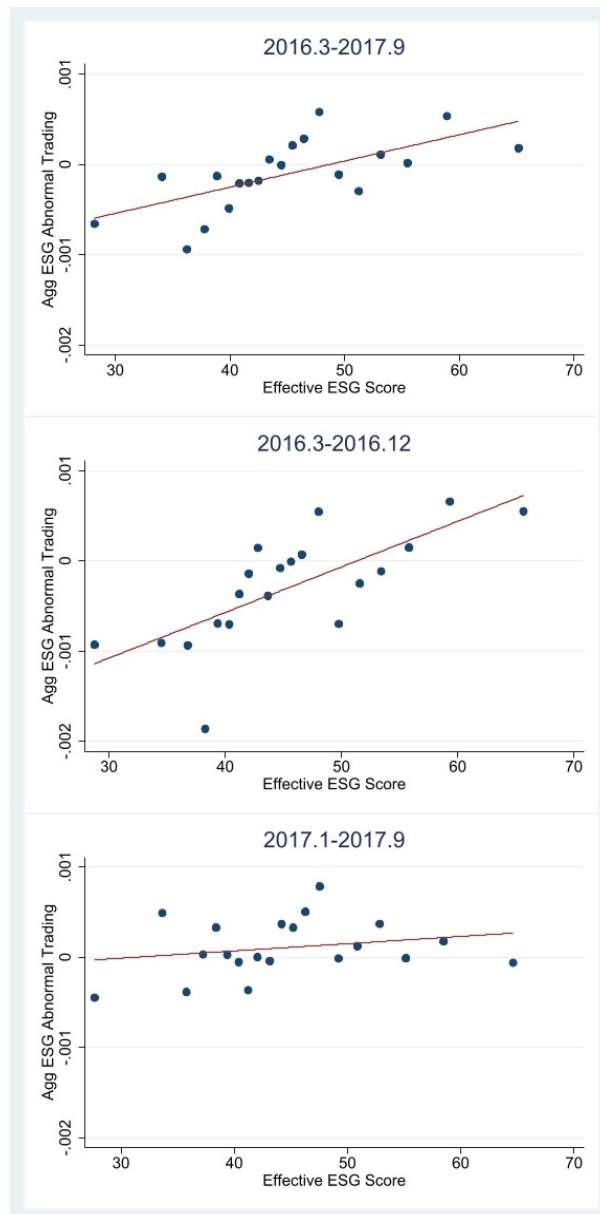
Flow (% TNA)	A fund's quarterly flows, defined as $FlowS_{j,q} = \frac{AUM_{j,q} - AUM_{j,q-1} \times (1 + R_{j,q})}{AUM_{j,q-1}}$ .
Expense Ratio	Ratio of total fees (as a percentage) that shareholders pay for a fund's operating expenses, including 12b-1 fees.
Ln TNA	Natural logarithm of the fund's month-end total net assets.
Fund Age	Natural logarithm of the fund's age, calculated as the number of years since the oldest share class was made available to investors.
Fund Ret	Monthly net return of a fund's share class.
Star Rating	Rating based on a fund's risk-adjusted return, using Morningstar's Risk-Adjusted Return % Rank for all funds in a given category. Morningstar calculates ratings based on the fund's historical performance in the previous three-, five-, and ten-year periods. The fund must have at least 36 continuous months of historical performance in order to receive a rating. More stars mean better performance. A fund's peer group for the three-, five-, and ten-year ratings is based on the fund's current category without adjusting for category changes. The overall star rating is based on a weighted average (rounded to the nearest integer) of the number of stars received for the past three-, five-, and 10-year performance. See Rating Details in Table A.1.
Globe Rating	A fund's sustainability rating, based on its portfolio sustainability scores. Funds are assigned absolute category ranks and percent ranks within their Morningstar categories. A fund rating is based on its percentile rank within the fund's Morningstar category, as detailed in Table A.1. To receive a globe rating, the fund's Morningstar category must have at least 10 funds with portfolio sustainability scores. See Rating Details in Table A.1.

*Panel C: Stock Characteristics*

Monthly Abnormal Return	A firm's monthly abnormal returns, calculated using the Fama-French four factor model, with betas estimated over the previous 36-months, computed using the quarter-end stock price.
Ln Market Cap	Natural logarithm of a firm's market capitalization.
Book to Market	Book-to-market ratio, calculated as book value of equity scaled by market value of equity, computed using the quarter-end stock price.
Leverage	Book leverage calculated as the sum of long-term debt and debt in current liabilities scaled by total assets.
ROA	Return on assets, calculated as operating income, divided by lagged total assets.
Sales Growth	Net sales at $t$ minus net sales at $t-1$ , divided by net sales at $t-1$ .
Stock Ret	Quarterly stock return.

## Figure 1. Demand pressure and stock ESG ratings

This figure presents binscatter plots of *Abnormal ESG Trading* pressure and a stock's *Effective ESG Score*. *Abnormal ESG Trading* pressure is the abnormal trading across all funds that improve their globe ratings between quarters  $t-1$  and  $t$ . *Effective ESG Score* is a firm's ESG score, normalized by subtracting the mean and dividing by the standard deviation of the ESG scores within each firm's peer group, minus a controversy deduction, as reported by Sustainalytics. Detailed variable definitions are provided in the Appendix. The top plot is based on the full sample period from March 2016 to September 2017. The middle plot reports results for the first half of the sample period (from March to December 2016), whereas the bottom plot reports results for the second half of the sample period (from January to September 2017).



**Table 1. Summary statistics**

This table reports summary statistics of mutual fund characteristics (Panel A), stock characteristics (Panel B), Morningstar ratings and other fund characteristics (Panel C), and fund-stock position changes (Panel D). The sample includes U.S. domiciled funds that invest in U.S. equities, have at least \$10 million in assets under management, and are at least two years old. The sample period is March 2016 to September 2017. All variables are defined in the Appendix.

	Num obs	Mean	Std dev	10 <sup>th</sup> pctl	Median	90 <sup>th</sup> pctl
<i>Panel A: Fund (Monthly)</i>						
Flow (% TNA)	34,771	-0.005	0.038	-0.030	-0.006	0.019
Ln TNA	34,771	19.950	1.911	17.360	20.090	22.370
Fund Age	34,787	5.149	0.706	4.078	5.288	5.897
Ret	34,787	1.640	2.686	-1.298	1.301	5.345
Expense Ratio	34,721	1.080	0.559	0.480	1.020	1.660
Star Rating	32,836	3.212	1.019	2	3	4
Globe Rating	31,103	2.980	1.114	1	3	4
Δ Star Rating	32,706	-0.003	0.368	0	0	0
Δ Globe Rating	29,327	0.003	0.482	0	0	1
Globe Downgrade	29,327	0.098	0.297	0	0	0
Globe Upgrade	29,327	0.105	0.306	0	0	1
Star Downgrade	32,706	0.068	0.252	0	0	0
Star Upgrade	32,706	0.065	0.246	0	0	0
<i>Panel B: Stock (Quarterly)</i>						
Abnormal ESG Trading (x10000)	21,456	-0.895	38.240	-21.910	0.000	20.980
Total Trading (% Shares Outstanding)	21,456	0.001	0.022	-0.012	0.000	0.013
Effective ESG Score	6,580	45.067	8.675	35.204	43.925	56.970
Ln Market Cap	21,456	13.680	2.048	11.000	13.680	16.380
Book to Market	20,551	0.513	0.521	0.078	0.429	1.070
ROA	20,010	0.008	0.060	-0.052	0.020	0.055
Ret	20,501	0.057	0.223	-0.175	0.036	0.293
Leverage	20,615	0.246	0.271	0.000	0.193	0.545
Sales Growth Rate	19,926	0.059	0.293	-0.130	0.025	0.230
<i>Panel C: Fund (Quarterly)</i>						
ESG Pressure Trading	9,983	0.045	0.048	0.006	0.031	0.096
Total Trading (% TNA)	10,893	0.161	0.159	0.025	0.125	0.315
<i>Panel D: Fund-Stock (Quarterly)</i>						
Position Change	1,966,535	0.0013	0.213	-0.079	0	0.077

**Table 2. Trading and stock ESG ratings**

This table reports the relation between a fund's position change and a stock's *Effective ESG Score*, which is interacted with an indicator – *Border Funds* – that equals one if a fund is within +/-2.5% of the cutoff between globes 1 and 2 or 4 and 5. *Effective ESG Score* is a firm-level ESG score, as reported by Sustainalytics. Detailed variable definitions are provided in the Appendix. Columns (1)-(5) include all U.S. domiciled U.S. equity funds; columns (6)-(7) exclude index funds. Column (1) shows results for the full sample period from March 2016 to September 2017. Columns (2), (4)-(5), and (6)-(7) report results for the first nine months (March – December 2016), whereas column (3) reports results for the second nine months (January – September 2017). *Few Peers* and *Many Peers* refer to the fund's peers in the same Morningstar category. All specifications include lagged firm-level controls and fund-by-year-quarter fixed effects. Standard errors are clustered at the fund level.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Position Change ( <i>f,i,t</i> )						
	<i>All Funds</i>				<i>Excluding Index Funds</i>		
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9	2016.3-2016.12	2016.3-2016.12		
				Few Peers	Many Peers	Few Peers	Many Peers
Effective ESG Score	0.001 (0.455)	0.001 (0.226)	0.003 (0.635)	-0.017** (-2.180)	0.010** (2.132)	-0.021** (-2.303)	0.019** (2.558)
Border Funds # Effective ESG Score	0.029** (2.203)	0.033* (1.769)	0.025 (1.379)	0.062** (2.386)	0.014 (0.648)	0.068** (2.185)	0.017 (0.778)
Ln Market Cap	0.127 (1.393)	0.221** (2.095)	0.019 (0.195)	0.344** (2.037)	0.038 (0.321)	-0.055 (-0.460)	-0.379*** (-3.599)
Book to Market	-0.041 (-0.329)	-0.029 (-0.177)	-0.333** (-2.086)	0.084 (0.269)	-0.264 (-1.357)	-0.278 (-0.946)	-0.283 (-0.892)
Leverage	-0.259* (-1.818)	-0.740*** (-3.672)	0.088 (0.448)	-0.271 (-0.804)	0.615** (2.330)	-0.450 (-1.143)	1.371*** (3.418)
ROA	-6.872*** (-5.226)	-7.590*** (-4.109)	-5.056*** (-2.914)	-14.642*** (-4.715)	-1.314 (-0.628)	-18.587*** (-4.934)	-1.095 (-0.345)
Sales Growth Rate	0.968*** (5.824)	0.822*** (3.707)	1.115*** (4.756)	1.555*** (4.020)	1.375*** (4.477)	2.056*** (4.261)	2.062*** (4.275)
Ret (t-1)	-3.579*** (-8.591)	-1.264*** (-2.676)	-7.049*** (-14.415)	-4.694*** (-6.310)	-3.307*** (-5.995)	-5.412*** (-5.805)	-4.049*** (-4.592)
Total Trading (% Shares Outstanding)	0.906*** (30.964)	0.964*** (37.445)	0.802*** (17.281)	1.126*** (24.064)	0.907*** (12.631)	1.219*** (22.879)	1.166*** (10.027)
Constant	-1.609 (-1.065)	-3.340* (-1.901)	0.585 (0.358)	-4.450 (-1.567)	-1.211 (-0.620)	0.927 (0.463)	4.407** (2.462)
Observations	884514	459257	425257	204258	247593	159351	154629
Adjusted R-squared	0.225	0.224	0.225	0.245	0.151	0.160	0.125
Fixed effects	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ

**Table 3. Sustainability ratings and funds' incentives**

This table summarizes the *Abnormal ESG Trading* pressure resulting from the funds' incentives to improve their sustainability (globe) ratings. *Ex-ante Abnormal ESG Trading* pressure is the aggregate abnormal trading by funds within  $\pm 2.5\%$  of the portfolio ESG score ranking cutoffs for globe ratings between 1 and 2 or 4 and 5. *Ex-post Abnormal ESG Trading* pressure is the aggregate abnormal trading by funds with improved globe ratings between quarters  $t-1$  and  $t$ . *Abnormal ESG Trading* pressure is multiplied by 10000 in the table below. Detailed variable definitions are provided in the Appendix. Column 1 presents results for the full sample period from March 2016 to September 2017. Column 2 reports results for the first half of the sample period (from March to December 2016), whereas Column 3 reports results for the second half of the sample period (from January to September 2017).

	(1)	(2)	(3)
<i>Ex-post</i> Definition	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
Abnormal ESG Trading	-0.895	-2.2077	0.262
t-stat	-3.4627	-5.1123	0.804
<i>Ex-ante</i> Definition	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
Abnormal ESG Trading	-0.273	-0.709	0.16
t-stat	-1.17	-2.907	0.404



**Table 4. Trading pressure and stock ESG ratings**

This table reports the relation between *Abnormal ESG Trading* pressure and a stock's *Effective ESG Score*. *Abnormal ESG Trading* pressure is the abnormal trading across all funds that improve their globe ratings between quarters  $t-1$  and  $t$ . *Effective ESG Score* is a firm-level ESG score, as reported by Sustainalytics. Detailed variable definitions are provided in the Appendix. Columns 1 and 4 present results for the full sample period from March 2016 to September 2017. Column 2 reports results for the first half of the sample period (from March to December 2016), whereas column 3 reports results for the second half of the sample period (from January to September 2017). All specifications include lagged firm-level control variables and industry-by-year-quarter fixed effects. Standard errors are clustered at the firm level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

	(1)	(2)	(3)	(4)
	Abnormal ESG Trading			
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9	2016.3-2017.9
Effective ESG Score	0.268*** (3.805)	0.464*** (3.684)	0.064 (0.967)	0.057 (0.847)
Effective ESG Score # First 9 mo				0.416*** (2.921)
Ln Market Cap	-0.119 (-0.303)	0.013 (0.021)	-0.235 (-0.506)	-0.149 (-0.379)
Book to Market	-1.822 (-0.873)	-4.877 (-1.555)	2.740 (1.368)	-1.730 (-0.833)
Leverage	-3.036 (-0.823)	-4.275 (-0.685)	-1.991 (-0.553)	-3.054 (-0.828)
ROA	16.166 (0.567)	6.090 (0.127)	31.845 (1.036)	16.449 (0.576)
Sales Growth Rate	0.007 (0.003)	1.457 (0.474)	-2.214 (-0.566)	0.140 (0.058)
Ret (t-1)	2.204 (0.433)	6.474 (0.884)	-4.156 (-0.743)	2.375 (0.467)
Constant	-9.166 (-1.263)	-20.133* (-1.796)	1.411 (0.165)	-9.124 (-1.259)
Observations	5846	3058	2788	5846
Adjusted R-squared	0.003	-0.004	0.028	0.004
Fixed effects	Ind*YQ	Ind*YQ	Ind*YQ	Ind*YQ

**Table 5. Sustainability-driven trading pressure and stock returns**

This table studies the effect of sustainability-driven trading pressure on stock returns. Reported are daily equal- and value-weighted returns on a zero-cost long-short portfolio, created by buying stocks with negative sustainability-driven trading pressure and shorting stocks with positive sustainability-driven trading pressure. The portfolio is rebalanced at the end of each quarter. Columns (1) and (3) show results for the six months from July 2016 through December 2016. Columns (2) and (4) report results for the nine months from January 2017 through September 2017. The estimation uses Newey-West standard errors with 22 lags. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

	(1)	(2)	(3)	(4)
	2016.7-2016.12	2017.1-2017.9	2016.7-2016.12	2017.1-2017.9
	Equal-weighted		Value-weighted	
Mkt-RF	-0.0123 (-1.098)	0.0255 (1.535)	-0.0077 (-0.233)	-0.0363 (-1.381)
SMB	-0.0118 (-0.368)	0.0127 (0.460)	-0.1028*** (-2.759)	0.0344 (0.760)
HML	-0.0583*** (-3.146)	-0.0104 (-1.282)	-0.0682** (-2.483)	0.0258 (1.429)
Mom	-0.0581** (-2.544)	0.0346*** (2.639)	-0.0505 (-0.759)	0.0140 (0.372)
Alpha	0.0093** (2.250)	-0.0083 (-1.516)	0.0214* (1.668)	-0.0225* (-1.760)
Observations	127	188	127	188
R-squared	0.298	0.101	0.107	0.033

**Table 6. Sustainability-driven trading pressure and trading of funds pursuing star ratings**

This table reports the effect of sustainability-driven trading pressure on stock trading by funds attempting to improve their star ratings. Panel A presents the trading of U.S. domiciled U.S. equity funds, excluding those with improved globe ratings in the quarter. Columns (5) and (6) separate U.S. equity funds into index and active funds, respectively. Columns (1) and (4) present results for the full sample period from March 2016 to September 2017. Columns (2) and (5)-(6) report results for the first half of the sample period (from March to December 2016), whereas column (3) reports results for the second half of the sample period (from January to September 2017). Panel B presents the trading of U.S. equity funds split by their closeness to the star rating cutoffs. Panel C presents the trading of U.S. equity funds that are above/below the median in terms of the number of peers with the same investment style. Odd-numbered columns report results for the first half of the sample period; even-numbered columns report results for the second half of the sample period. All specifications include fund-by-year-quarter fixed effects. Standard errors are clustered at the fund level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

Panel A. Trading by U.S. equity funds (excluding funds with improved globe ratings)						
	(1)	(2)	(3)	(4)	(5)	(6)
	Position Change ( $f,i,t$ )					
	<i>All funds</i>				<i>Index Funds</i>	<i>Active Funds</i>
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9	2016.3-2017.9	2016.3-2016.12	
Abnormal ESG Trading	-0.383*** (-5.996)	-0.675*** (-8.034)	0.094 (1.212)	0.092 (1.170)	-0.128* (-1.688)	-0.964*** (-8.017)
First 9 months dummy # Abnormal ESG Trading				-0.768*** (-7.183)		
Total Trading (% Shares Outstanding)	0.772*** (26.918)	0.769*** (29.074)	0.781*** (18.963)	0.773*** (26.964)	0.419*** (15.002)	0.930*** (27.089)
Constant	0.001*** (51.467)	-0.001*** (-26.768)	0.004*** (28.218)	0.001*** (48.478)	0.018*** (396.323)	-0.011*** (-206.509)
Observations	1809124	960270	848854	1809124	329971	630299
Adjusted R-squared	0.239	0.246	0.229	0.239	0.540	0.186
Fixed effects	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ

Panel B. Trading by U.S. equity funds split by closeness to the star rating cutoffs

	(1)	(2)	(3)
	Position Change ( $f,i,t$ )		
	Other	Within $\pm 5\%$	Within $\pm 2.5\%$
Abnormal ESG Trading	0.199* (1.962)	-0.021 (-0.120)	-0.008 (-0.050)
First 9 months dummy # Abnormal ESG Trading	-0.624*** (-4.409)	-0.680** (-2.443)	-1.012*** (-4.811)
Total Trading (% Shares Outstanding)	0.627*** (17.814)	0.826*** (16.977)	0.924*** (23.259)
Constant	0.009*** (250.337)	-0.000* (-1.746)	-0.008*** (-192.307)
Observations	865230	335510	608384
Adjusted R-squared	0.287	0.247	0.181
Fixed effects	Fund*YQ	Fund*YQ	Fund*YQ

Panel C. Trading by U.S. equity funds with below/above median peers within their star rating category

	(1)	(2)	(3)	(4)	(5)	(6)
	Position Change ( $f,i,t$ )					
	2016.3-2016.12	2017.1-2017.9	2016.3-2016.12	2017.1-2017.9	2016.3-2016.12	2017.1-2017.9
	<i>All Funds</i>		<i>Below-Median Peers</i>		<i>Above Median-Peers</i>	
Abnormal ESG Trading	-0.371*** (-3.307)	0.208* (1.787)	-0.655*** (-4.184)	-0.167 (-0.981)	0.042 (0.287)	0.704*** (4.463)
Within $\pm 5\%$ of Rating Cutoff # Abnormal ESG Trading	-0.523*** (-3.133)	-0.242 (-1.415)	-0.528** (-2.382)	-0.329 (-1.420)	-0.477* (-1.908)	0.328 (1.257)
Total Trading (% Shares Outstanding)	0.792*** (28.108)	0.818*** (18.365)	0.922*** (21.137)	0.834*** (15.028)	0.689*** (19.499)	0.787*** (10.728)
Constant	-0.008*** (-170.264)	0.000*** (2.952)	-0.007*** (-94.198)	0.002*** (8.363)	-0.009*** (-152.072)	-0.002*** (-9.301)
Observations	855394	775733	512734	454510	342660	321223
Adjusted R-squared	0.205	0.196	0.228	0.230	0.166	0.140
Fixed effects	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ	Fund*YQ

**Table 7. Sustainability-driven trading pressure and trading of funds pursuing star ratings (ex-ante analysis)**

This table reports the effect of sustainability-driven trading pressure on stock trading. Column 1 reports the trading of funds within 2.5% of the star rating cutoffs, column 2 includes funds within 5% of the star rating cutoffs (excluding funds in column 1), and column 3 reports the trading of all other funds. All specifications include fund-by-year-quarter fixed-effects. Standard errors are clustered at the fund level.

	(1)	(2)	(3)
	Position Change ( $f,i,t$ )		
	Within $\pm 2.5\%$	Within $\pm 5\%$	Other
Abnormal ESG Trading (ex-ante)	0.279** (2.022)	0.067 (0.455)	0.064 (0.670)
First 9 months dummy # Abnormal ESG Trading (ex-ante)	-2.084*** (-7.097)	-1.495*** (-3.890)	-1.406*** (-7.166)
Constant	-0.007*** (-467.212)	0.001*** (28.599)	0.009*** (1204.445)
Observations	608384	335510	865230
Adjusted R-squared	0.167	0.236	0.280
Fixed effects	Fund*YQ	Fund*YQ	Fund*YQ

**Table 8. Trade-off between star and globe ratings**

Panel A of this table reports the trade-off between star and globe ratings. For each fund in each quarter, we rank the position change (as a percentage of TNA) into quintiles. We then identify *ESG Pressure Trading* as the purchase of a stock with sustainability-driven trading pressure (top quintile of *Abnormal ESG Trading*) or the selling of a stock from the bottom quintile of *Abnormal ESG Trading*. Then, we aggregate all the pressure trading for each fund in each quarter  $t$ , and estimate (at the fund level) the relationship between the star/globe rating changes and *ESG Pressure Trading* in the previous quarter. Column 3 reports results for the first half of the sample period (from March to December 2016), whereas column 4 reports results for the second half of the sample period (from January to September 2017). Panel B reports the relationship between funds' abnormal returns and *ESG Pressure Trading*. Abnormal returns are estimated using the Fama-French four-factor model with a 36-month rolling window. All specifications include lagged fund-level controls and investment style-by-year-quarter fixed effects. Standard errors are clustered at the fund level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

Panel A. Rating downgrades and upgrades				
	(1)	(2)	(3)	(4)
	$\Delta$ Globe Rating		$\Delta$ Star Rating	
	2016.3 - 2017.9	2016.3 - 2017.9	2016.3-2016.12	2017.1 - 2017.9
ESG Pressure Trading	1.398*** (11.682)	-0.094 (-1.089)	-0.401*** (-2.748)	0.067 (0.614)
Total Trading (% TNA)	-0.376*** (-9.746)	-0.016 (-0.625)	0.076* (1.670)	-0.062* (-1.959)
One Star (t-1)	-0.021 (-1.350)	0.171*** (10.763)	0.207*** (8.759)	0.145*** (8.041)
Two Star (t-1)	-0.004 (-0.408)	0.086*** (8.055)	0.103*** (6.726)	0.075*** (6.338)
Four Star (t-1)	0.005 (0.748)	-0.086*** (-9.913)	-0.104*** (-8.162)	-0.076*** (-7.765)
Five Star (t-1)	0.026** (2.410)	-0.216*** (-17.197)	-0.241*** (-13.709)	-0.201*** (-14.094)
One Globe (t-1)	0.202*** (14.473)	0.005 (0.581)	-0.001 (-0.048)	0.007 (0.699)
Two Globe (t-1)	0.100*** (8.415)	0.002 (0.386)	0.010 (1.004)	-0.002 (-0.338)
Four Globe (t-1)	-0.104*** (-8.711)	0.008 (1.472)	0.029*** (2.791)	-0.003 (-0.519)
Five Globe (t-1)	-0.164*** (-11.392)	-0.006 (-0.668)	-0.005 (-0.353)	-0.006 (-0.599)
Flow (t-1)	-0.006 (-0.058)	0.643*** (8.377)	0.856*** (6.278)	0.504*** (5.659)
Ret(t-1)	-0.003 (-1.124)	0.005** (2.107)	0.010** (2.555)	0.001 (0.428)
Ln TNA (t-1)	0.001 (0.491)	0.020*** (13.463)	0.022*** (9.174)	0.018*** (10.904)
Age	0.009* (1.803)	-0.011*** (-2.730)	-0.008 (-1.191)	-0.014*** (-2.898)
Constant	-0.046 (-1.147)	-0.343*** (-11.938)	-0.399*** (-8.383)	-0.304*** (-9.100)
Observations	21913	21893	7967	13926
Adjusted R-squared	0.057	0.051	0.064	0.043
Fixed effects	Cat*YM	Cat*YM	Cat*YM	Cat*YM

Panel B. Fund performance

	(1)	(2)	(3)
	Abnormal returns		
	2016.3 - 2017.9	2016.3-2016.12	2017.1 - 2017.9
ESG Pressure Trading	-0.320 (-1.093)	-1.666*** (-3.336)	0.359 (1.091)
Total Trading (% TNA)	0.069 (0.833)	0.546*** (3.752)	-0.223** (-2.375)
Flow (t-1)	0.039 (0.206)	0.358 (1.022)	-0.020 (-0.088)
Ln TNA (t-1)	0.018*** (3.791)	0.038*** (5.081)	0.006 (1.121)
Age	-0.035*** (-3.369)	-0.059*** (-3.461)	-0.022* (-1.947)
Exp Ratio (t-1)	0.006 (0.596)	0.009 (0.865)	-0.002 (-0.163)
Ret(t-1)	-0.025*** (-3.234)	0.011 (1.058)	-0.061*** (-5.390)
Ret(t-12,t-1)	-0.006*** (-2.935)	-0.026*** (-7.166)	0.006** (2.312)
Constant	-0.267*** (-2.661)	-0.664*** (-4.381)	-0.149 (-1.313)
Observations	25327	9966	15361
Adjusted R-squared	0.178	0.181	0.183
Fixed effects	Cat*YM	Cat*YM	Cat*YM



**Table 9. Effects of ratings on fund flows**

Panel A of this table reports the effects of globe ratings on fund flows. Columns 1 and 4 show results for the full sample period from March 2016 to September 2017. Columns 2 and 5 report results for the first half of the sample period (from March to December 2016), whereas columns 3 and 6 report results for the second half of the sample period (from January to September 2017). Columns 1–3 use globe 3 as the baseline; columns 4–6 use the three middle globe ratings as the baseline. Panel B reports the effects of star and globe ratings on fund flows. Panel C reports the effects of star and globe ratings on fund flows for institutional and retail share classes, respectively. All specifications include lagged controls for the fund's star rating, flows, returns, size, age, and expense ratio as well as investment category-by-year-month fixed effects. Standard errors are clustered at the fund level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

Panel A. Globe ratings and fund flows

	(1)	(2)	(3)	(4)	(5)	(6)
	Flow (% TNA)					
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
One Globe	-0.001 (-0.994)	-0.002** (-2.022)	0.000 (0.273)	-0.001 (-1.362)	-0.002** (-2.333)	0.000 (0.061)
Two Globe	-0.000 (-0.013)	-0.001 (-0.760)	0.000 (0.549)			
Four Globe	0.001 (1.224)	0.001 (1.305)	0.000 (0.531)			
Five Globe	0.002** (2.066)	0.002** (1.984)	0.001 (1.228)	0.002** (2.001)	0.002** (2.021)	0.001 (1.102)
Observations	27579	12326	15253	27579	12326	15253
Adjusted R-squared	0.173	0.186	0.165	0.173	0.186	0.165
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Fixed effects	Cat*YM	Cat*YM	Cat*YM	Cat*YM	Cat*YM	Cat*YM

Panel B. Star and globe ratings and fund flows

	(1)	(2)	(3)
	Flow (% TNA)		
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
One Globe	-0.001 (-1.242)	-0.002* (-1.940)	-0.000 (-0.135)
Two Globe	0.000 (0.080)	-0.001 (-0.723)	0.000 (0.589)
Four Globe	0.001 (1.267)	0.001 (1.460)	0.000 (0.427)
Five Globe	0.002** (2.025)	0.002** (2.134)	0.001 (1.012)
One Star	-0.007*** (-5.830)	-0.006*** (-4.543)	-0.007*** (-4.498)
Two Star	-0.004*** (-6.818)	-0.004*** (-4.949)	-0.005*** (-5.610)
Four Star	0.006*** (11.317)	0.007*** (9.186)	0.006*** (8.718)
Five Star	0.016*** (13.400)	0.016*** (11.749)	0.016*** (10.852)
Observations	27658	12360	15298
Adjusted R-squared	0.174	0.186	0.166
Controls	Yes	Yes	Yes
Fixed effects	Cat*YM	Cat*YM	Cat*YM

Panel C. Institutional and retail share classes

	(1)	(2)	(3)	(4)	(5)	(6)
	Institutional Shares			Retail Shares		
	2016.3- 2017.9	2016.3- 2016.12	2017.1- 2017.9	2016.3- 2017.9	2016.3- 2016.12	2017.1- 2017.9
One Globe	0.000 (0.049)	-0.002 (-1.099)	0.002 (0.919)	-0.002* (-1.689)	-0.003** (-2.406)	-0.001 (-0.562)
Two Globe	0.000 (0.460)	0.000 (0.211)	0.001 (0.405)	0.001 (0.949)	-0.001 (-0.930)	0.002** (2.084)
Four Globe	0.002 (1.525)	0.003* (1.751)	0.001 (0.587)	-0.000 (-0.114)	0.000 (0.403)	-0.000 (-0.600)
Five Globe	0.004** (2.225)	0.004* (1.880)	0.004 (1.566)	-0.000 (-0.458)	0.002 (1.580)	-0.003* (-1.885)
One Star	-0.016*** (-6.393)	-0.017*** (-4.482)	-0.016*** (-4.986)	-0.007*** (-5.539)	-0.006*** (-4.892)	-0.007*** (-4.195)
Two Star	-0.009*** (-6.476)	-0.007*** (-4.061)	-0.010*** (-5.523)	-0.005*** (-8.377)	-0.006*** (-7.979)	-0.005*** (-5.558)
Four Star	0.008*** (7.763)	0.010*** (7.532)	0.007*** (4.910)	0.007*** (10.533)	0.008*** (8.590)	0.007*** (8.200)
Five Star	0.025*** (11.682)	0.028*** (10.905)	0.022*** (9.228)	0.019*** (10.395)	0.021*** (8.940)	0.016*** (8.610)
Observations	23099	10050	13049	60395	27238	33157
Adjusted R-squared	0.113	0.144	0.093	0.103	0.114	0.097
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Fixed effects	Cat*YM	Cat*YM	Cat*YM	Cat*YM	Cat*YM	Cat*YM

**Table 10. Effects of rating upgrades and downgrades on fund flows**

This table reports the effects of star and globe rating upgrades and downgrades on fund flows. Column 1 presents results for the full sample period; column 2 reports results for the first half of the sample period (from March to December 2016); column 3 reports results for the second half of the sample period (from January to September 2017). All specifications include lagged controls for the fund's star rating, flows, returns, size, age, and expense ratio as well as investment category-by-year-month fixed effects. Standard errors are clustered at the fund level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

	(1)	(2)	(3)
	Flow (% TNA)		
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
Globe Downgrade	-0.001 (-1.422)	-0.000 (-0.462)	-0.001 (-1.464)
Globe Upgrade	-0.001 (-1.291)	-0.001 (-0.797)	-0.001 (-0.996)
Star Downgrade	-0.003*** (-3.882)	-0.003*** (-2.800)	-0.003*** (-2.736)
Star Upgrade	0.002*** (3.216)	0.003*** (2.779)	0.002* (1.778)
One Globe (t-1)	-0.000 (-0.050)	-0.001 (-1.224)	0.001 (0.982)
Two Globe (t-1)	0.000 (0.127)	-0.000 (-0.152)	0.000 (0.278)
Four Globe (t-1)	0.001 (1.334)	0.001 (1.322)	0.000 (0.567)
Five Globe (t-1)	0.002* (1.806)	0.003** (2.325)	0.000 (0.351)
One Star (t-1)	-0.008*** (-6.722)	-0.008*** (-5.399)	-0.008*** (-5.159)
Two Star (t-1)	-0.005*** (-7.182)	-0.005*** (-6.141)	-0.004*** (-4.841)
Four Star (t-1)	0.006*** (11.049)	0.007*** (9.057)	0.006*** (8.620)
Five Star (t-1)	0.016*** (13.106)	0.017*** (11.128)	0.015*** (10.923)
Observations	27601	12339	15262
Adjusted R-squared	0.165	0.186	0.148
Controls	Yes	Yes	Yes
Fixed effects	Cat*YM	Cat*YM	Cat*YM

**Table 11. Effects of sustainability scores on fund flows**

This table reports the effects of sustainability scores on fund flows. Column (1) shows results for the full sample period from March 2016 through September 2017. Column (2) reports results from March 2016 through December 2016, whereas column (3) reports results from January 2017 to September 2017. All specifications include lagged controls for the fund's star rating, flows, returns, size, age, and expense ratio as well as investment category-by-year-month fixed effects. Standard errors are clustered at the fund level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

	(1)	(2)	(3)
	Flow (% TNA)		
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
Portfolio Sustainability Score	0.000*** (2.766)	0.001*** (3.473)	0.000 (0.827)
One Star (t-1)	-0.008*** (-6.458)	-0.007*** (-4.882)	-0.008*** (-5.318)
Two Star (t-1)	-0.004*** (-6.552)	-0.004*** (-4.741)	-0.005*** (-5.013)
Four Star (t-1)	0.006*** (10.969)	0.006*** (8.239)	0.007*** (8.920)
Five Star (t-1)	0.016*** (12.623)	0.016*** (10.964)	0.016*** (10.303)
Ret (t-1)	0.002*** (8.066)	0.001*** (5.820)	0.002*** (6.376)
Ln TNA (t-1)	-0.001*** (-7.306)	-0.001*** (-5.697)	-0.001*** (-6.201)
Age	-0.002*** (-4.759)	-0.001* (-1.738)	-0.003*** (-5.611)
Exp Ratio	-0.001* (-1.793)	-0.000 (-0.126)	-0.002*** (-2.792)
Flow (t-1)	0.309*** (12.692)	0.333*** (10.551)	0.290*** (10.379)
Constant	0.007 (0.812)	-0.009 (-0.796)	0.022** (2.049)
Observations	27579	12326	15253
Adjusted R-squared	0.158	0.170	0.150
Controls	Yes	Yes	Yes
Fixed Effects	Cat*YM	Cat * YM	Cat * YM

**Table 12. Morningstar's modified methodology and fund flows**

This table reports the effects of star and globe ratings on fund flows after Morningstar modified its globe rating methodology in November 2018. Column (1) uses globe 3 as the baseline; column (2) uses the middle three globe ratings as the baseline. All specifications include lagged controls for the fund's star rating, flows, returns, size, age, and expense ratio as well as investment category-by-year-month fixed effects. Standard errors are clustered at the fund level. Statistical significance at the 10%, 5%, and 1% level is denoted by \*, \*\*, and \*\*\*, respectively.

	(1)	(2)
	Flow (% TNA)	
	2018.11-2019.9	
One Globe	-0.001 (-0.953)	-0.002 (-1.639)
Two Globe	0.001 (1.641)	
Four Globe	0.001 (1.613)	
Five Globe	0.001 (0.696)	0.000 (0.145)
One Star (t-1)	-0.005*** (-4.078)	-0.005*** (-3.803)
Two Star (t-1)	-0.002*** (-2.718)	-0.002*** (-2.661)
Four Star (t-1)	0.007*** (11.060)	0.007*** (11.004)
Five Star (t-1)	0.019*** (13.171)	0.019*** (13.010)
Observations	17236	17116
Adjusted R-squared	0.179	0.178
Controls	Yes	Yes
Fixed effects	Cat*YM	Cat*YM

**Table A.1. Morningstar's Star and Globe ratings**

Morningstar Performance Ratings (Star Ratings)		
Score	Percent	Label
5	Top 10%	High
4	Next 22.5%	Above Average
3	Next 35%	Average
2	Next 22.5%	Below Average
1	Bottom 10%	Low

Morningstar Sustainability Ratings (Globe Ratings)		
Score	Percent	Label
5	Highest 10%	High
4	Next 22.5%	Above Average
3	Next 35%	Average
2	Next 22.5%	Below Average
1	Lowest 10%	Low

**Table A.2. Ratings turnover over the sample period**

This table shows the frequency of globe and star rating upgrades and downgrades in the first and second part of the sample period from March 2016 to September 2017. Panel A includes all globe/star upgrades and downgrades, whereas Panel B focuses on upgrades from globe/star 1 to 2 and 4 to 5 and downgrades from globe/star 5 to 4 and 2 to 1.

	Globes		Star	
	<i>Upgrade</i>	<i>Downgrade</i>	<i>Upgrade</i>	<i>Downgrade</i>
Panel A: all changes				
2016.3 - 2016.12	11.95%	10.43%	6.65%	7.06%
2017.1 - 2017.9	9.81%	9.73%	6.00%	6.35%
Panel B: change to/from top/bottom rating				
2016.3 - 2016.12	2.55%	2.18%	1.49%	1.67%
2017.1 - 2017.9	2.82%	2.85%	1.33%	1.30%



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