Essays on Sustainable Mutual Funds

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Abstract

This dissertation consists of an introduction and three original essays.

The first essay (joint with Markku Kaustia) investigates mutual funds' potential "greenwashing" behavior. We find that ESG-profiled funds receive higher inflows compared to otherwise similar funds. We show this is true also for ESG labeled funds having inferior objective ESG profiles, as based on Morningstar sustainability ratings, applying to both retail and institutional funds. Analyzing funds repurposing into ESG shows that fund families especially tend to convert funds that had somewhat lackluster flows. Detecting and understanding greenwashing is key to curbing it, and thus promoting public trust in this proliferating market, with high hopes for its role in the green shift.

The second essay investigates whether investors can digest raw ESG information directly. Using a quasi-exogenous shock of Morningstar's criteria change for the sustainable fund list, an event without any fundamental news, I show that ESG investors blindly follow this signal and respond, implying a lack of information digestion ability and a heavy reliance on ESG information providers. Funds that are excluded from the list suffer a substantial decrease in net flows, both in the short term and long term. Studying investors' digestion channels and the role of ESG information intermediaries is crucial in helping regulators promote better practices in the booming world of ESG investment.

The third essay investigates how mutual funds behave under the EU Sustainable Finance Disclosure Regulation (SFDR). It provides the first glimpse of how funds’ characteristics are correlated with their SFDR category choice ("dark green," "light green," or "others") and how investors react to the initial stage of the SFDR. I find that greener mutual funds are more likely to be in the greener profiles under the SFDR classification, consistent with the purpose of the regulation. Interestingly, funds with better past performances in terms of returns and flows are slightly more likely to be in the not-green-stated group than the light green group. In the post-SFDR period, I find no evidence of these new green profiles bringing additional flows given the existing sustainability-related labels.

Keywords Sustainable Finance; ESG Investment; Investor Behavior; Greenwashing

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1. Greenwashing in mutual funds
   Markku Kaustia, Wenjia Yu
   *Unpublished Manuscript*

2. Do fund flows react to non-fundamental ESG information? Evidence from Morningstar’s sustainability criteria change
   Wenjia Yu
   *Unpublished Manuscript*

3. SFDR and mutual funds
   Wenjia Yu
   *Unpublished Manuscript*
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Introduction

In the past decade, financial markets have been undergoing a transformation as market participants started to integrate environmental, social, and governance (ESG) information into investment decisions. With ESG investing going mainstream, greenwashing has become one of the major worries for investors. The term refers to the behavior of firms or financial products overstating their ESG credentials to gain additional attention from investors. The lack of a regulatory environment (e.g., Delmas and Burbano, 2011; Marquis et al., 2016) and investors’ confusion over divergent ESG ratings (e.g., Berg et al., 2020; Christensen et al., 2022) leave plenty of room for greenwashing. The three essays in this dissertation focus on mutual funds’ behavior under the ESG investment domain in the above contexts.

The first paper, coauthored with Markku Kaustia, studies mutual funds’ greenwashing behavior and describes the motivation for, the strategy behind, and the results of greenwashing. It provides direct evidence of this phenomenon in the mutual fund industry. In the second and the third paper, I explore the potential challenges regulators may meet while tackling greenwashing and the effectiveness of regulation. Specifically, the second paper sheds light on investors’ digestion channels for ESG information and the role of ESG information intermediaries. Understanding these two aspects is crucial because having a unified disclosure requirement, which many regulators plan on, may not be enough if investors blindly react to non-fundamental ESG information disseminated by data providers. The third paper concentrates on the Sustainable Finance Disclosure Regulation (SFDR), the first EU-level standardized mandatory disclosure requirements on financial market participants. I examine how effective the regulation is in two aspects: fund characteristics associated with the SFDR green classification and fund flows in the post-SFDR period. The three essays are introduced in more detail in the following parts.
**Essay 1: Greenwashing in mutual funds**

In the first essay, we study mutual funds’ potential greenwashing behavior. As a major challenge of ESG investing, greenwashing has drawn a lot of attention in the emerging literature. However, unlike those studies that focus on the alignment between the UN Principles for Responsible Investment (PRI) signatory and portfolio-level ESG scores (e.g., Kim and Yoon, 2021; Gibson et al., 2021; Liang et al., 2021), we provide more direct evidence of the greenwashing behavior in the fund offering space. Therefore, this paper is crucial for uncovering the motives and the potential strategies behind ESG investing and promoting investor and regulatory awareness.

Specifically, our analyses include three parts: a) Can self-designation as a sustainable fund be rewarded with higher flows? b) What is the strategy behind a decision to repurpose a fund into an ESG fund? and c) What happens to these funds after repurposing?

The first question is about the ESG-labeling effect. Using pairwise comparisons of objective and self-designated ESG profiles’ ability to attract flows, we find that the self-designated ESG label itself can help funds attract flows, even when the third-party objective ESG rating disagrees with the label. It provides the ground for greenwashing since the self-proclaimed ESG label seems to benefit funds. Next, we examine the potential strategy behind the ESG-repurposing behavior, a phenomenon of funds adding ESG in their prospectus. In this question, we use manually collected dates of each non-ESG fund being repurposed to an ESG fund and run a stacked logistic regression. The results show that fund families tend to rebrand funds whose ability to attract flows has been lagging behind, consistent with family-level strategic optimizing behavior as documented in the literature (e.g., Nanda et al., 2004; Gaspar et al., 2006). Further investigating those ESG-repurposing funds after their repurposing event, we find no obvious evidence of short-term benefits of the repurposing behavior. There is essentially no change in flows and returns. On the brighter side, in the post-repurposing period, we find that those funds move their
investments away from “sin” industries such as oil & gas and that they do not charge higher fees than before.

**Essay 2: Do fund flows react to non-fundamental ESG information?**

*Evidence from Morningstar’s sustainability criteria change*

The second essay examines whether fund flows react to ESG information that contains no fundamental news. It aims to understand whether investors can directly digest the raw ESG information. Therefore, this essay plays an important role in the current time when regulators try to tackle greenwashing through disclosure transparency requirements. If investors cannot process the raw information from disclosures and heavily rely on third-party agencies’ data, education on ESG investments and regulation on data providers may be needed to ensure a clear and efficient information transmission.

Uncovering investors’ pure information digestion ability is not easy since they commonly rely on information intermediaries when facing search costs. Also, the information provided by intermediaries is usually repackaged to easy-to-process rating scales and exposed to various media outlets. It is difficult to disentangle whether investors respond to the information itself, the repackaged information such as the Morningstar star rating (Del Guercio and Tkac, 2008), or the media coverage such as WSJ Category Kings (Kaniel and Parham, 2017).

In this paper, I use an event when Morningstar changed its methodology to construct the sustainable investment list, resulting in 1/3 of funds being dropped off the list. Because nothing has changed in these funds’ prospectus or ESG profiles, this event contains no fundamental news. Moreover, this setting has two other unique features. First, there is no repackaged information involved since Morningstar’s list extracts information from funds’ prospectus without additional analyses. Second, the list had been on various platforms before the event, and thus no extra media attention came along with the event. Therefore, I argue that studying fund flows under this setting allows me to answer whether
investors can directly digest the raw ESG information.

Using this quasi-exogenous shock and a difference-in-differences framework, I find that funds that are excluded from the list suffer a substantial decrease in their net flows, both in the short term and long term, suggesting a lack of pure information digestion ability of ESG investors. In this analysis, I need to rule out other possible events that might happen and affect fund flows around the event. As a result, a large portion of this essay focuses on the validity of the parallel trend assumption and various robustness checks.

**Essay 3: SFDR and mutual funds**

In the third essay, I take a closer look at the first major move of regulators to standardize the ESG disclosure — the EU Sustainable Finance Disclosure Regulation (SFDR). The regulation aims to help investors better understand, compare and monitor different firms’ and financial products’ sustainability performance and ultimately make more informed decisions. Under the initial stage of the SFDR (effective on March 10th, 2021), UCITS asset managers are required to classify their funds into three categories: dark green, light green, or all others.¹ Funds with green categories will need to disclose further how their investments align with sustainability in more detail at later stages. This study provides the first glimpse of mutual funds’ behavior under this new regulation.

Using the Morningstar dataset and multinomial logistic regressions, I find that greener funds are more likely to be in the greener profiles in the SFDR classification categories, consistent with the purpose of the regulation. Interestingly, better past performances in terms of returns and flows appear to be associated with funds being in the not-green-stated group than the light green group. This implies that asset managers may not rush to put well-performing funds into green groups, especially when their funds’ green profiles are not very strong, in fear of the misclassification and the consequent downgrade in funds’

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¹ The term UCITS stands for Undertakings for Collective Investment in Transferable Securities. UCITS funds are European well-regulated funds.
green credentials.

By examining fund flows in the post-SFDR period, I find no evidence that the green profiles under the SFDR classification can bring extra flows to funds, at least in the initial stage, given the funds’ existing sustainability-related indicators. It is more important to have both above-average Morningstar sustainability ratings and the ESG label.

This paper provides some practical implications for asset managers and regulators. When there are ambiguities in the new regulation like in the SFDR, the existing ESG profiles matter more to the asset managers to attract flows, and regulators may not be able to witness desired effects quickly.

Reference


