

# IS DISCLOSURE A SOLUTION TO GREENWASHING?

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# Challenges on the road to a sustainable economy

- Hard to evaluate which firms are really sustainable
  - Ratings are noisy signals
  - Companies and intermediaries engage in greenwashing
    - “Glossy green banks”
- Increasing transparency and regulating disclosures is often viewed as a panacea
- **But does it work?**

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FTfm ESG investing ✓ Added

## EU rules promise to reshape opaque world of sustainable investment

Landmark regulations will force asset managers to up their game on ESG but data gaps may hinder progress



The sustainable finance disclosure regulations require fund groups to provide information about the ESG risks in their portfolios for the first time © Dreamstime/Reuters/Alamy

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# Transparency and Sustainable Investment

- Are there enough investors with genuine preferences for sustainability over financial performance?
- Revealed preferences approach
  - Flows into ESG funds
  - Flows into funds with high sustainability ratings
  - Investors' propensity to purchase ESG funds even if they have high fees
- But preferences for what?
- Sustainability can be interpreted as a sign of future performance
- Important to know how investor trade off sustainability and performance

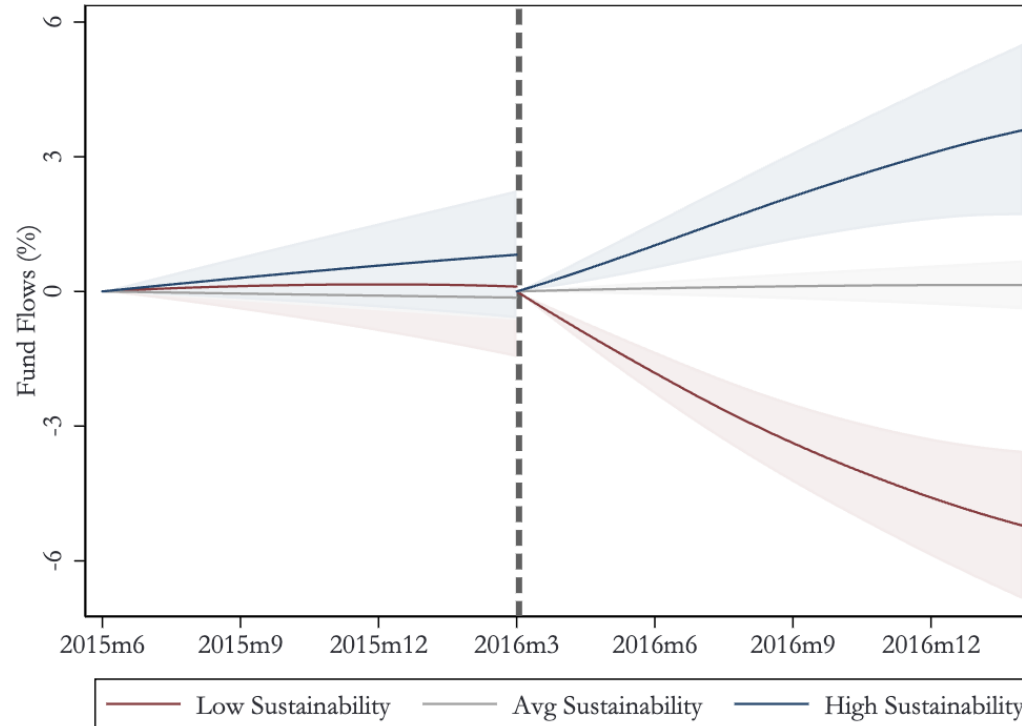
# Joint work with Gantchev and Li (JFE 2024)

- Can greater transparency affect the capital allocation of mutual funds  
*...when the [trade-off between sustainability and performance is salient?](#)*
- Introduction of [Morningstar globe ratings](#) to rank funds based on the sustainability of their portfolios
  - In the aftermath of the introduction, flows to the funds that received the highest sustainability ratings increased (Hartzmark and Sussman, 2019)
  - We show that in the longer-term the globe ratings led to a trade-off between sustainability and performance....  
....and we explore how investors reacted

# Morningstar Sustainability Ratings

- **Globe ratings** – introduced on March 1, 2016
  - Range from one (low) to five (high) globes
  - Weighted average of company-level ESG scores from Sustainalytics
  - Based on the percentile rank of a fund's portfolio sustainability score, relative to other funds in the same Morningstar category
- Existing literature
  - In the six months following the introduction of the Morningstar sustainability ratings, the funds with the highest globe ratings experienced higher inflows; the converse was true for the funds with the lowest ratings (Hartzmark and Sussman, 2019).

# Effects of the globe ratings introduction on flows (from Hartzmark and Sussman, 2019)



Often interpreted as evidence that investor value sustainability

**Figure 1. Cumulative fund flows by sustainability rating.** Estimates are accumulated from a local linear plot of monthly flows after removing year-by-month fixed effects for nine months before and 11 months after rating publication (denoted by the dashed vertical line). Shaded areas indicate the 90% confidence interval. (Color figure can be viewed at [wileyonlinelibrary.com](http://wileyonlinelibrary.com))

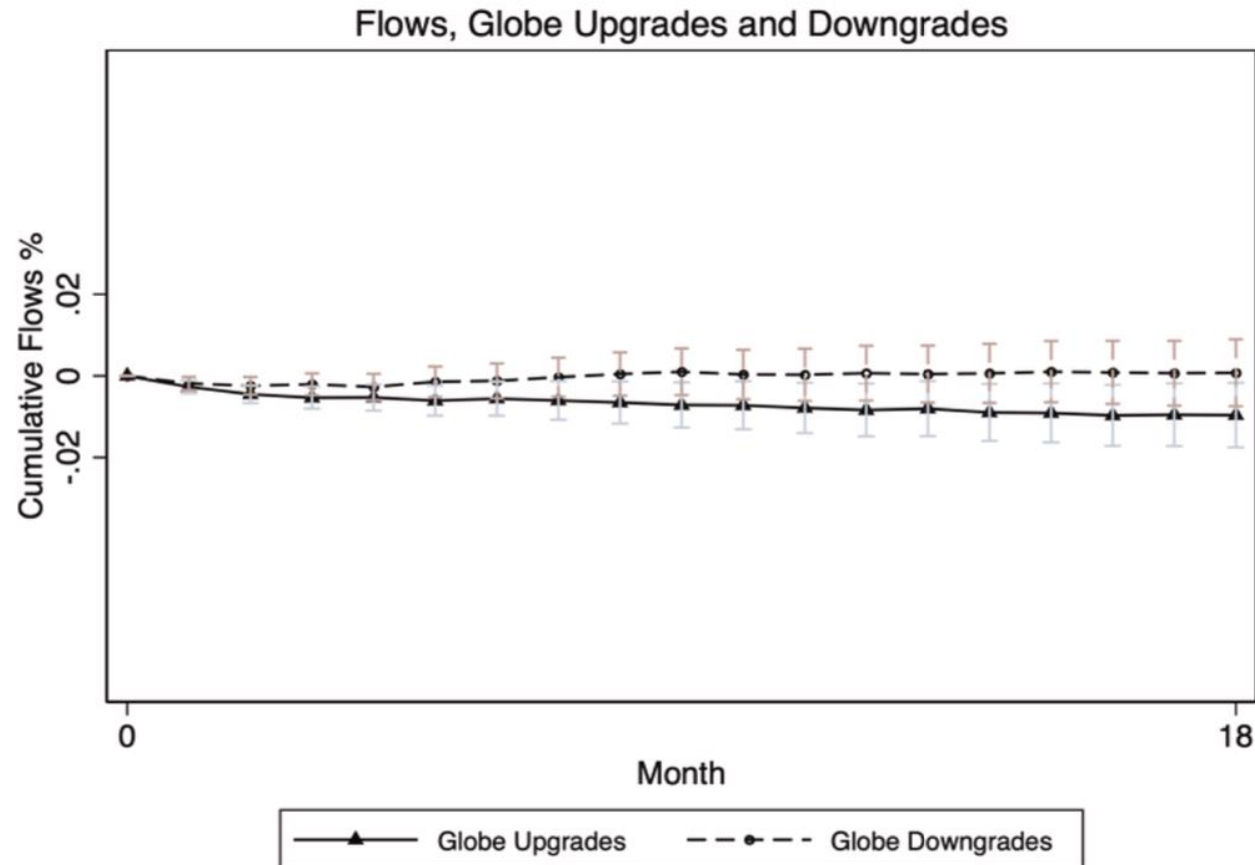
# The globe ratings in the period subsequent to their introduction: Rating Upgrades and Downgrades

	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%

Upgrades/downgrades of globe ratings are high throughout the sample period, and higher than those of star (performance) ratings.

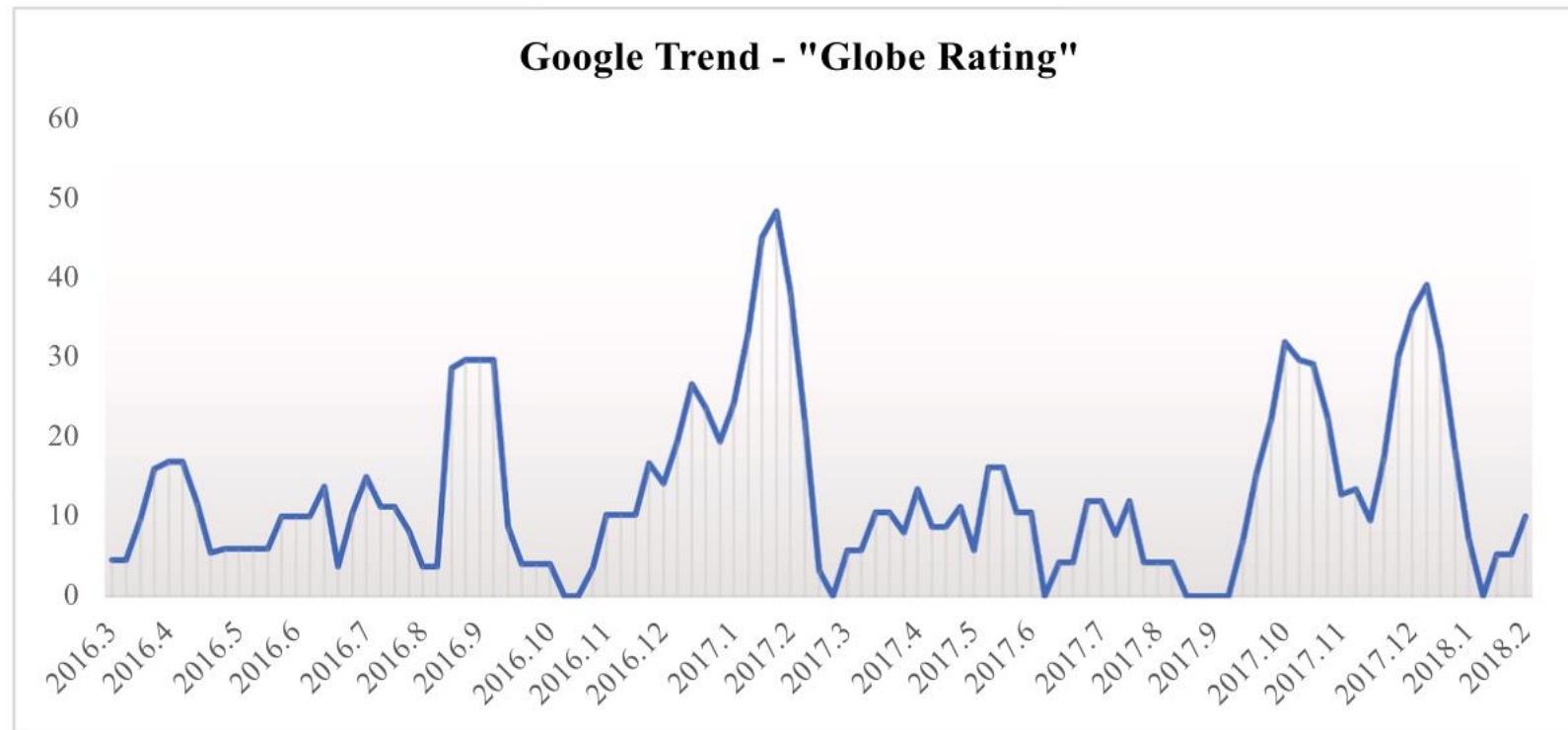
# Effects of globe rating upgrades and downgrades on flows

Panel A. Fund flows and globe upgrades/downgrades



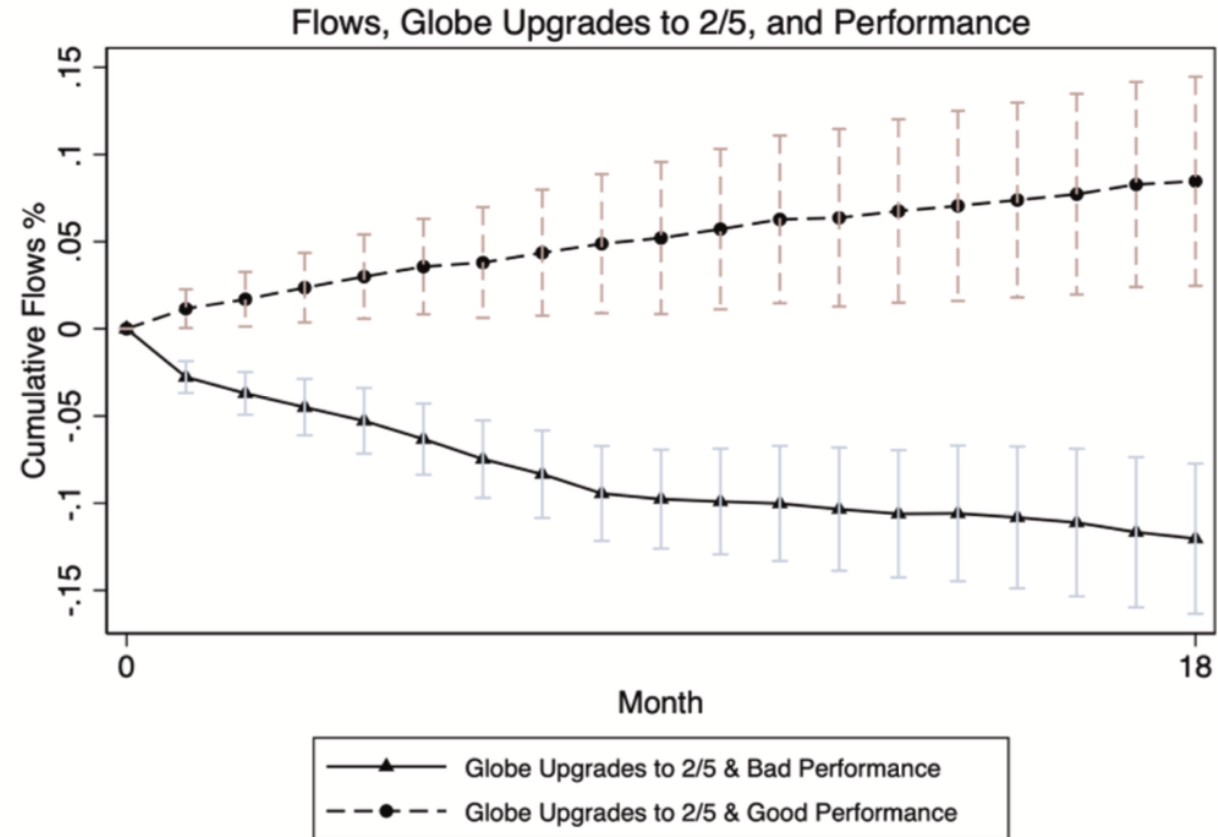


# Do investors still care about globe ratings?



# Rating upgrades, fund flows, and performance

Panel B. Fund flows, performance, and upgrades to globe 2 or 5



# The equilibrium explanation: a summary of our results

- After the introduction of the sustainability ratings, mutual funds **changed investment strategies** to achieve higher globe ratings
  - Funds increased (decreased) their investments in stocks with high (low) ESG scores
  - This behavior was more pronounced for funds with stronger incentives to improve their globe ratings, e.g., **closer to the cutoffs for the top and bottom globe ratings**
- However, the globe ratings affected funds' portfolio allocation **only in the short run**
  - Less than a year after the introduction, funds stopped tilting their portfolios to obtain better globe ratings

# Preview of Results (cont'd)

- Trade-off between sustainability and performance emerges
  - Funds improving their globe ratings experienced **poor performance in the high-ESG stocks they purchased**; these funds also **sold low-ESG stocks that ended up performing well**
- As the globes stopped affecting flows, **globe-improving funds suffered net outflows** because of their poor performance
  - Managers stopped pursuing more sustainable portfolios
- Given the preferences of the average mutual fund investor, **the globe ratings do not seem to have long-term effects on the allocation of capital to sustainable investments**

# Demand for High-ESG Stocks

- If fund managers expect better globe ratings to increase AUMs, they should attempt to achieve a better rating
  - Incentives should be stronger for funds close to the rating cutoffs
  - Define *Border Funds* as funds whose portfolio sustainability score is within +/- 2.5% from the cutoff for each globe rating (consider also broader definitions)
- Construct *quarterly fund-stock-level panel* and investigate

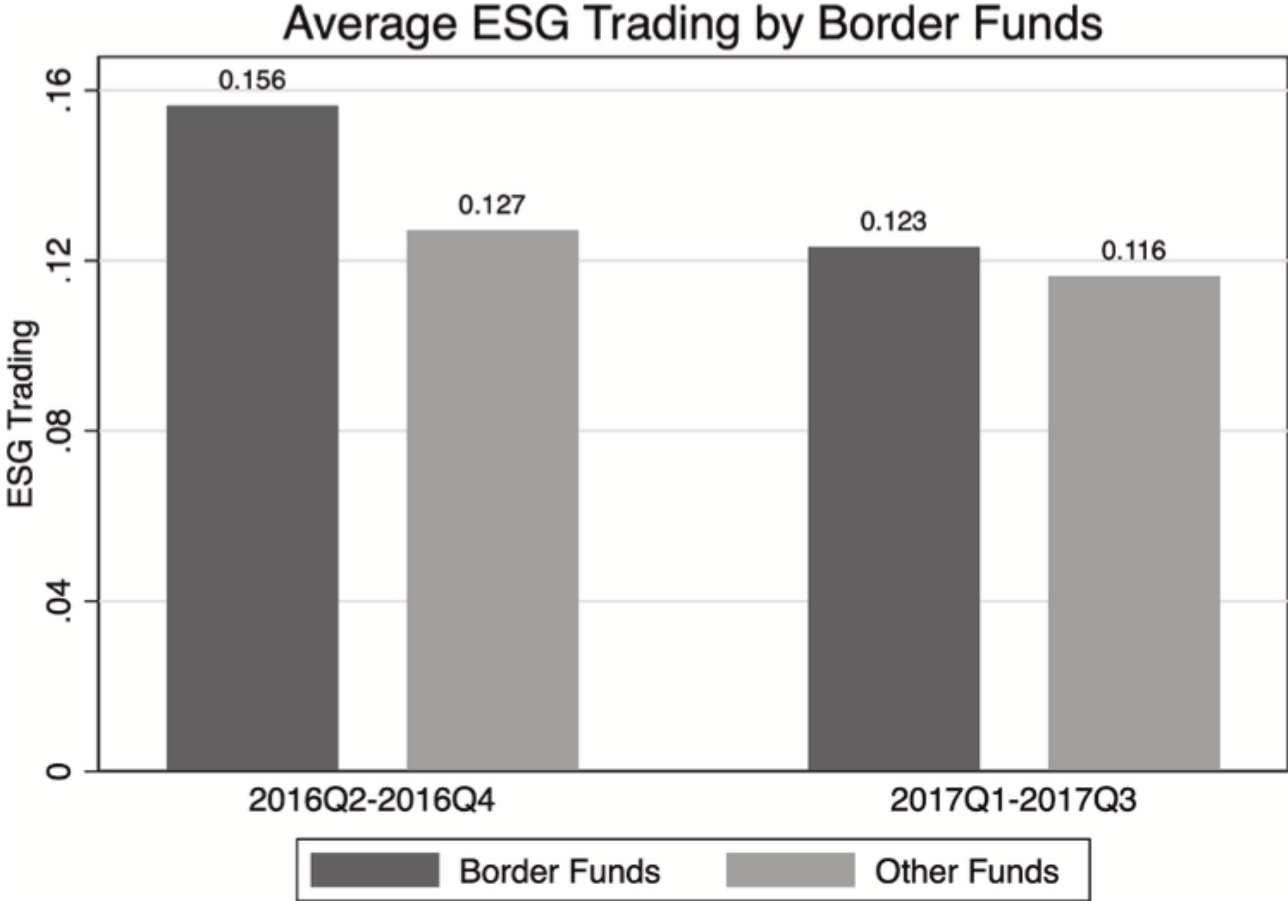
$$Position\ Change(f, i, t) = \frac{Price(i, t - 1) * [(NumShares(f, i, t) - NumShares(f, i, t - 1))]}{TNA(f, t - 1)}$$

# Demand for High-ESG Stocks (cont'd)

	(1)	(2)	(3)
	Position Change $(f,i,t)$		
	All Funds		
	Pre-globes	Post-globes	
<i>Border Fund definition:</i>	2015Q3-	2016Q2-	2017Q1-
<i>Within 2.5%, Globes 1/5</i>	2016Q1	2016Q4	2017Q3
ESG Score	-0.013** (-2.241)	-0.007 (-1.418)	0.009** (2.316)
ESG Score × Border Funds	-0.005 (-0.183)	0.046** (2.167)	0.020 (1.083)
Observations	426213	641819	785203
Adjusted R-squared	0.183	0.249	0.272
Controls	Yes	Yes	Yes
Fixed effects	Fund*YQ	Fund*YQ	Fund*YQ

A one-SD increase in a stock's ESG Score => 34% increase in Border funds' positions in the stock (based on the interquartile variation of position changes).

# ESG Trading – Border Funds



# ESG Trading – Globe Upgrades/Downgrades

	(1)	(2)
	Globe Upgrade	Globe Downgrade
ESG Trading	0.126*** (9.278)	-0.146*** (-11.802)
Fund Turnover (% TNA)	0.002 (0.497)	0.013*** (3.358)
One Star	-0.001 (-0.100)	0.010 (1.287)
Two Stars	0.003 (0.622)	0.007 (1.354)
Four Stars	-0.007 (-1.615)	-0.002 (-0.410)
Five Stars	0.000 (0.068)	-0.003 (-0.428)
One Globe	0.015** (2.246)	-0.052*** (-9.959)
Two Globes	0.026*** (5.289)	-0.002 (-0.435)
Four Globes	-0.018*** (-4.069)	0.019*** (3.813)
Five Globes	-0.057*** (-9.975)	0.002 (0.241)
Controls	Fund Age, Ln TNA, Flow, Expense Ratio	
Observations	28270	28270
Adjusted R-squared	0.048	0.030
Fixed effects	Cat*YM	Cat*YM

An interquartile change in ESG trading is associated with a 3.10% higher probability of a globe rating upgrade, 28.6% of the average probability of a globe upgrade.



# ESG Trading and Performance

	(1)	(2)	(3)
	Fund Excess Return		
	<i>Full Sample</i>	<i>First half</i>	<i>Second half</i>
	2016.3-2017.9	2016.3-2016.12	2017.1-2017.9
ESG Trading	-0.351*** (-3.086)	-0.523** (-2.412)	-0.173 (-1.204)
Globe One	0.055 (0.807)	0.234* (1.702)	-0.009 (-0.084)
Globe Five	-0.019 (-0.266)	-0.045 (-0.266)	-0.005 (-0.051)
Controls	Fund Age, Turnover, Ln TNA, Flow, Expense Ratio		
Observations	29771	13808	15943
R-squared	-0.033	-0.046	0.010
Fixed effects	Fund	Fund	Fund

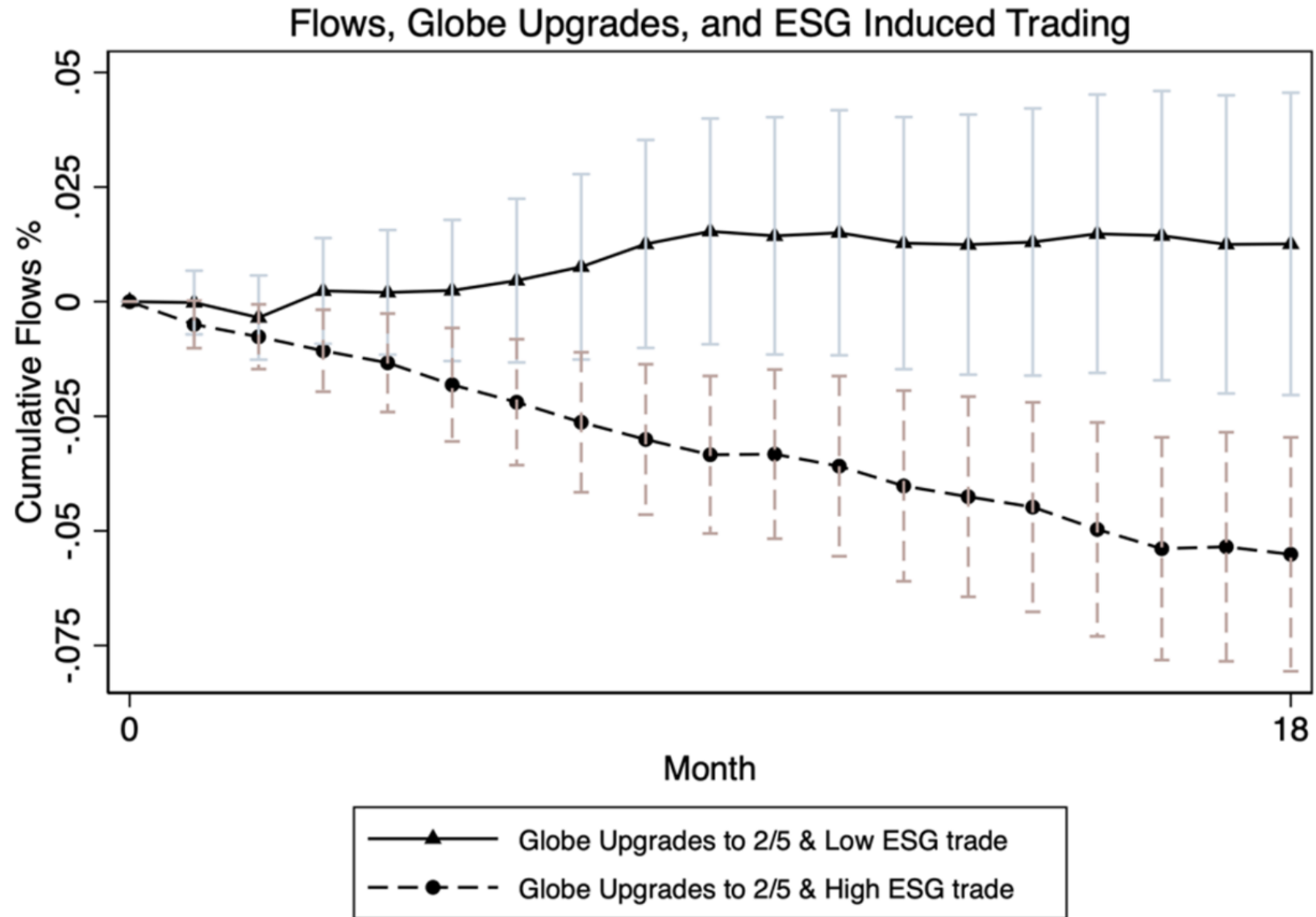
More ESG trading is negatively related to fund performance *only* in the first part of the sample period.

# ESG Trading and Performance (cont'd)

	(1)	(2)	(3)	(4)	(5)	(6)
	Buy	Sell	Buy	Sell	No-Trade	No-Trade
	High ESG	Low ESG	Other	Other	High ESG	Low ESG
ESG Trading	0.502*** (2.672)	-0.362* (-1.781)	0.045 (0.296)	0.180 (1.263)	0.234* (1.781)	-1.028*** (-7.352)
ESG Trading × First half	-0.849*** (-3.712)	0.777*** (3.402)	0.103 (0.614)	-0.586*** (-3.574)	-0.191 (-1.003)	1.707*** (10.115)
Controls	Fund Age, Turnover, Ln TNA, Flow, Expense Ratio					
Observations	31918	31918	31918	31918	31918	31918
Adjusted R-squared	0.027	0.020	0.022	0.022	0.110	0.084
Fixed effects	Fund, YM	Fund, YM	Fund, YM	Fund, YM	Fund, YM	Fund, YM

Funds' underperformance is due to purchasing High ESG stocks and selling Low ESG stocks rather than driven by poor managerial skills.





**Fig. 5.** Fund flows, ESG trading, and globe upgrades

# Effect of Ratings on Fund Flows (cont'd)

- Mechanisms and Robustness tests

- No evidence that investor flows respond to **upgrades and downgrades** from/to the bottom/top globe rating in the second part of the sample
- Outflows from upgraded funds that experience poor performance
- Results are identical for ESG funds
- **Interactions between globe ratings and fund performance** are not statistically significant, i.e., a top globe rating does not mitigate the negative effects of weak performance
- **Institutional and retail share classes** respond similarly – globe ratings lose explanatory power for both types of investors in the second part of the sample

# Conclusion

- A lot of research efforts in sustainability focus on greenwashing
  - Do intermediaries do what they say?
  - Evidence from disclosures and commitments of banks suggests greenwashing (Glossy green banks...)
- But also important to evaluate **why** investors and firms do what they do
  - Investor flows
  - ESG compensation
- If you believe that investors are selfish, transparency is neither a necessary nor a sufficient condition to achieve sustainability objectives
  - Need for regulation and international cooperation!