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Expectations for the real-world impact of sustainable investing are unrealistic

*The asset management industry has shown support for sustainable investing, but do they follow sustainability principles in their investment decisions? Together with two colleagues, **Dirk Jenter** surveyed 509 equity portfolio managers on how much firms' environmental and social performance feature in their investment decisions. He writes that most investors wouldn't sacrifice profitability only to advance environmental and social goals. And funds marketed as sustainable aren't that different from traditional ones.*

Advocates of sustainable investing want asset managers to incorporate companies' environmental and social performance into their investment decisions, in order to make companies better citizens, reduce carbon emissions, and create a more just society. And the asset management industry has made a significant show of support for sustainable investing in recent years, with thousands of firms signing the U.N. Principles for Responsible Investment and adding "sustainable" to their fund names.

Our research, however, shows that high expectations for the real-world impact of sustainable investing are unrealistic.

In a recent project, I joined forces with Alex Edmans and Tom Gosling from London Business School to survey 509 equity portfolio managers—290 from traditional funds and 219 from funds marketed as sustainable—on whether, why and how they take firms' environmental and social (ES) performance into account when making investment decisions.

Our study found that both traditional and sustainable asset managers approach investment decisions in much more similar ways than many people realise.

For example, most of the investors we surveyed, including a majority running sustainable funds, said they wouldn't voluntarily sacrifice even one basis point of return to advance ES goals, citing their fiduciary duty to clients. That means most managers, regardless of their fund's label, will incorporate ES performance into their investment decisions *only* if they believe that doing so will boost financial returns or if they are forced to because of fund mandates or other constraints. And, when asked what drives a company's long-term value, managers in both camps ranked ES performance as significantly less important than several other issues.

Fund managers' beliefs

We first asked managers to rank the importance of ES performance for long-term firm value against five other factors. Both traditional and sustainable investors ranked it last, below strategy, operational performance, governance, corporate culture and capital structure, in that order.

However, the low ranking of ES performance does not mean that investors view it as irrelevant. Many free text responses emphasised that all value drivers are interlinked, that ES performance can affect the firm's competitive position or operational performance, and that deficiencies in any of the value drivers are a concern.

The low relative ranking of ES performance also does not imply that investors view it as irrelevant in absolute terms. When asked to rate the financial importance of eight specific ES issues, from greenhouse gas emissions to employee well-being, 85 per cent of respondents, including 78 per cent of traditional fund managers, rated at least one ES issue as material.

Next, we explored fund managers' expectations for stock returns, and again found lots of similarities between the two camps. Seventy-three per cent of respondents managing sustainable funds expect companies with good environmental and social performance to deliver positive abnormal returns, and 45 per cent of traditional managers agree. Unexpectedly, by far the most popular reason is that ES performance is seen as correlated with other factors that improve shareholder returns—it is seen as signalling a well-managed company, rather than mattering directly.

At the same time, a majority of both sustainable and traditional fund managers (67 and 61 per cent, respectively) believe companies that perform poorly on environmental or social issues will deliver negative abnormal returns. This shows that sustainable funds are not the only ones paying attention to ES issues. Many traditional funds take ES performance into account, too, because they think it affects their returns.

We then asked investors whether, from a shareholder value perspective, firms over- or underinvest in the eight specific ES issues. For all eight, the modal response was that they invest at the optimal level. Thus, fund managers are mostly content with firms' ES performance, so it is not surprising that managers are selective in their support of ES proposals and engagements.

Fund objectives and constraints

Maybe the difference between sustainable and traditional investing is that sustainable investing is not focused solely on making money.

Yet only 27 per cent of the managers we surveyed (24 per cent traditional, 30 per cent sustainable) said they would tolerate the sacrifice of even one basis point of long-term return in support of ES objectives and almost none would tolerate a significant sacrifice. “We could never accept lower risk-adjusted returns out of the goodness of our hearts,” one manager said. Another stressed that a mutual fund’s purpose “is to maximise risk-adjusted returns for the public. It would be unethical and illegal if I deviated from that purpose.”

The same principle guides how fund managers vote on shareholder proposals. While 78 per cent of portfolio managers say they have voted for ES shareholder proposals that they thought were neutral for shareholder value, only 27 per cent (24 per cent traditional, 31 per cent sustainable) say they have ever voted for a proposal that was even slightly negative for shareholder value, citing their fiduciary duty.

If traditional and sustainable fund managers have similar objectives and beliefs, what makes sustainable funds different? One force that can cause sustainable funds to hold different portfolios are ES-related constraints. These are limitations on the kinds of companies and sectors in which a fund is allowed to invest. Eighty-four per cent of sustainable fund managers report that firmwide ES policies, fund mandates, client wishes and reputational concerns have led them to make different investment decisions than they otherwise would have. However, we also found that ES constraints are not unique to sustainable funds. About two-thirds of traditional fund managers have had to make different decisions, too, because of ES policies of their fund family or to address clients’ concerns.

These ES constraints have consequences; the most frequent were that investors had to avoid stocks that they believed would improve returns or diversification. Paradoxically, ES constraints sometimes led investors to take actions that reduced their ES impact, such as not investing in ES laggards whose performance they could have improved.

Implications

Our results have several interesting implications. First, they imply that the asset management industry is unlikely to lead the charge in improving the aggregate ES performance of firms. Most fund managers do not place significant weight on ES performance beyond what is required to improve financial returns, nor do they believe that firms are systematically underinvesting in ES. Consequently, they will invest in ES leaders that offer superior financial returns, and vote and engage on ES issues that are financially material. But they won’t subsidise ES investments that offer below-market returns or stop companies from engaging in profitable activities that harm society.

Second, the industry does not readily partition into traditional funds with a purely financial objective and sustainable funds with both financial and social objectives, nor into unconstrained traditional and constrained sustainable funds. Instead, both types of funds have a dominant financial objective but also face a range of formal and informal ES constraints. Many of their beliefs are also similar: both manager types rank ES performance low relative to other value drivers, yet over three quarters of both view at least some ES issues as financially material.

Third, fund labels can be misleading. Individuals often view the fund name as a strong signal of a fund's investment approach. But as our research shows, many sustainable managers see financial returns as their main priority, and many traditional managers take ES performance into account if they think it's financially material. Therefore, investors who want sustainable portfolios need to look beyond the label and scrutinise a fund's actual stock selection, voting and engagement decisions.

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- *This blog post is based on Sustainable Investing: Evidence from the Field, with Alex Edmans and Tom Gosling. The paper won the 2024 Principles for Responsible Investment Outstanding Research Award.*
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