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Too Many ESG Funds Mislead Investors

Regulatory reckoning with ESG funds does not go far enough.

Regulators are cracking down on ESG funds that pretend to want to save the planet without actually investing in green stocks – an all-too-common practice known as greenwashing. The European Union has recently adopted a corporate sustainability reporting directive that includes guidelines for funds targeting the ESG market. Similarly, the Securities and Exchange Commission (SEC) is proposing rules requiring ESG funds to disclose information about their strategies.

However, even without greenwashing, investors are too often misled by ESG fund promoters. A typical ESG fund advertisement reads like this: "Investors in the fund will reduce global warming, without giving up returns."

Let's analyse such a statement.

Where does the money go?

The first part of this statement, which relates to reducing global warming, is often a lie. The typical ESG fund doesn't bring fresh funds to the companies in their portfolio.

Such funds exploit the apparent ignorance of investors who confuse financial investment in stocks with capital expenditures. Many investors believe that if they invest in funds with names such as the Wind Energy Fund (fictitious name), the firms in the fund will receive money to produce wind energy. Nothing is further from the truth.

In reality, the money invested in the fund is used to buy shares from other investors who are selling their wind energy shares. For all we know, these sellers may turn around and buy petrol-guzzling SUVs with the proceeds. The underlying companies are not affected. For them, it's a zero-sum game.

Some funds try to counter this by saying that they "engage" with the wind energy companies and send emails to their CEOs. But what's the point of engaging companies that already have a high ESG rating?

Engagement would make sense if the fund were to buy stocks from companies with a low ESG ranking, such as oil and gas companies, then convert them with the ESG doctrine. Recent **research** on voting behaviour of socially responsible mutual funds concludes that "funds support ESG proposals that are far from the majority threshold, while opposing them when their vote is more likely to be pivotal, consistent with greenwashing".

The worst offenders are funds that exclude politically incorrect stocks and claim to make the world a better place. If you eliminate an oil and gas company from your portfolio, someone else who does not care about the planet will buy it. The world's carbon footprint will not be affected.

Faulty logic regarding returns

According to some, there could be a beneficial effect via the cost of capital: If ESG funds become the dominant investors in green stocks, the cost of capital of green companies will fall, leading to more investment (and a corresponding disinterest in brown or sin firms).

But as a lower cost of capital corresponds with a lower expected return on equity, the claim that investors in ESG funds won't give up returns is false as well. In equilibrium, brown stocks will earn higher expected returns than green stocks.

The most recent empirical **research** shows that ESG funds may have benefitted from "unexpected" positive returns as a result of ESG hype and inflows in the last ten years. However, in the long run, they are expected to underperform, for the same reason that sin stocks are expected to outperform.

Moreover, ESG ratings have a huge industry bias: Big tech companies typically get high ESG ratings and fossil fuel companies get low ones. When the first group underperforms and the second group (consisting of coal stocks and oil and gas companies) outperforms, as they did in 2022, investors in ESG funds do give up returns for a non-existing benefit (i.e. saving the planet).

The role of regulators

So, what should regulators do? A modest proposal would be to require every ESG fund to put the following information on the first page of their prospectus (when applicable):

- The companies in the fund won't receive the money invested in the fund. Therefore, the fund will not affect their carbon footprint.
- Investors may have to give up returns because of reduced diversification and because the stock price of green stocks may reflect perceived non-monetary benefits.

This regulation would not kill the ESG fund industry. Some investors will still want to invest in ESG funds because, as one of my colleagues put it, they feel a "warm glow" from the *perception* that they are saving the planet.

Theo Vermaelen *is a Professor of Finance at INSEAD and the UBS Chair in Investment Banking, endowed in honour of Henry Grunfeld. He is the Programme Director of* ***Advanced International Corporate Finance****, an INSEAD Executive Education programme.*

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