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The Sustainability Stress Test

Investor Interest in ESG Holds Up Amid a Pandemic

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ESG investing has grown immensely in fund flows[1] and in the value that investors place on it.[2] A common question in investing circles has been what would happen to interest in ESG during a downturn: would people pay attention only to returns and ditch ESG as a "nice to have," or would ESG information be used by investors as they make long-term investing choices?

This research looks at whether investors paid attention to ESG information when making new investment choices, and we find that even during a pandemic and substantial market volatility, ESG information matters to many investors. We also find that ESG information broadens many investors' perspective and helps them avoid a myopic focus on recent returns. Advisors can use this fact to help have a meaningful conversation with their clients, even in uncertain times.

1 Hale, Jon. "Sustainable Funds U.S. Landscape Report." Morningstar (2020). https://www.morningstar.com/lp/sustainable-funds-landscape-report
2 Sin, Ray, Murphy, Ryan O., and Samantha Lamas. "The True Faces of Sustainable Investing Busting Industry Myths Around ESG." Morningstar (2020). https://www.morningstar.com/lp/esg-investors

The Obstacles Investors Face

Many Americans face the difficult task of evaluating investment options when they set up retirement plans, direct personal brokerage accounts, consider their advisor's investment proposals, and more. Researchers have pointed out the biases and mistakes investors might fall prey to while tackling this task.

Some studies, for example, have found that investors suffer from recency bias—a tendency to overweight recent information when making a decision[3]—which is to their detriment in investing.[4] Recency bias is one example of a damaging shortcut that investors use, and an investor's tendency to rely on such shortcuts can be exacerbated by overstimulated or overwhelming environments, such as severe market downturns and volatility.

Are Investors Paying Attention to Sustainability?

Prior researchers have hypothesized that ESG investors might be more resilient against these biases, because of sustainable investments' role in durable, values-oriented goals. We wanted to take a closer look at the role of ESG information in investment selection. Would the Morningstar Sustainability Rating[5] impact allocation decisions?

To better understand the role of ESG information on investors, we tried two routes. First, we checked whether just the inclusion of ESG information reminded people of factors that mattered to them. Second, we used a technique called *identity priming* that may nudge individuals to reflect more on certain aspects of their identity in a way that increases the salience of their values-based preferences and then influences their behavior.[6]

We conducted an online experiment (a formal, randomized control trial), using a sample of 626 people selected to represent the U.S. population of investors.[7] The participants were asked to imagine that they'd started a new job and were setting up their retirement account, choosing assets among the 15 fund options provided. The context of that choice varied in the experiment; the participants were randomly assigned into one of three groups:

3 De Bondt, Werner FM. and Richard Thaler. "Does the Stock Market Overreact?" The Journal of Finance 40, no. 3 (1985): 793–805. Hoffmann, Arvid OI., Post, Thomas, and Joost ME Pennings. "Individual Investor Perceptions and Behavior During the Financial Crisis." Journal of Banking & Finance 37, no. 1 (2013): 60–74.

4 Barber, B.M., Odean, Terrance, and N. Zhu. "Systematic Noise." Journal of Financial Markets, 12 (2009b):469–547.

5 "Morningstar Sustainability Rating Methodology." Morningstar (2019). https://www.morningstar.com/content/dam/marketing/shared/research/methodology/744156_Morningstar_Sustainability_Rating_for_Funds_Methodology.pdf

6 Cohn, Alain, and Michel André Maréchal. "Priming in Economics." Current Opinion in Psychology 12 (2016): 17–21.

7 We use the term "investors" here very broadly. The analyses are based on our full samples, not excluding people who claim they are not investors. Our thinking is that the kinds of asset allocation decisions we are investigating here are very common, and many people who are not-yet-investors will have to make exactly these kinds of decisions. Moreover the research questions are at a high level about how people use information when making important investment decisions, and rather than use the general term "decision maker" we chose to use the specific term "investor."

- In Group 1 (n=195), participants received standard metrics about each investment: the name, category, Morningstar Fund Category (e.g., Large Value, Mid-cap Growth), five-year total return, 10-year total return, annual reported net expense ratio, and Morningstar Rating (the star rating).
- In Group 2 (n= 198), participants were offered the exact same line-up and information, but they were also given each investment's Morningstar Sustainability Rating.
- Group 3 (n=233) was first asked questions about their personal preferences regarding environmental, social, and governance issues, with the intention of prompting individuals to non-financial aspects of securities when choosing investments. That set of preceding questions was the identity prime. People in this group then received the exact same line-up and information as Group 2.

The core question across these three groups was simple: did people pay attention to the ESG information and incorporate it in their investment selections? Our experiment was run during the beginning of the extreme market volatility caused by the COVID-19 pandemic (March 26, 2020, to March 29, 2020). Running the study during these real-world conditions allowed us to see how people made allocation decisions during market turmoil and specifically determine if and how ESG information was used during uncertain times.

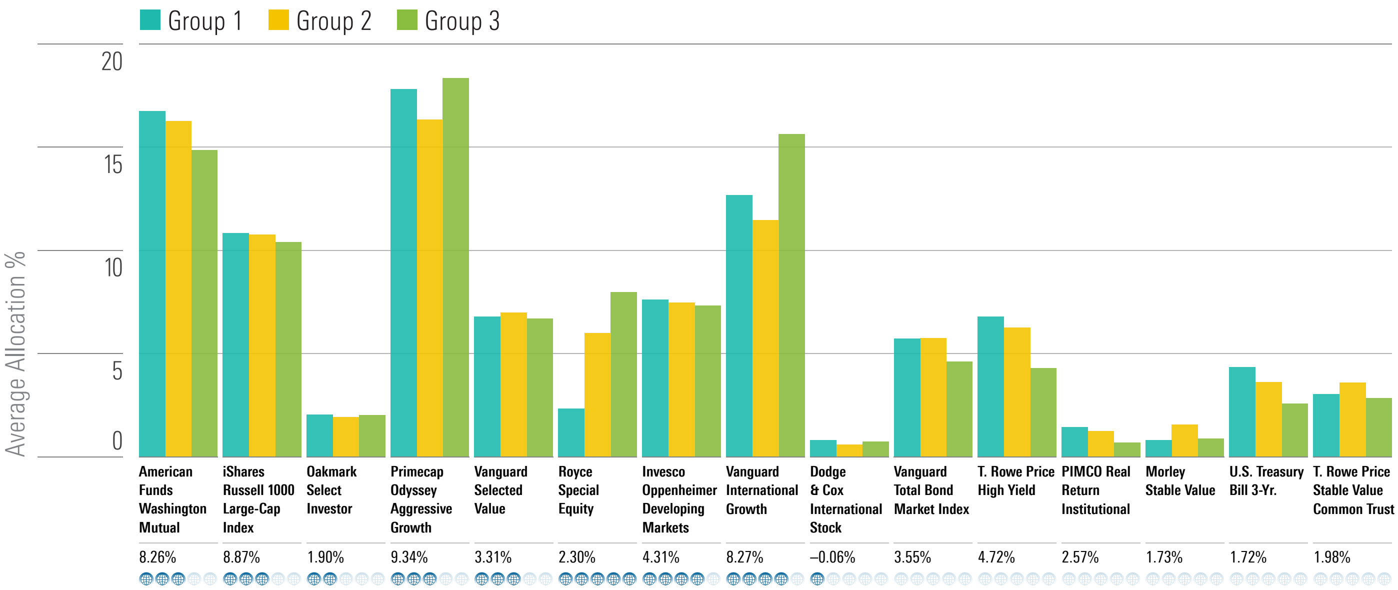
Do Investors Pay Attention to ESG in Turbulent Times?

We compared the average amount invested in each option among the three groups. Exhibit 1 shows detailed results: the average amount allocated to each investment option by group. The Morningstar Sustainability Rating for the fund is represented by the globe symbols at the bottom of the chart, and the percentage is the fund's five-year return.

One investment in particular required people to trade-off between returns and a high Sustainability Rating: Royce Special Equity, which had a five-globe Sustainability Rating but a fairly low five-year trailing return. Although Group 1 (which recall had no ESG information about the investment alternatives) largely ignored Royce Special Equity; Groups 2 and 3 invested substantially more of their money into it. In other words, investors do seem to be swayed by a fund's Sustainability Rating when making asset allocation decisions, and moreover identity priming isn't needed to encourage people to invest with sustainability in mind.

Given the market volatility present at the time, these findings also suggest that investors still pay attention to their ESG preferences even during times of uncertainty.

Exhibit 1: Investors' Allocation Decisions Suggest ESG Interest



Source: Morningstar.

What does this mean for the resulting portfolios? In both moving to an otherwise-ignored investment (Royce) and more broadly, the average Sustainability Rating of the rated portion of the portfolio increases: from a mean of 3.3 Globes (with no ESG information) to 3.4 (with ESG information) and 3.5 (with ESG information and an identity prime).[8]

ESG information caused more than simply an increase in ESG investments; let's look next at what it *decreased*.

Can Investing With ESG in Mind Prompt Investors to Depend Less on Past Returns?

Earlier, we discussed how investors often use shortcuts when investing, like focusing unduly on past returns. We evaluated whether adding ESG information helped investors look beyond past returns, and indeed it did.

Specifically, we calculated the correlation between each investor's allocations and the funds' five-year returns. We found that investment allocations in Group 2 and 3 were less correlated with returns overall, suggesting that participants focused less on returns when they made their investment selections.[9] Group 1, on the other hand, had a higher correlation between their allocations and past returns, suggesting that this group followed returns more closely when choosing their investment assets.

8 This analysis only includes portfolios with at least 50% of their assets covered by a Sustainability Rating. When all options without Globe ratings are included (money market, bond funds), the results are similar, but naturally muted: 2.58 Globes with no ESG information; 2.65 with ESG information; and 2.88 with ESG information and an identity prime.

9 The difference in the average correlations between Group 1 ($M=.48$, $SD=.26$) and Group 2 ($M=.40$, $SD=.28$), ($t(388)=3.2$, $p=.002$, $d=-.32$), and Group 1 and Group 3 ($M=.38$, $SD=.3$), ($t(388)=3.8$, $p=.0002$, $d=-.37$) are statistically significant.

Keeping an Eye on Diversification

Adding ESG information may, however, exacerbate the known problem that investors can be overwhelmed by too much information and resort relying *more* on simple shortcuts. To check this, we compared allocation diversification among the three groups: by looking at the standard deviation of participants' allocations. By this metric, a portfolio with a *high* standard deviation is invested in *fewer* funds, and vice versa.

Among the three arms, we do see that investors seem to choose *fewer* funds when given the extra information. This effect is magnified by adding the identity prime. Although the difference between Group 1 and Group 2 is not statistically significant, the difference between Group 1 and Group 3 is—meaning that identity priming questions may prompt some individuals to under-diversify.[10] In particular, there appears to be a group of investors who "put all their eggs in one basket" when they were presented with ESG information. These individuals invested all their assets in one fund. This could be an example of "choice overload" where people feel overwhelmed by options and information and therefore resort to simple rules of thumb. This might be a useful heuristic when picking a meal from a multipage menu, but in the context of investing, under-diversification can hurt a portfolio. The effect here is not huge, but it does serve as a useful reminder for advisors to make sure their clients, regardless of their personal motivations, keep diversification in mind as they make their investment choices.

Naturally, allocation diversification is not the end of the story. What really matters isn't the number of funds an investor selects, but the diversification of the underlying assets: that is why widely diversified index funds can be a good choice for investors. However, holding the diversification of the underlying assets constant, this finding tells us to be cautious: unless advisors and plan providers are ensuring diversification *within* investment options, the addition of ESG information may have the unintended consequence of decreasing diversification *across* investment options.

Cautious Optimism

The ESG-oriented information seems to help investors focus less on past returns when making allocation decisions, which is a common shortcut for investors. In particular, it appears that ESG information may "open peoples' minds" toward funds that otherwise would have been ignored or discounted—for investments with low returns, a high Sustainability Rating can encourage some investors to include that asset in their portfolio. These results may also be of special interest to contrarian advisors, who are trying to encourage investors to take on investments with lower recent returns, but strong fundamentals. ESG information may be an indirect way to encourage contrarian thinking and avoid return chasing.

10 The difference in the average standard deviations between Group 1 ($M=11.07$, $SD=4.6$) and Group 2 ($M=11.29$, $SD=5.1$), ($t(388)=-.45$, $p=.66$) is not statistically significant. The difference in the average standard deviation between Group 1 and Group 3 ($M=12.46$, $SD=5.0$), ($t(388)=-2.9$, $p=.003$, $d=-.29$) is statistically significant.

We also find, however, that adding ESG information could have the detrimental effect of decreasing between-investment diversification. This may be because some investors simply care very strongly about ESG, or that the additional information further overwhelms investors with more data. In the latter case, investors may resort to an investing shortcut: allocating assets to only one investment. Nevertheless, this can be mitigated by ensuring within-investment diversification (that is, a broad index of sustainable companies).

ESG investing allows people to invest according to their preferences and have more of a voice in the investing space. Investors, at least a notable subset, do pay attention to ESG information when it is available. Moreover, this interest and attention to ESG information endures even during one of the most unusual periods in the history of the U.S. stock market: the COVID-19 crash (and whipsaw volatility) of March 2020.

What does this mean specifically for advisors?

1. Previous research has shown that a broad swathe of investors are interested in sustainable investing.[11] We've found that even in the midst of tremendous market volatility, ESG is still important. When ESG information is provided, the average ESG score of the portfolio increases: People vote with their dollars.[12]
2. Even if you personally are not interested in ESG, information about ESG investing (and perhaps other factors) can open investors' minds from a myopic focus on returns to other aspects they consider important. This can be quite useful to allow for a more balanced and meaningful discussion with clients. ESG helps investors look beyond past returns.
3. Be careful however, to ensure that the underlying options presented to investors are properly diversified — since the addition of ESG information may cause concentration to a fewer number of funds. IM

Recommended Reading

The True Faces of Sustainable Investing: Busting the Myths Around ESG Investors
By Ryan O. Murphy and Samantha Lamas

Our research found that the surveys the industry uses to identify sustainability-minded investors might be the source of stereotypes, and that relying on them may ignore a large, untapped market for sustainable strategies among retail investors.

The paper explores:

- How previous studies on sustainable investing are susceptible to behavioral biases
- How using a different methodology helped us realize investors' true interest in ESG strategies
- What these insights reveal about the future of sustainable investing

Download the Paper

11 Sin, Ray, Murphy, Ryan O., and Samantha Lamas. "The True Faces of Sustainable Investing Busting Industry Myths Around ESG." Morningstar (2020). https://www.morningstar.com/lp/esg-investors
12 Hartzmark, Samuel M., and Abigail B. Sussman. "Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows." The Journal of Finance 74.6 (2019): 2789–2837.

About Samantha Lamas

Samantha Lamas is an associate behavioral researcher at Morningstar. She focuses on developing content and conducting research to better understand who investors are and how we can help them reach their financial goals. She began her career at Morningstar as a product consultant working directly with the individual investor and advisor audience segments. Samantha holds a bachelor's degree in business with a concentration in finance from Dominican University.

About Ryan O. Murphy, Ph.D.

Ryan O. Murphy, Ph.D., is head of decision sciences for Morningstar Investment Management and part of the behavioral insights team. Murphy's research is interdisciplinary, bringing together methods from experimental economics, cognitive psychology, and mathematical modeling to understand how people make decisions and develop ways to improve decision-making.

The Investor Success Project

Beginning in 2018, Morningstar started rolling out new research on investors—who they are, what their goals are, and how the advisors and asset managers that serve them can make the most impact in helping them reach those goals.

We don't know what we'll find, but we'll share everything we learn. We believe every bit of data that's uncovered can move the industry toward a future that emphasizes investors' front-and-center role in the markets and helps them succeed.

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