Who decides what ESG is and how to make investments greener?

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More than 30 US states have proposed or implemented legislation in recent years to stop the government and its pension funds from investing in environmental social and governance (ESG) funds. These products integrate ESG issues into their investment strategies, which mainly involve buying stocks but also bonds.

US conservatives claim that ESG has an overly large impact on corporations and the whole economy—hence recent moves to ban the strategy for government investments. But critics in Europe argue that ESG funds are not doing enough to have a positive impact in the real world.

Both cannot be right. So, who is?

Our recently published research explores this question by looking at the actual sustainability impact that these funds have. Although financial industry groups claim that one-third of all investment assets are already sustainable, our research shows most ESG investing actually does not create any meaningful sustainability impact.

Most ESG funds take conventional mutual funds as their baseline and tweak their capital allocation according to ESG criteria. Those that stay closest to their conventional peers are called "broad ESG" or "ESG integration" funds. Broad funds are prone to accusations of greenwashing because their capital allocation only slightly deviates from conventional funds.

For example, these funds usually exclude producers of thermal coal from their portfolio and assign slightly less weight to oil firms. As a result, large tech firms such as Amazon, Microsoft and Alphabet often make up a bigger share of these funds' portfolios due to their huge market capitalisation and their relatively small emissions footprint (compared with fossil fuel producers, anyway). Overall, however, changes to their portfolios are more cosmetic than anything else.

Our market analysis of ESG funds showed that, out of all index-tracking ESG funds, 88% are broad ESG funds. But there are also "light green" and "dark green" ESG funds, which do not track conventional or benchmark stock indices as closely. Light green funds comprise 7% and dark green funds make up 5% of the market.

When it comes to firms that offer these ESG funds, our research shows Blackrock is the largest provider, but its market share is only 15%, followed by Fidelity with 12% and Pictet with 8% of the pie. This indicates ESG asset management is a rather fragmented market, and so asset managers themselves are less likely to be able to set the standard for ESG.

Who really sets ESG standards?

Instead, we found that asset managers such as Blackrock, which are passive investors, essentially delegate their investment decisions to ESG indices. And most large active managers such as Fidelity hardly deviate from their non-ESG index benchmarks. So, what ultimately matters when it comes to defining ESG capital allocation are indices.

Indices are basically a basket of particular stocks that aim to represent a specific economic entity. There are many but, for example, the S&P 500 represents the US stock market, while the MSCI ESG Leaders U.S. Index supposedly represents the leading US companies with respect to ESG criteria.

These index providers play a key role in this age of passive asset management. We found that ESG funds tend to merely track existing stock indices these days, essentially delegating investment decisions to the firms that create these indices. As a result, this is where ESG standards are actually set.

One firm in particular dominates the development and provision of ESG indices: MSCI has a stunning global market share of 57%, compared to only 12% each for its closest competitors, S&P Dow Jones and FTSE Russell. This is largely because MSCI is one of the very few firms that not only provides ESG ratings, but also data and indices. Offering a number of related products in this way creates a strong "network" effect.

Further, most ESG funds are based on the ESG ratings of companies, which do not seek to measure a corporation's sustainability impact on the environment or society. In fact, they measure the exact opposite: the potential impact of ESG on the corporation and its shareholders.

Broad ESG investing based on MSCI and other rating and index providers is therefore really only a risk management tool for investors. Rather than monitoring how a company is affecting or helping with the escalating climate crisis and other ESG issues, it actually tracks how ESG factors are affecting companies.

This means that broad ESG funds, which constitute the lion's share of the market, often only make a rather feeble attempt to manage ESG. Their typical capital allocation—the amount of money invested in a fund—hardly deviates from conventional funds.

How ESG funds could boost sustainability

Capital allocation is only one of the potential ways ESG investing can boost sustainability, however. Shareholder engagement could be even more powerful. This can either be pursued by investors via their proxy voting behavior at the annual general meetings of the firms that are part of their portfolio, or through other forms of interactions (such as private engagements) with the management of these companies.

Research has shown that funds are able to create significant impact via these routes. But at the moment, shareholder engagement is neither a standard part of ESG methodologies nor of ESG indices. Our research shows this could be a crucial factor in ensuring ESG funds have maximum impact, but there is a need for significant changes in the regulation of the industry.

This should include clear criteria for broad ESG funds to dictate how capital allocation should deviate from conventional funds, plus favorable taxation or regulatory arrangements to boost the market share of light and dark green funds. International regulators should also develop minimum standards for ESG funds' proxy voting behavior and private engagements.

In its current form, ESG will not decarbonize our economies. The volume of "true" ESG funds is still so small that they cannot possibly change contemporary capitalism, indicating the US conservatives' "war" on ESG is just electioneering. Instead, EU discussions about ESG greenwashing seem a much more fitting description of what is going on in the world of (allegedly) sustainable finance.

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