Behavioral Insights
The Sustainability Stress Test and What it Means for Advisors

Introduction

ESG investing has grown immensely in fund flows¹ and in the value that investors place on it.² Some wondered what would happen to interest in ESG during a market downturn: Would people pay attention only to returns and ditch ESG as only a "nice to have," or would investors persist in using ESG information as they make long-term investing choices?

We studied this issue and found that even during a pandemic and substantial market volatility, ESG information mattered to many investors as they made portfolio construction decisions. We also found 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, especially during uncertain times.

Key Takeaways

► Investor interest in ESG investing did not wane during the pandemic-induced market volatility and declines in March 2020, our research found.
► Giving survey respondents ESG information about potential investments not only increased the likelihood they would invest more in higher-rated ESG strategies, it also led respondents to pay less attention to recent returns.
► Talking to clients about ESG considerations may allow for a more balanced and meaningful investment discussion with clients as ESG helps investors look beyond past returns and think more broadly about their "why" for investing.

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 complex task.

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

Where We Put Our Attention: Where Investors Put Their Attention

Prior researchers have hypothesized that ESG motivated investors might be more resilient against these biases because they tend to have 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 impact allocation decisions, and in particular would ESG information be relevant for investors during profound market volatility and global uncertainty?

We tried two routes. First, we checked whether the mere 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 thus influences their choice behavior.

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. 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:

In Group 1 (195 people), participants received standard metrics about each investment: the name, category, Morningstar Fund Category (e.g., Large Value, Mid-cap Growth, etc.), five-year total return, ten-year total return, annual reported net expense ratio, and Morningstar Rating (the Star Rating).

References:
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 2 (198 people), participants were offered the same line-up and information as Group 1, but they were also given each investment’s Morningstar Sustainability Rating.

Group 3 (233 people) 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 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 intentionally run during 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. We also denote the Morningstar Sustainability Globe Rating of the fund and the percentage is the fund’s five-year annualized return.

One investment in particular required people to trade 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 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. Also, identity priming isn’t needed to encourage people to invest with sustainability in mind, as we found no marginal effect in Group 3 (the priming condition) relative to Group 2.

Given the market volatility present at the time, these findings also suggest that investors still have ESG motivations even during times of uncertainty. Put another way, people’s preferences for integrating ESG information into their investment portfolios appears to be more than a "nice to have", and these non-pecuniary preferences are resilient to whipsaw markets and widespread unpredictability.

How did this affect the respondents’ hypothetical portfolios? In both moving to an otherwise-ignored investment (Royce) and more broadly, the average Sustainability Rating of the rated portion of the portfolio increased, 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).\(^8\)

But ESG information didn’t just increase ESG investments; let’s look next at what it decreased.

**Can ESG Considerations Improve Other Investor Behaviors?**

Earlier, we discussed how investors sometimes use shortcuts when investing, like focusing unduly on past returns as a way to build a portfolio. We evaluated whether adding ESG information helped investors look beyond past returns, and indeed we found that it did.

Specifically, we calculated the correlation between each investor’s allocations and the funds’ five-year returns. We found that investment allocations in groups 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, however, had a higher correlation between allocations and past returns, suggesting that this group followed past returns more closely when choosing their investment assets.

**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 to 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 across available investments. By this "investment concentration" metric, a portfolio with a high standard deviation is invested in fewer funds, and vice versa.

Among the three groups, we saw investors seemed to choose fewer funds when given the extra information. This effect was magnified by adding the identity prime. Although the difference between groups 1 and 2 was not statistically significant, the difference between groups 1 and 3 was — meaning

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\(^8\) 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.
that identity-priming questions may just be enough to prompt some individuals to under-diversify. In particular, there appeared 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, which is arguably not ideal. This result could be an example of “choice overload” where a person feels overwhelmed by options and information and therefore resorts to just using a simple rule of thumb to make a choice. This might be a useful heuristic when picking a meal from a multi-page menu in a new restaurant, but in the context of investing, under-diversification can have deleterious effects. The effect we find 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. Also, this effect can be mitigated by ensuring within-investment diversification alternatives are presented (that is, using investment building blocks that are multi-asset funds that are already broadly diversified among their exposures).

**What does this mean for advisors?**

Previous research has shown that a broad swath of investors are interested in sustainable investing. We’ve found that even in the midst of tremendous market volatility and global uncertainty, ESG is still important to many people as they may investment choices. When ESG information is provided, the average ESG score of the portfolio increases: People vote with their dollars, and persistently so.

Even if you personally are not interested in ESG, information about ESG investing (and perhaps other factors) can open investors’ minds and counter a natural myopic focus on returns, and in doing so reorient their attention to other aspects of investing they consider important. This can be useful as part of a way to foster a richer and more meaningful discussion with clients about what they want to achieve as investors.

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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.


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