SUSTAINABLE FUNDS: DOES ACTIVE MANAGEMENT ADD VALUE?

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ABSTRACT

This study tested how 20 top equity mutual funds, ranked by Barron's with sustainable-investing grades related to environmental, social and governance -ESG- screens, stack up to style-specific custom Benchmarks, in terms of net returns. Sharpe's Style methodology using a constrained quadratic regression ranked 20 sample funds by their style performance over a four-year period using monthly returns. Exchange-traded- funds or ETF indices that acted as proxies for asset classes, were the regressors. Regressand was the returns on the mutual fund. Active management had a big role to play, particularly in pacific markets, and small cap stocks. The results were noteworthy and important to the extent that one can say that the sustainability strategy had a crucial impact on the performance of the mutual funds.

***Keywords**: ESG, ETF, Style Analysis, Mutual fund performance, active/passive management, custom benchmarks, Risk management, Quantitative finance, Quadratic programming. Sustainable fund, valuation; SRI, Ethical investing, Corporate social responsibility, Financial Economics, Math and Quantitative methods.*

1. INTRODUCTION

Sustainable Investing and ESG Risk Scores

Before investing in any mutual fund or exchange-traded fund, investor must consider its investment objectives, risks, and expenses. Big pension funds, mutual funds, and socially responsible investors are jumping on the sustainable investment bandwagon.

Mutual funds are looking to invest in firms with favorable environmental, social and governance (ESG) characteristics. Each ESG fund is different, and it is important to pay close attention to a fund's strategy. Active managers of these funds use style as an important decision factor but are not consistent with their style. A central question is whether these mutual funds provide strong style and risk-adjusted returns? Sustainability trend is becoming integral to portfolio construction. Does sustainability equal to profitability?

It ranks twenty sample mutual funds by their style performance over a four-year period using monthly returns from January 2015 to February 2019. This ranking is contrasted with Barron's ranking of the funds.

The remainder of the paper is organized as follows. Section 2 describes the data and the style analysis methodology. Section 3 discusses the results. Section 4 presents an analysis based on the ETF indices. Finally, Section 5 concludes.

2. LITERATURE REVIEW

Early research and conventional wisdom on active management of mutual funds up to Carhart (1997) did not support value creation by managers. A recent 20-year review (Cremers, et al. (2019)) suggests that the conventional wisdom is too negative on the value of active management (also see Amihud, and Goyenko (2013) and Elton & Gruber (2020)).