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INDIA'S ESG MUTUAL FUND FINANCING: A REALITY CHECK

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ABSTRACT

Globally and in India investors now demand corporates to discharge not only their societal concerns but also environmental and governance obligations. Corporate social responsibility gained momentum long back, in India Companies Act 2013 made it mandatory for certain companies to invest 2% of the net average profits of the last three years on social activities. But now investors are also focussing on climatic and good governance factors. Post Covid-19, sustainability has been buzzword. Everyone in general and informed investors in particular want to invest in corporates having good environmental, social and governance impact. This brings into picture ESG investing. ESG investing means investing in corporates which work towards achieving sustainability by following Environmental, Societal and Governance parameters. ESG investing may be in form of stocks, bonds or mutual funds. Since Mutual Fund offer advantages of diversification and penny investing, the paper seeks the evaluate the growth of ESG funds and the challenges faced by ESG investors in India. The study found that though post covid 19, ESG investing got a boost but still the sector is in its nascent stage. There is lack of awareness regarding ESG scores and lack of long-term data to adequately evaluate performance of the fund. Nevertheless, in long term, ESG mutual funds will provide the much-needed finance to achieve sustainable goals.

Keywords: *Governance, Environment, Social, Sustainability, Covid 19, ETF, Fund of Funds.*

Introduction

Environmentally mindful, ethical and socially responsible investors are looking beyond traditional investments which mainly focusses on financial parameters of growth and higher returns as the selection criteria Approximately two-thirds of millennial and Gen Z investors are concerned about environmental and social issues like carbon emissions and income inequality (Gelfand, 2022). Hence, Corporations have also started aligning their investments in line with global ESG concerns (Alsayegh et al., 2020). This brings into picture financing opportunities in the form of ESG investing. ESG financing stands for environmental, social and ethical financing. ESG investing can take the form of bonds, stocks or mutual funds. Since this being new arena of investment and mutual funds offer the benefit of expert advice and penny investing, the paper tries to understand the ESG mutual fund industry in India, the advantages and challenges of investing in ESG mutual funds.

ESG Mutual Funds-Concept

ESG mutual are thematic funds that invest in socially and environmentally responsible companies. The idea is to finance and support the companies that have positive societal impact. The cost of operation for these companies is high since these companies also spend on addressing environment and stakeholders concerns but such companies promote long term sustainable development. ESG financing also referred to as sustainable financing is way to future survival. While creating a ESG portfolio, fund house may follow an exclusive as well as inclusive criteria. Exclusive criteria mean excluding companies that invests in activities having negative impact on society like tobacco, alcohol or nuclear weapons. Inclusive strategy involves including companies on their ESG awareness parameters. For this the fund house may look at ESG scores of the companies. Though ESG score is not mandatory but all good companies to get themselves evaluated for the score. In the absence of ESG score the fund house may look for the carbon footprints, societal contribution and the quality of relationship of the company with the stakeholders.

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Literature Review

Several studies have demonstrated a positive correlation ESG performance and firm value. The trend is visible across the globe. As early as 1970's researchers starting exploring link between ESG parameters and corporate financial success. Friede et al. (2015), reviewed 2200 papers, and validated that 90% of the studies establishes positive relationship between ESG and firm financial performance. Another meta-analysis of 132 published papers found that 78% of the papers established a positive linkage between ESG initiatives and firms' performance. (Alshehhi et al., 2018). Several other recent studies also reported that companies which follow ESG initiatives have a positive effect on firm value (Naeem et al., 2022; Velte, 2017; Xie et al., 2019; Yoon et al., 2018). Studies also found that ESG score has a positive effect on financial success (Dalal & Thaker, 2019; De Lucia et al., 2020). Studies further reported that strength in ESG activities and reporting improves firm value in long term(Fatemi et al., 2018; Bhaskaran et al., 2020).

Objectives

- To understand the growth of ESG mutual fund industry.
- To understand the various advantages and disadvantages of investing in ESG funds.
- To evaluate the challenges faced by the sector.

Evolution of ESG Mutual Funds India

Though world-wide ESG mutual funds existed long back, in India first ESG mutual funds was introduced in 2019 by Quantum Mutual Fund. Although SBI Magnum ESG Equity fund came in 2018 but it was a scheme which was relaunched by renaming an old scheme SBI Magnum Equity fund. The journey to 2019 launch of Quantum Mutual Fund dates back to year 2008. K.L.D. Research & Analytics, CRISIL and Standard and Poor launched the first S&P E.S.G India Index in the year 2008. It was the first index that comprised investible universe of companies that met environment, ethical and social concerns. In 2009 Ministry of Corporate Affairs talked of corporate governance for the first time. It advised all companies to prepare policies and discharge their corporate social responsibility. In 2012, Securities and Exchange Board of India mandated almost 100 listed companies to report about their CSR activities in annual report. In 2014, government amended in Companies Act requiring companies to spend 2% of their average profits of preceding 3 years on C.S.R. activities. In 2015 SEBI further extended the scope of mandatory CSR spending to more companies. In 2016, SEBI issued green bonds guidelines.

Growth of ESG Mutual Fund Industry-India

Since the launch of first domestic ESG mutual fund in 2019 awareness about concept and importance of sustainable financing has increased. In 2020 six fund houses launched their ESG funds viz. Axis, ICICI, Quant, Mirae Asset, Kotak, and Aditya Birla Sun Life As on September 30, 2021, post second wave of Covid -19, there were eight ESG Thematic equity schemes with an AUM of INR 12,085 Crores, one ESG ETF and one ESG ETF Fund of Fund with AUM of INR 174 Crores and 144 crores respectively. (SEBI Report 26 oct 2021). At present there are 10 ESG fund scheme of which 8 are equity and one is ETF and one is fund of funds. On 30 May 2023, AUM under Equity ESG was INR 10011.65 Crores, AUM under Fund of Funds ESG was INR 117.65 Crores and ESG ETF was INR 136.57 Crores. AUM under all three categories have fallen from 2021 levels. This implies outflows are more than inflows in these schemes which explains why no ESG funds have been introduced recently.

Table 1: List of ESG Fund Schemes in India

ESG Mutual Fund Scheme	Category	AUM as on 30 May 2023 (in crores)
SBI Magnum Equity E.S.G. Fund	Equity	4543.71
Quantum India E.S.G Equity Fund	Equity	63.08
Axis E.S.G. Equity Fund	Equity	1496.55
ICICI Prudential E.S.G Fund	Equity	1219.28
Invesco India E.S.G Equity Fund	Equity	597.97
Aditya Birla Sun Life ESG Fund	Equity	800.50
Quant E.S.G Equity Fund	Equity	165.09
Kotak E.S.G. Opportunities Fund	Equity	1125.47
	Total	**10011.65**
Mirae Asset Nifty 100 ESG Sector Leaders Fund of Fund	Fund of Funds	**117.65**
Mirae Asset Nifty 100 ESG Sector Leaders ETF	ETF	**136.57**

Source: Author's Compilation from web portals of various mutual fund houses

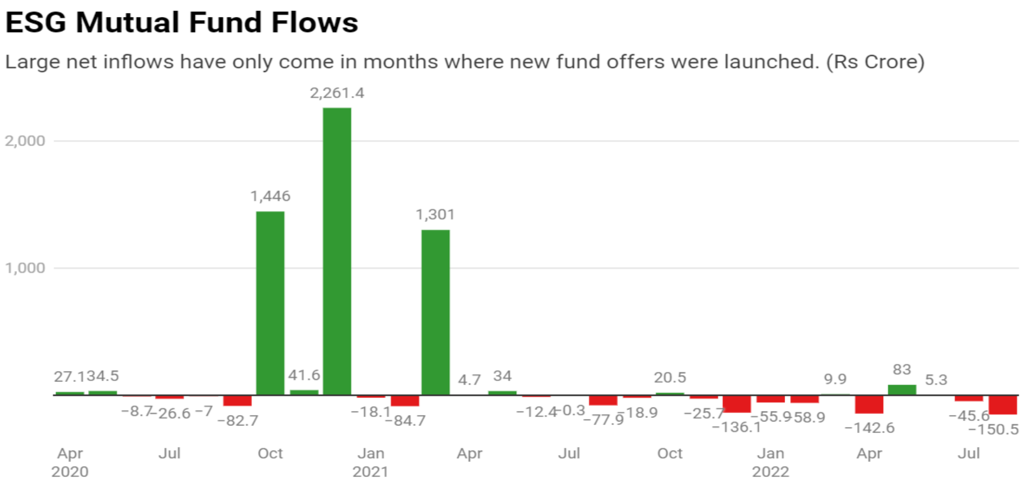

Chart: 1: ESG Mutual Funds Inflows(in crores) from April 202o to July 2022

Source: Bloomberg: https://www.bqprime.com/

Since June 2021, the sector is witnessing net outflows which is not a good sign and indicates some underlying problem with the ESG mutual fund which is making these not so popular with the investors.

Advantages

- ESG funds provide an opportunity to invest in companies having good societal impact.
- ESG funds are good investment opportunities for socially ethical enlightened green investor.
- ESG funds can provide superior risk adjusted returns as compared to traditional funds.

Disadvantages

- **Greenwashing:** Many companies are resorting to greenwashing to lure green investors by making false claims about their ESG activities just to attract green investments. This defeats the entire purpose of green investing and confuses the investors in selecting the right investment.
- **Absence of Stringent Regulations:** A company after raising money on premise of ESG investing may or may not use the proceeds for sustainable activities. There are no clear guidelines to ensure adherence to sustainable investing.

Reality Check /Challenges

The growth showed considerable promise in 2020 and year 2021.However, Post Covid-19, this sector has failed to achieve expected growth. The reasons for this may be found in the following contentions:

- **Lack of data on ESG parameters:** While selecting a security, the fund house may look at ESG score of the companies. Since ESG score is not mandatory, not every company gets it. In that case while evaluating a company the fund house may obtain such data from company's sustainability report, annual report, news articles and any other publicly available information. But it is very tedious and time-consuming task to evaluate each and every company like this. Hence, in selecting a ESG portfolio, fund manager faces data collection and accuracy issues.
- **Absence of Market Standards:** The term ESG investment is very wide. It includes all sorts of environmental, social and impactful investments. Further there is absence of standardisation in collection of data, its reporting and impact measurement standards adopted by companies. This further makes the comparison and selection of companies difficult.
- **High Operation Costs:** Operating costs of ESG funds is very quiet high as compared to traditional mutual funds. This is due to extra time and effort involved in selection of companies for the portfolio. This extra operation cost eats into the returns of the fund, A traditional investor does not understand these nuisances and compare the funds on the basis of NAV. This leads to lesser demand for ESG funds.

- **Little depth in ESG Mutual Fund Industry:** Since ESG Fund has lesser awareness among investors as compared to traditional funds, there is lack of depth in ESG mutual fund industry. Lack of depth further makes ESG funds less popular making it a vicious circle.
- **Recent Initiative:** First ESG mutual fund was launched in India as recently as 2019. Rest of the funds have come up in only last 2-3 years. Hence, in India there is not much long-term data regarding the performance of the ESG funds. Hence, the investors are still sceptical about investing in ESG funds.

Way Forward

In the new normal, post Covid-2019, there is increasing awareness regarding sustainable development. Sustainable development requires greater transparency and accountability on the part of all, particularly investors and corporates. Enhanced sustainable measures involve additional costs which can come through sustainable financing. So ESG financing is the only way out. Though it is still in infancy stage in India. But as the awareness is growing, this industry is bound to grow. This will lead to growth of the sector which will lead to more awareness. More awareness will address and resolve many of the challenges faced by the sector. This in turn would mean further growth for industry. Investor who avails the opportunity well in time emerges as the winner. ESG mutual funds investing is that opportunity which an informed investor is surely going to realise sooner.

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