STANFORD CLOSER LOOK SERIES

ESG INVESTING

WHAT SHAREHOLDERS DO FUND MANAGERS REPRESENT?

BY STEPHEN H. HABER, JOHN D. KEPLER, DAVID F. LARCKER, AMIT SERU, AND BRIAN TAYAN
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INTRODUCTION

Institutional voting through the proxy process is a powerful tool for directing corporate governance policy and practices. An extensive research literature demonstrates the leverage that institutional investors have over governance choices, such as director elections, executive pay, and mergers and acquisitions.[1]

In recent years, institutional investors have played an increasingly prominent role in determining the outcome of shareholder-sponsored ESG (environmental, social, and governance) proxy proposals. ESG proxy proposals generally seek to require a company to make investment or engage in activities for the benefit of stakeholders, with the cost of the activity funded by shareholders. Examples of ESG proposals include those that would require companies to reduce Scope 3 carbon emissions, report on gender pay gaps, report on the use of child labor in supply chains, and conduct racial equity audits. Whereas a decade ago, proposals such as these rarely received majority support, recent years have witnessed a surge in average support and number of proposals passing. According to data from ISS, average support for environmental and social shareholder-sponsored proxy proposals among S&P 500 companies increased from 18 percent in 2012 to 35 percent in 2021, while the number of proposals passed increased from 0 to 28.[2] Large institutional investors have played a critical part in these outcomes because of the size of their ownership positions.[3] A decade ago, major institutional investors rarely voted in favor of environmental and social proposals, but many have since adopted guidelines that are generally supportive of ESG.[4]

The financial benefits of ESG, however, are not clearly established by the research literature. Various studies find that ESG increases, decreases, or has no discernable impact on corporate performance or stock-price returns.[5] In aggregate they provide no clear direction to inform institutional investor voting. As a result, institutional investors make their own assessment in determining how to vote on proposals.[6] To support an environmental or social proposal, they must determine that doing so is in the financial interest of their investor base or that their investor base supports ESG without a view to its financial impact.

Investor bases, however, are not homogenous in their views or objectives. They include individuals across age, wealth, and other demographic variables who might have different investment horizons, return objectives, and risk tolerances. While considerable research has documented that younger investors are significant drivers of ESG, less research has explored the views of older investors or those with little in terms of retirement savings.[7]

In this Closer Look, we examine individual investor perception of ESG to gauge their concern for environmental and social issues, their view of whether fund managers should use their voting power to influence ESG practices, and their willingness to sacrifice return in the advancement of ESG objectives. We find that investors are not homogenous in their viewpoints and demonstrate significant divergence based on age and wealth, with the most vulnerable investors—those who are older and those with low levels of savings—largely opposed to ESG and unwilling to risk their assets to advance these objectives, in contrast to younger, wealthy investors who are much more supportive and willing to forfeit returns. Significant differences in perception of ESG also exist within and across fund companies. The results suggest that fund managers should consider the various viewpoints of their investor base and potentially split their votes on controversial proposals to reflect the divergent interests of beneficial owners.

INDIVIDUAL INVESTOR VIEWS OF ESG

In summer 2022, the Rock Center for Corporate Governance, the Hoover Institution at Stanford University, and the Stanford Graduate School of Business jointly surveyed 2,470 individual investors, widely distributed by geography, age, wealth, race, and gender.[8]

Respondents have average (median) investments worth $198,900 ($125,000) held across retirement and taxable accounts. The wealth levels of respondents are fairly evenly distributed with 33 percent having total investments less than $50,000, 38 percent between $50,000 and $250,000, and 30 percent greater than $250,000. Their money is invested through mutual funds and exchange-traded funds offered by Fidelity (47 percent of respondents), American Funds (40 percent), Vanguard (31 percent), Invesco (18 percent), BlackRock/iShares (16 percent), State Street/SPDRs (16 percent), and other fund companies (22 percent—see Exhibit 1).

We group investors by age, with "young investors" (Millennials and Generation Z) defined as those aged 18 to 41 years old, and "older investors" (Baby Boomers and older) defined as those 58 years and older. Generation X investors are 42 to 57 years old.

Concern for Social and Environmental Issues by Age

Survey responses highlight considerable differences in views on ESG based on age. For example, while 70 percent of young investors say they are very concerned about environmental issues (such as carbon emissions goals and renewable energy sourcing), only 35 percent of older investors say the same. Most older investors (65 percent) have low concern for environmental issues. Similar patterns are exhibited with social issues, with 65 percent of young investors saying they are very concerned about social issues (such as workplace diversity, income inequality, and workplace conditions), compared with only 30 percent of older investors.

Younger investors also profess to have more concern for governance issues (such as CEO also serving as board chair, independence of the board, and board members not overly busy in terms of outside obligations), with 64 percent saying they are very concerned about governance, compared with only 28 percent of older investors.

Older investors are also much less willing to see the investment company that purchases stocks for them through mutual funds or exchange-traded funds use their size and voting power to influence the environmental practices of companies. Less than half (42 percent) say it is extremely or very important to them that they influence environmental practices, compared with 79 percent of younger investors. Older investors also do not want to see investment companies advocate for social (36 percent) or governance (34 percent) issues.

Older investors are even less willing to *lose money* as a result of how their fund manager vote regarding ESG. Only 35 percent of older investors want their fund manager to use its voting power to influence environmental practices if doing so were to decrease the value of their investment. Even fewer want their fund manager to influence social policies (29 percent) or governance practices (26 percent) if doing so were to lead to a loss of wealth (see Exhibit 2).

These responses underscore the importance of economic analysis in determining how to vote on ESG-related proxy proposals, with older investors in particular unwilling to bear financial loss as a result of ESG.

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Concern for ESG by Investment Company

The survey data also demonstrates differences in views on ESG across investment fund companies. For example, we find that investors in funds offered by State Street and Invesco have nearly twice the net concern level for environmental issues than investors in funds offered by Fidelity. (Net concern is calculated as the percentage of investors responding they are "very concerned" minus those who are only "somewhat or not concerned."). Investors in funds offered by Capital Group (American Funds), BlackRock, and Vanguard fall in the middle in terms of concern.

Similar patterns show up with regard to social and governance issues, with investors in funds offered by State Street having twice the net concern level compared with investors in Vanguard and Fidelity Funds.

Investors who do not use any of these fund companies have very different profiles from those who do invest through these fund companies. By a wide margin, investors who do not use these fund companies have significantly lower concern levels for environmental, social, and governance issues than investors who do use these fund companies (see Exhibit 3).

The data shows that investors select into funds based in part on perceptions of the stances those funds have on ESG-related issues. The data also suggests that investor preferences for ESG-related issues are not homogenous and vary across funds and fund families.[9]

Willingness to Pay for ESG by Age and Wealth

Next, we consider the extent to which investors are willing to trade off investment returns to improve the environmental, social, and governance practices of companies they are invested in.

We find significant differences based on age. Older investors are overwhelmingly opposed to the idea of forfeiting investment return to advance ESG objectives. When presented with a list of potential ESG initiatives, the vast majority of older investors (between 86 percent and 91 percent, depending on the issue) say they do not want to forfeit any return or only a trivial amount of money (between 1 and 5 percent) to bring about the proposed change. By contrast, most young investors claim to be willing to give up moderate (between 5 and 15 percent) or large amounts (over 15 percent) to bring about environmental, social, and governance changes. Examples include the following:

- *Carbon emission reductions.* 86 percent of older investors do not want to forfeit any of their retirement savings or only a trivial amount to have the companies they are invested in change from industry-standard carbon emission levels to a "net zero" by 2050. This compares with 64 percent of young investors who would pay moderate or large amounts.
- *Workplace diversity.* 91 percent of older investors do not want to forfeit any savings or only a trivial amount to have the companies they are invested in change from industry-average levels of gender and racial diversity to mirror the diversity levels of the general population. Two thirds (62 percent) of young investors would give up moderate or large amounts to increase diversity, while only one third (38 percent) would give up nothing or close to nothing.
- *Labor working conditions.* 88 percent of older investors do not want to give up meaningful investment amounts to have the companies they are invested in be required to provide healthcare coverage for domestic partners, parental leave, onsite daycare, flexible work hours to all employees. By contrast, 62 percent of younger investors would give up moderate or large returns to see these policies adopted (see Exhibit 4).

Next, we test how perceptions vary with current wealth levels. While we might expect that an investor's willingness to forfeit returns is related to their current levels of savings, we find that this is not uniformly true. While young and middle-aged investor preferences do vary with wealth, the preferences of older investors do not.

Specifically, we find that older investors with very modest savings (less than $50,000) are almost equally opposed to the idea of forfeiting investment savings to advance environmental, social, and governance initiatives in their investment portfolio as are older investors with very large savings (over $250,000). Across all issues and wealth levels, we find that older investors would be willing to give up only around 2 percent of their wealth to support ESG.

This is not the case for younger investors. While younger investors are willing to give up more than older investors, their willingness to pay falls precipitously with decreasing wealth. On average, younger investors with large levels of wealth (over $250,000) say they would give up approximately 14 percent of their wealth to advance ESG issues, while those with modest savings (less than $50,000) would only give up 5 or 6 percent (see Exhibit 5).

This underscores that young investors, and in particular young wealthy investors, are the primary driver of ESG. Aside from ideological preferences, the willingness of this demographic to forfeit such large levels of wealth might be due to the fact that they have accumulated large investment balances early in their lives or a recognition that they are most exposed to the long-term cost of environmental or social failure. It might also be driven by unrealistic expectations for future market returns.[10]

Willingness to Pay for ESG Across Fund Companies

We see that investors across various fund companies exhibit very different attitudes toward their willingness to pay for ESG. A significant percentage of investors in Fidelity and Vanguard funds (between 40 and 45 percent, depending on the issue) are not willing to forfeit meaningful amounts of money to improve environmental, social, and governance practices. Sizeable minorities within the investment bases of American Funds and BlackRock (25 to 30 percent) are similarly unwilling to give up meaningful savings. By contrast, investors in funds offered by State Street and Invesco claim to have a much greater willingness to forfeit savings to advance ESG (see Exhibit 6).

Finally, investors across all demographics believe that fund managers should take into account their personal views when the manager uses their shares to vote on environmental, social, and governance issues. 83 percent of investors hold this view, which does not vary significantly by age or wealth.

CONCLUSION

Overall, these survey results demonstrate distinct differences in preferences for ESG across age ranges. This includes differences in concern for environmental, social, and governance issues, in support for fund companies' use of an investor's shares to advance these issues, and in willingness to forfeit investment balances or future returns to promote ESG. While age is a significant driver of these differences, so is wealth—with older investors and investors with the least savings most opposed to the concept of forfeiting retirement savings to advance environmental, social, and governance causes.

Survey results also demonstrate significant variations across investment companies. Investors clearly select into funds in part based on their views of the stances those fund managers take with regard to ESG advocacy. Even within funds, however, heterogeneity of preferences can be observed. Nevertheless, shareholders across all demographic groups express a desire that their fund managers vote their shares in accordance with their (the investor's) personal views. These results suggest that in situations where the fund manager does not have a definite view on the economic benefits of shareholder-sponsored proxy proposals, the institutional investor might decide to split its votes to reflect the divergent preferences of its shareholder base. For example, a fund whose shareholders are divided 70 percent to 30 percent with regard to a specific topic might choose to allocate its votes on a 70/30 basis to reflect the views of its investors.

WHY THIS MATTERS

1. In recent years, institutional investors have played an increasingly important role in deciding the outcome of shareholder-sponsored proxy proposals regarding environmental, social, and other stakeholder-related activity. Rigorous empirical research, however, does not provide clear evidence on the economic impact of ESG-related activities. How do fund managers determine how to vote shares? How rigorous is their evaluation of the financial impact of these activities on the company and its shareholders? Are their votes based on rigorous analysis or educated guesses?
2. The survey results in this Closer Look suggest that demographic groups express very different willingness to pay for ESG activities. Younger investors, and specifically young investors with large wealth, profess to be willing to forego substantial savings (in excess of 15 percent of their wealth) to advance environmental, social, and governance causes. By contrast, older investors and investors with the lowest levels of savings are opposed to the idea of forfeiting any amount. How do fund managers balance the conflicting interests of their investor base when deciding how to vote?
3. A hallmark of effective corporate governance is the protection of minority interests from potential abuse by majority owners. Would split voting improve mutual fund governance by protecting the interest of minority voters—whether that minority is in favor of or opposed to ESG? ■

[1] See Reena Aggarwal, Sandeep Dahiya, and Nagpurnanand R. Prabhala, "The Power of Shareholder Votes: Evidence from Uncontested Director Elections," *Journal of Financial Economics* (2019); Fabrizio Ferri and David A. Maber, "Say on Pay Votes and CEO Compensation: Evidence from the UK," *Review of Finance* (2013); Peter Iliev, Karl V. Lins, Darius P. Miller, and Lucas Roth, "Shareholder Voting and Corporate Governance Around the World," *Review of Financial Studies* (2015); and Joseph A. McCahery, Zacharias Sautner, and Laura T. Starks, "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors," *Quarterly Journal of Economics* (2016).

[2] ISS data from FactSet and WRDS. Calculations by the authors.

[3] According to one calculation, the Big Three institutional investors (BlackRock, Vanguard, and State Street) collectively own approximately 22 percent of the average S&P 500 company. See Sam Potter, "BlackRock-Led 'Big Three' May Forestall Chaos in Stock Markets," *Bloomberg* (June 20, 2021).

[4] See BlackRock, "Making Sustainability Our Standard," (December 2020), available at: https://www.blackrock.com/corporate/literature/publication/esg-integration-approach.pdf; Capital Group, "ESG Policy Statement," (August 2022), available at: https://www.capitalgroup.com/advisor/pdf/shareholder/ITGEOT-001-643701.pdf; Fidelity Asset Management, "Report on Investment Sustainability and Impact," available at: https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/mutual-funds/Stewardship-report.pdf; State Street Global Advisors, "Asset Stewardship Report," available at: https://www.ssga.com/us/en/institutional/ic/insights/asset-stewardship-report; and Vanguard Group, "Investment Stewardship," available at: https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/perspectives-and-commentary/IS_about_our_program_092021_online.pdf.

[5] For extensive reviews, see Joshua D. Margolis, Hillary Anger Elfenbein, and James P. Walsh, "Does it Pay to Be Good...And Does it Matter? A Meta-Analysis of the Relationship between Corporate Social and Financial Performance," *Social Science Research Network* (March 1, 2009), available at: https://ssrn.com/abstract=1866371; Markus Kitzmueller and Jay Shimshack, "Economic Perspectives on Corporate Social Responsibility," *Journal of Economic Literature* (2012); and Ulrich Atz, Zongyuan (Zoe) Liu, Christopher C. Bruno, and Tracy Van Holt, "Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions," *Social Science Research Network* (September 9, 2021), available at: https://ssrn.com/abstract=3708495.

[6] Many also rely on the voting recommendations of third-party proxy advisory firms, such as ISS and Glass Lewis.

[7] Zytnick (2021) examines the relation between the ideological preferences of individual investors and the voting patterns of fund managers and finds no relation (i.e., fund managers do not appear to cast votes in a manner that reflects the ideological preferences of investors). See Jonathon Zytnick, "Do Mutual Funds Represent Individual Investors?" *Social Science Research Network* (December 21, 2021), available at: https://ssrn.com/abstract=3803690. For a summary of the views of younger investors toward ESG, see Sergio Alberto Gramitto Ricci and Christina M. Sautter, "How Retail Investors Yolo for Environmental and Social Causes," *Social Science Research Network* (July 24, 2022), available at: https://ssrn.com/abstract=4171224; see also Rob Bauer, Tobias Ruof, and Paul Smeets, "Get Real! Individuals Prefer More Sustainable Investments," *The Review of Financial Studies* (2021). .

[8] The survey was distributed to a preliminary sample of respondents nationally representative by these attributes. Because respondents were screened to include only those with personal wealth invested in the stock market through retirement or personal accounts (thereby excluding those who do not own stocks), the resulting sample more closely represents the investment public rather than the public as a whole. See: Rock Center for Corporate Governance at Stanford University, the Hoover Working Group on Corporate Governance at Stanford University, and Stanford Graduate School of Business, "2022 Survey on Investors, Retirement Savings, and ESG," (2022).

[9] This is consistent with Hartzmark and Sussman (2019) which shows that investor fund flows respond to Morningstar fund sustainability ratings. See Samuel M. Hartzmark and Abigail B. Sussman, "Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows," *The Journal of Finance* (2019).

[10] The average young investor expects the market to return 15.9 percent over the next year, and 16.8 percent annually over the next ten years. In comparison, the average older investor expects only 4.6 percent over the next year and 10.7 percent annually over the next decade.

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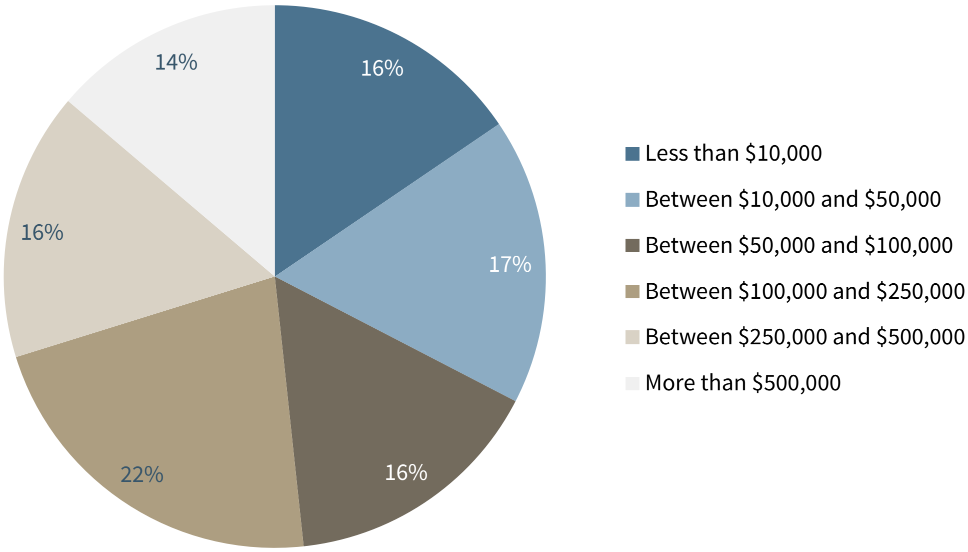
The Stanford Closer Look Series is dedicated to the memory of our colleague Nicholas Donatiello and to the retirement of our colleague Michelle E. Gutman.

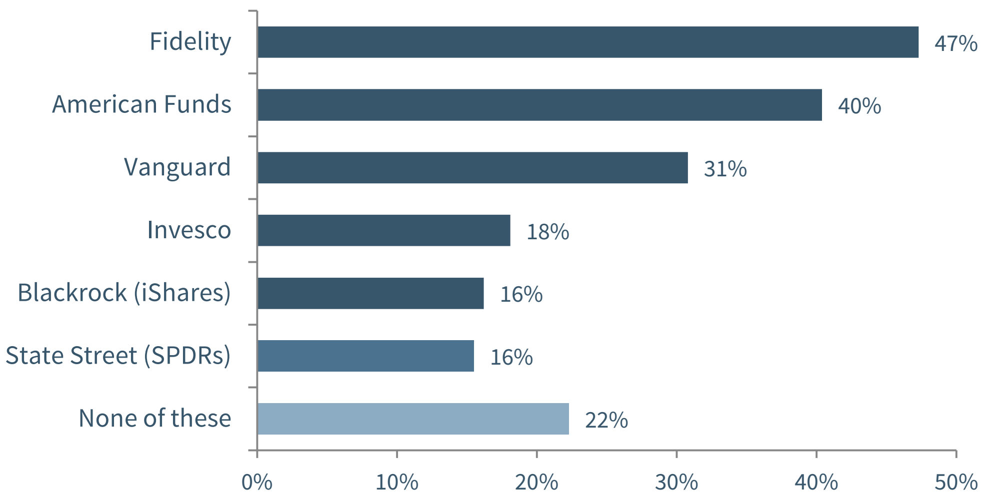
The Stanford Closer Look Series is a collection of short studies that explore topics, issues, and controversies in corporate governance and leadership. It is published by the Corporate Governance Research Initiative at the Stanford Graduate School of Business, The Hoover Working Group on Corporate Governance at Stanford University, and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http:/www.gsb.stanford.edu/cgri.

EXHIBIT 1 — DESCRIPTIVE DATA: WEALTH AND FUND OWNERSHIP

APPROXIMATELY HOW MUCH MONEY IN TOTAL DO YOU HAVE INVESTED IN THE STOCK MARKET, ACROSS ALL OF YOUR ACCOUNTS?



DO YOU HAVE MONEY INVESTED IN MUTUAL FUNDS OR EXCHANGE-TRADED FUNDS MANAGED BY THE FOLLOWING INVESTMENT FIRMS? (SELECT ALL THAT APPLY)



Source: Rock Center for Corporate Governance at Stanford University, Hoover Institution at Stanford University, and Stanford Graduate School of Business, "2022 Survey of Investors, Retirement Savings, and ESG," (2022).

EXHIBIT 2 — INVESTOR CONCERN FOR ENVIRONMENTAL AND SOCIAL ISSUES, BY AGE

HOW CONCERNED ARE YOU ABOUT:

- ENVIRONMENTAL ISSUES (E.G., CARBON EMISSIONS GOALS, RENEWABLE ENERGY SOURCING)?
- SOCIAL ISSUES (E.G., WORKPLACE DIVERSITY, INCOME INEQUALITY, WORKPLACE CONDITIONS)?
- GOVERNANCE ISSUES (E.G., CEO ALSO SERVING AS BOARD CHAIR, INDEPENDENCE OF THE BOARD, AND BOARD MEMBERS NOT OVERLY BUSY IN TERMS OF OUTSIDE OBLIGATIONS)?

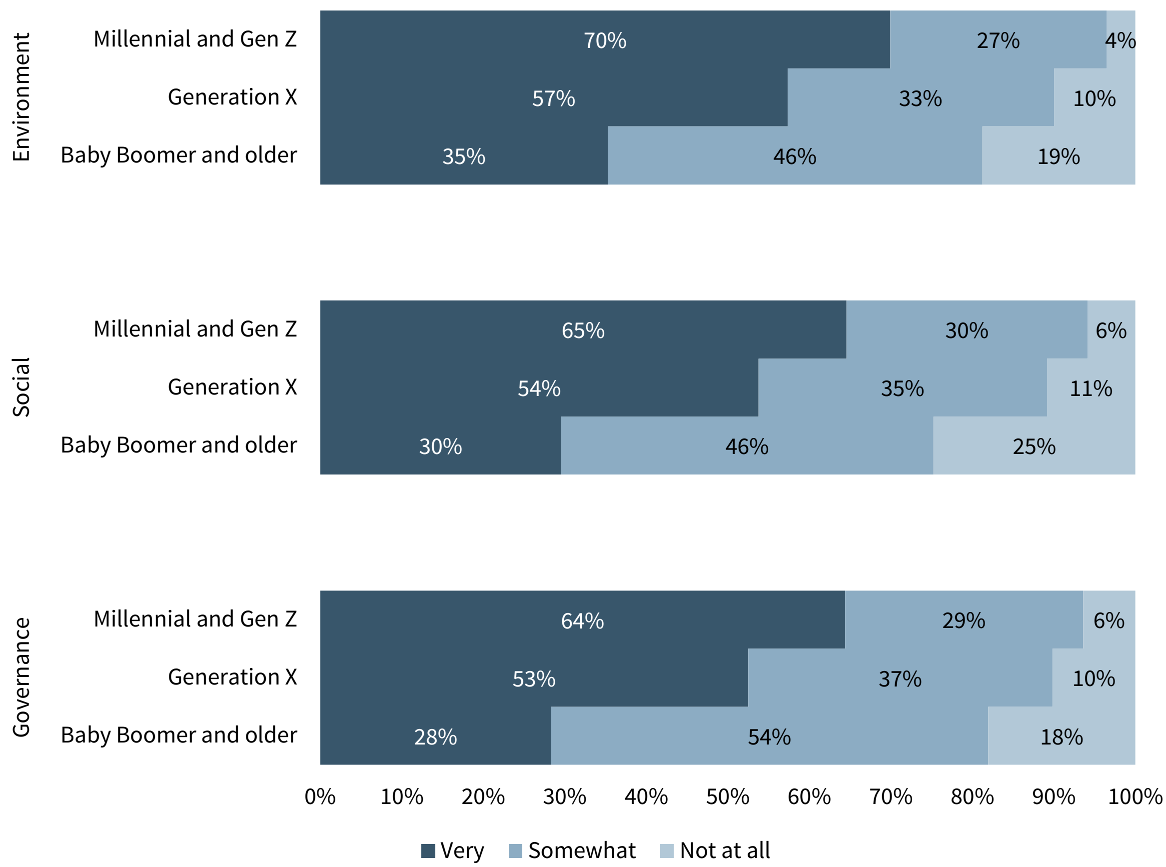


EXHIBIT 2 — CONTINUED

HOW IMPORTANT IS IT TO YOU THAT AN INVESTMENT COMPANY THAT PURCHASES STOCKS FOR YOU (THROUGH A MUTUAL FUND OR ETF) USES ITS SIZE AND VOTING POWER TO INFLUENCE THE ENVIRONMENTAL, SOCIAL, AND GOVERNANCE PRACTICES OF THE COMPANIES IT INVESTS IN FOR YOU?

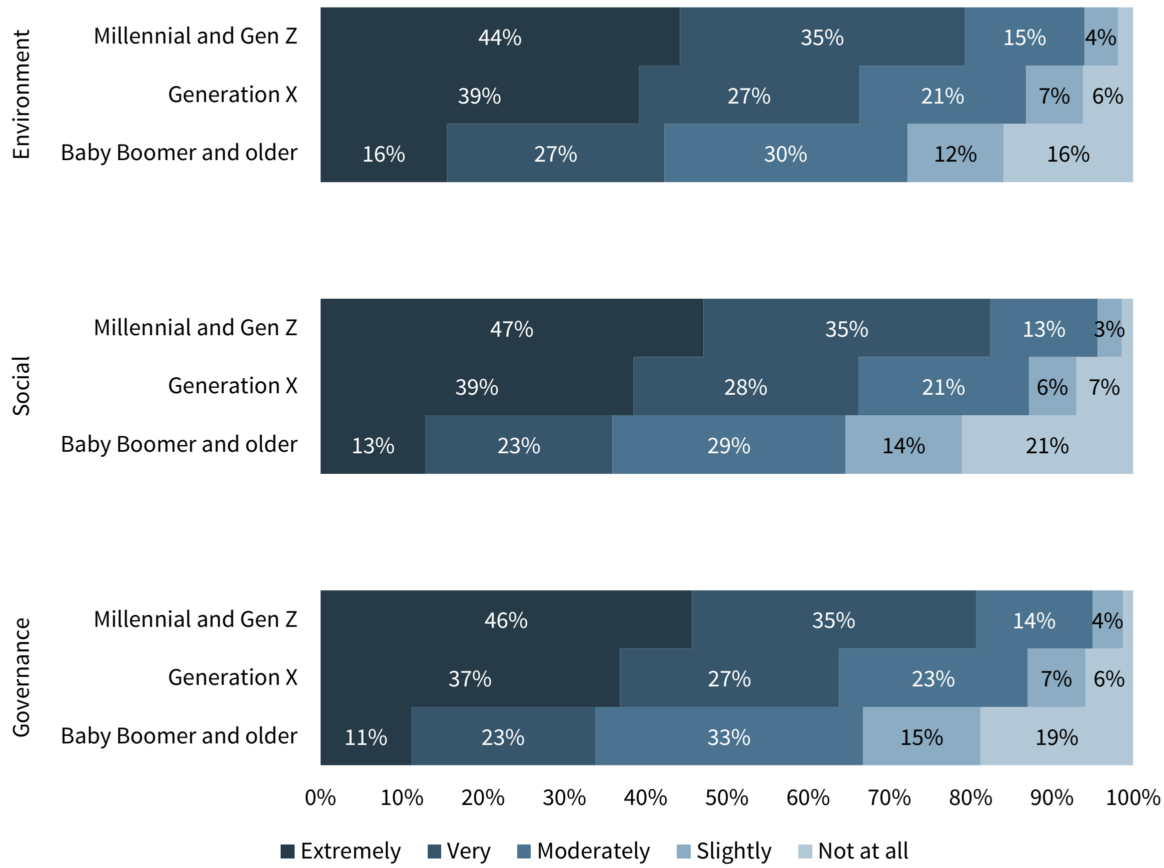
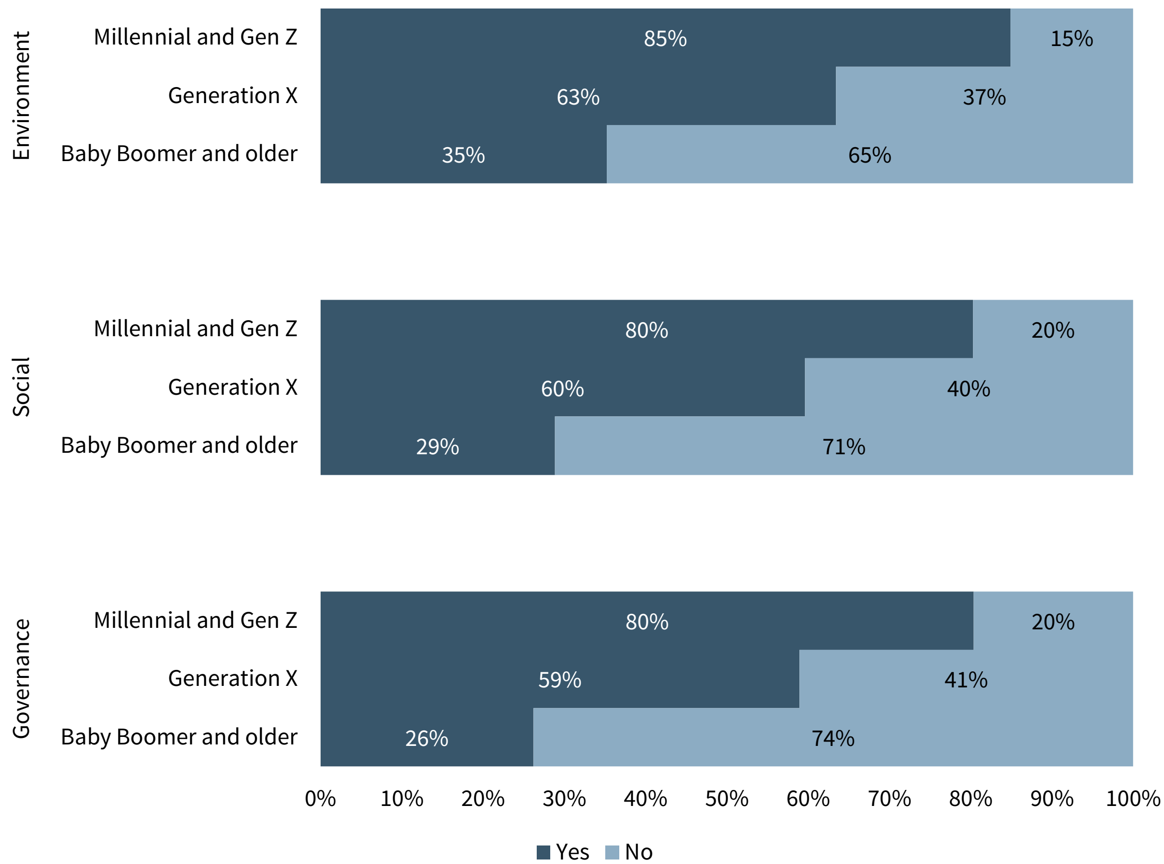


EXHIBIT 2 — CONTINUED

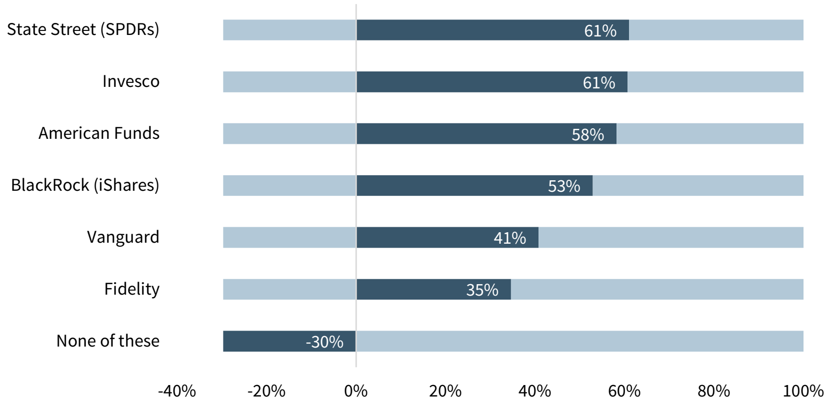
SHOULD THE INVESTMENT COMPANY USE ITS SIZE AND POWER TO INFLUENCE THE ENVIRONMENTAL, SOCIAL, AND GOVERNANCE PRACTICES OF THESE COMPANIES, IF DOING SO DECREASES THE VALUE OF YOUR INVESTMENT?



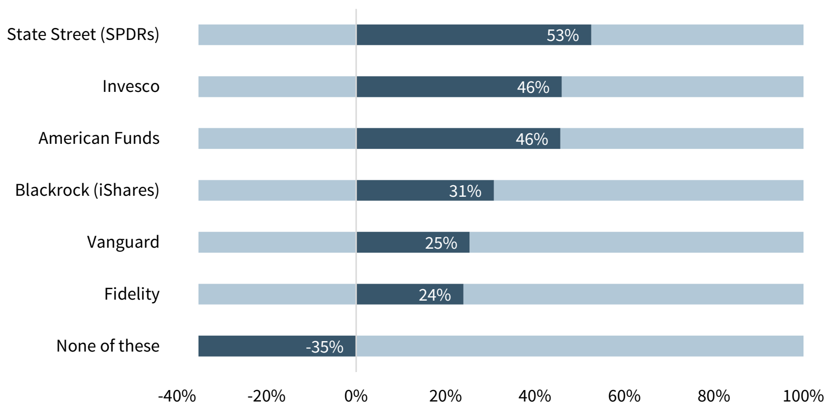
Source: Rock Center for Corporate Governance at Stanford University, Hoover Institution at Stanford University, and Stanford Graduate School of Business, "2022 Survey of Investors, Retirement Savings, and ESG," (2022).

EXHIBIT 3 — NET CONCERN FOR ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES, BY FUND COMPANY

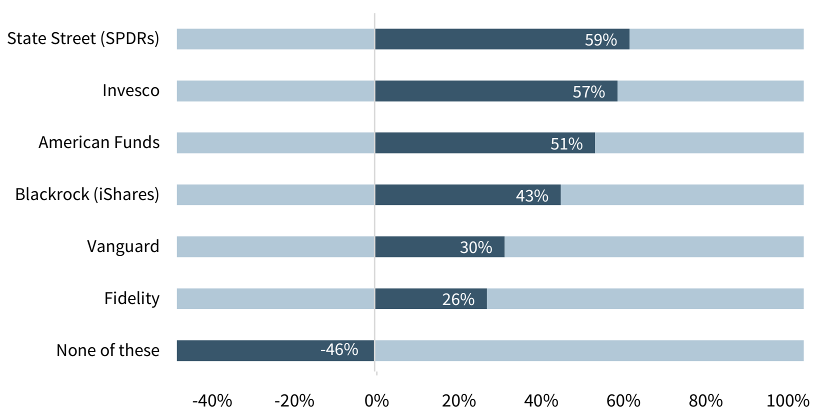
CONCERN FOR ENVIRONMENTAL ISSUES (SORTED BY NET CONCERN*)



CONCERN FOR SOCIAL ISSUES (SORTED BY NET CONCERN*)



CONCERN FOR GOVERNANCE ISSUES (SORTED BY NET CONCERN*)

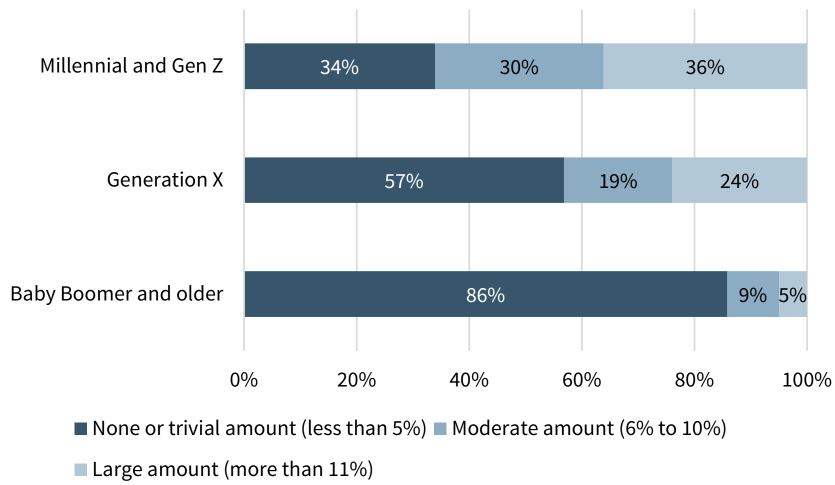


* Net concern is calculated as percentage of respondents “very concern” minus those “somewhat or not concerned.”
Source: Rock Center for Corporate Governance at Stanford University, Hoover Institution at Stanford University, and Stanford Graduate School of Business, “2022 Survey of Investors, Retirement Savings, and ESG,” (2022).

EXHIBIT 4 — WILLINGNESS TO LOSE MONEY TO SUPPORT ESG, BY AGE (SELECTED ISSUES)

CARBON EMISSIONS

Assume you have retirement savings of $100,000. How much would you be willing to lose in retirement savings to have the companies you are invested in change from industry-standard carbon emission levels to a "net zero" by 2050?



WORKPLACE DIVERSITY

Assume you have retirement savings of $100,000. How much would you be willing to lose in retirement savings to have the companies you are invested in change from industry-average levels of gender and racial diversity to mirror the diversity levels of the general population?

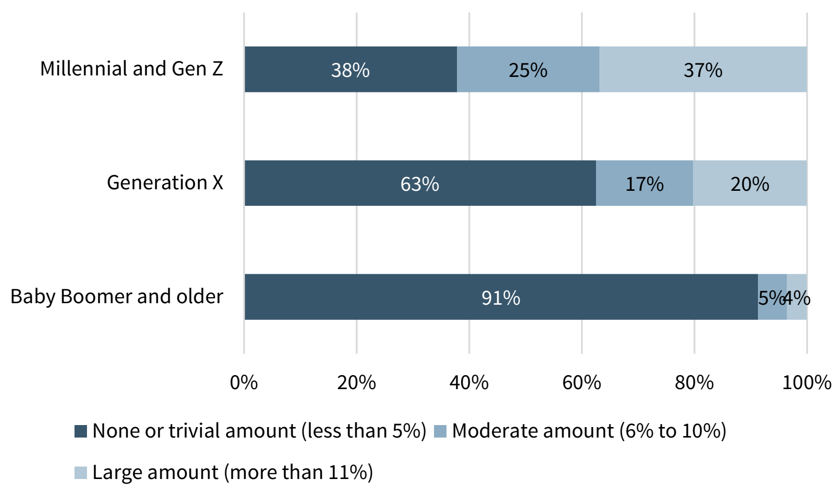
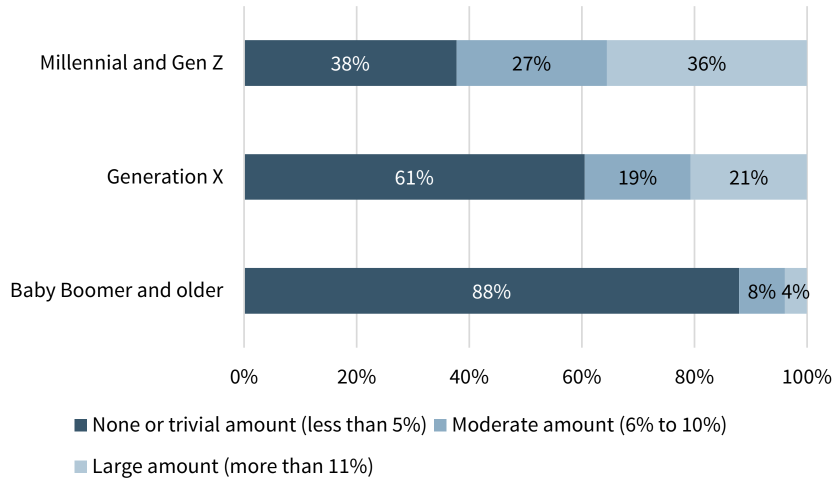


EXHIBIT 4 — CONTINUED

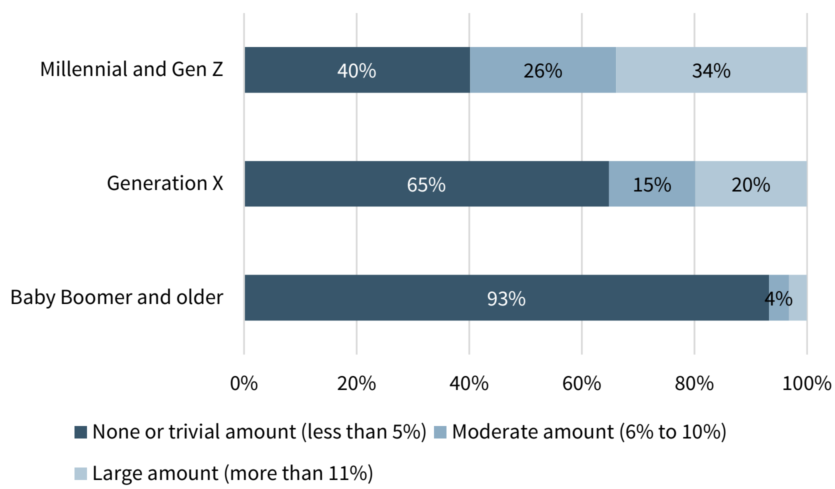
LABOR WORKING CONDITIONS

Assume you have retirement savings of $100,000. How much would you be willing to lose in retirement savings to have the companies you are invested in be required to provide the following to all employees: healthcare coverage for domestic partners, parental leave, onsite daycare, flexible work hours?



CEO ALSO CHAIRMAN OF THE BOARD

Assume you have retirement savings of $100,000. How much would you be willing to lose in retirement savings to have the companies you are invested in be required to separate the chairman and CEO roles?

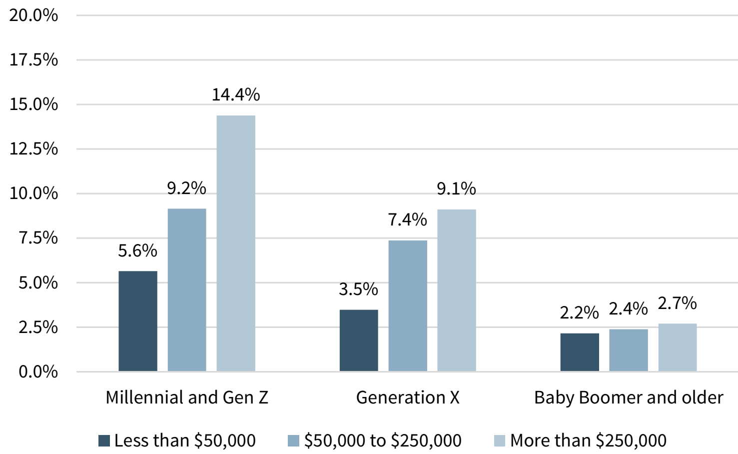


Note: Exhibit presents data for 4 of 9 issues. For more data, see the full report.

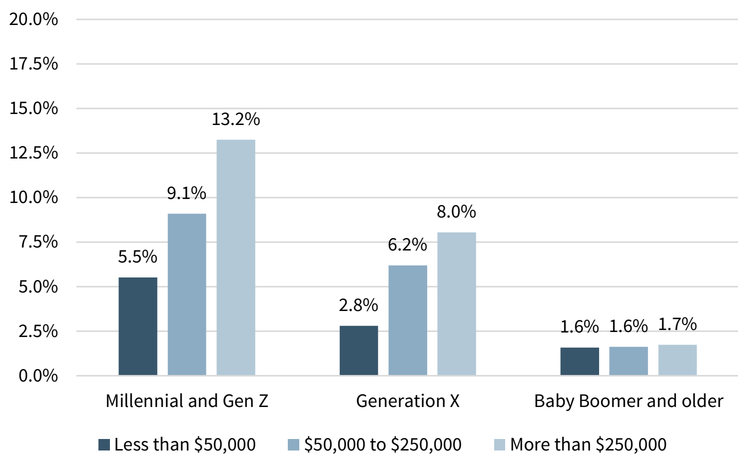
Source: Rock Center for Corporate Governance at Stanford University, Hoover Institution at Stanford University, and Stanford Graduate School of Business, "2022 Survey of Investors, Retirement Savings, and ESG," (2022).

EXHIBIT 5 — AVERAGE PERCENTAGE OF WEALTH WILLING TO LOSE TO SUPPORT ESG, BY WEALTH AND AGE (SELECTED ISSUES)

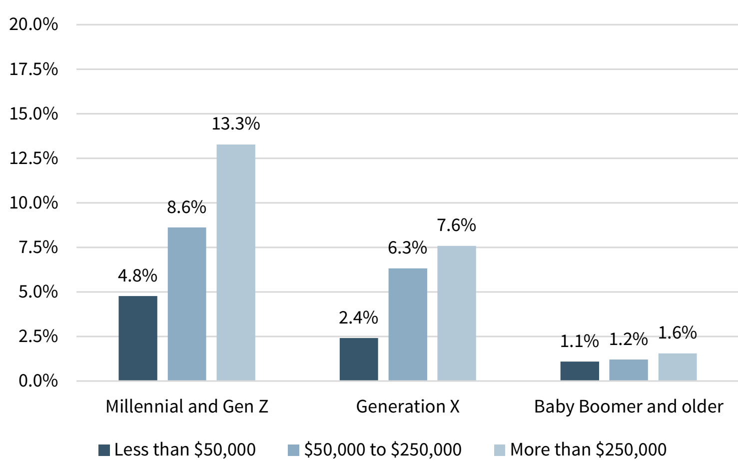
CARBON EMISSION REDUCTIONS



WORKPLACE DIVERSITY



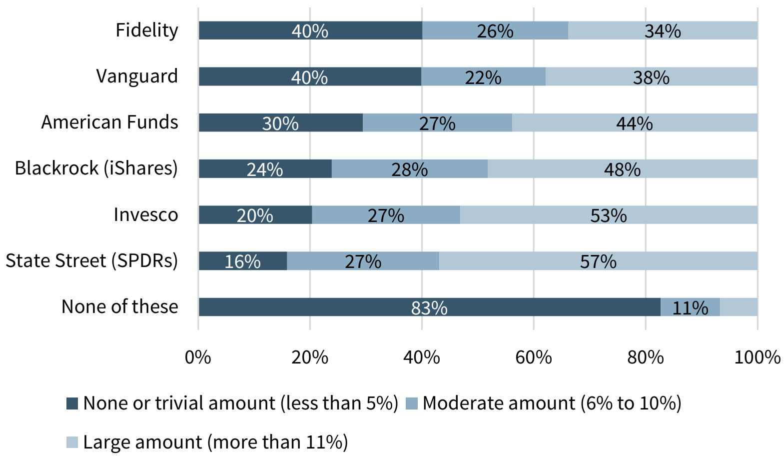
CEO ALSO CHAIRMAN OF THE BOARD



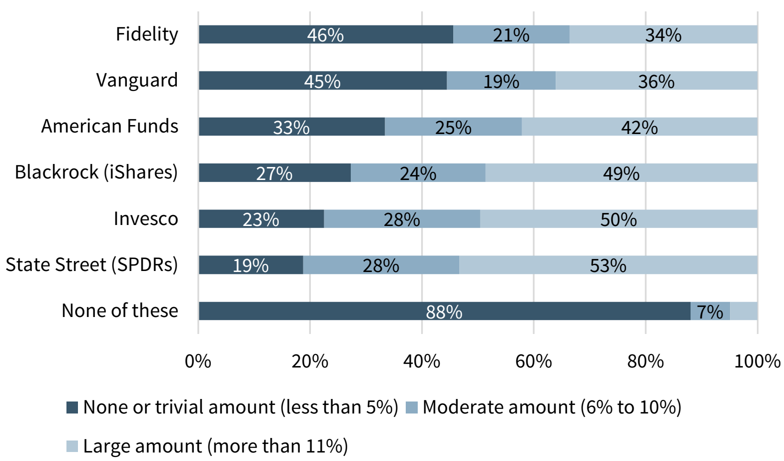
Note: Exhibit presents data for 3 of 9 issues. For more data, see the full report.
Source: Rock Center for Corporate Governance at Stanford University, Hoover Institution at Stanford University, and Stanford Graduate School of Business, "2022 Survey of Investors, Retirement Savings, and ESG," (2022).

EXHIBIT 6 — WILLINGNESS TO LOSE MONEY TO SUPPORT ESG, BY FUND COMPANY (SELECTED ISSUES)

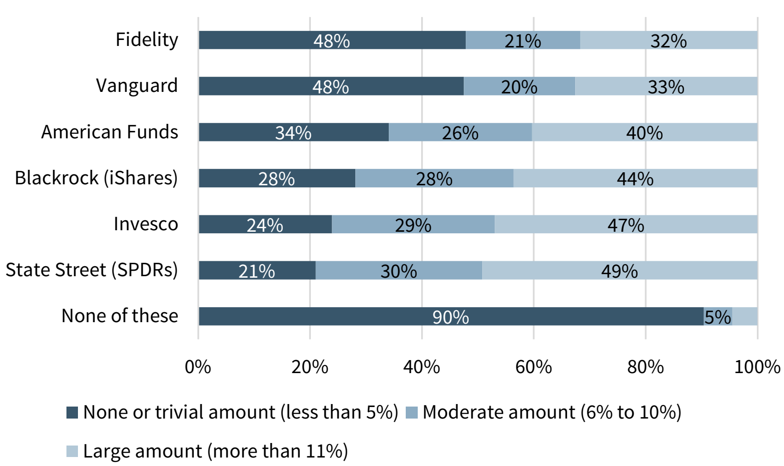
CARBON EMISSION REDUCTIONS



WORKPLACE DIVERSITY



CEO ALSO CHAIRMAN OF THE BOARD



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