Flow-Driven ESG Returns

Abstract
I show that the returns from sustainable investing are strongly driven by price pressure from flows towards sustainable funds, causing high realized returns that do not reflect high expected returns. Using a structural model, I estimate investors' ability to accommodate the demand from sustainable funds, which is given by their elasticity of substitution between stocks. I show that every dollar flowing from the market portfolio into sustainable mutual funds increases the aggregate value of green stocks by $0.4. The price pressure from flows supports the effectiveness of impact investing by lowering green firms' cost of capital. In the absence of flow-driven price pressure, sustainable funds would have underperformed the market from 2016 to 2021. To this end, I develop a new measure of total capital flows into managed portfolios. The price pressure from total ESG flows is highly correlated with empirically observed returns, both in the time-series and in the cross-section. I support the structural estimates with reduced-form evidence, showing that index inclusions and mandate-driven portfolio additions by sustainable mutual funds significantly boost the prices of green stocks.