Battle of Trends: The Rise of Retail Traders and ESG Investing

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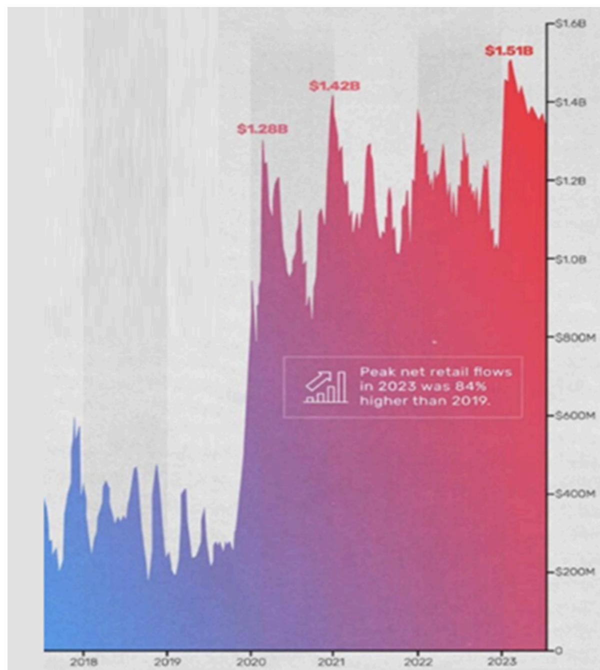
Comparing Two Trends on the Equity Market

The current market landscape can be characterized by a number of trends, but none is as far reaching as the steep increase in retail trader activity. The availability of zero commission trading apps, combined with COVID boredom has incentivized a whole new generation to directly participate in the market (Rao, 2023). In concrete terms, this has led to a more than quadrupling of funds supplied by retail traders in the market (Figure 1). With retail traders now far surpassing hedge funds in terms of market share (Martin & Wigglesworth, 2021), their effect on equity prices becomes increasingly relevant.

In a different vein, another trend driven by recent events is the emerging interest in sustainability within markets, commonly referenced through the ESG matrix. Although ESG started gaining notable notoriety before COVID, its reputation only increased during the ensuing crisis as an alleged means to reduce volatility in uncertain times (Beloskar & Rao, 2023). More concretely, its newfound prominence can be seen in both the steep rise in Google Searches for ESG (Figure 2) and the rapid increase in ESG ETF investment in recent years (Figure 3). Both facts also indicate that this interest specifically includes retail traders.

Neither trend shows any sign of stopping, with apparent growing interest. As such, this article will consider how the inflow of retail investors may influence the effectiveness of ESG investment strategies. The ensuing analysis will make use of various market mechanisms as well as latest research on retail investor interactions with ESG.

Figure 1: Daily Net Flows into the Market from Retail Investors in the U.S.



Source: Rao (2023)

Figure 2: Worldwide Google Trends Results for the Topic of ESG

Source: Google Trends

ESG as a Source of Equity Value

To begin, it may be helpful to provide a brief overview of how the consideration of ESG data may lead to equity gains. Environmental, Social and Governmental performance can be seen as a value driver that enables firms to adapt to the intensifying green transition. In doing so, they can avoid potential risks from non-compliance and make use of all the opportunities that the green transition presents (Cappucci, 2018). As new investment lanes become possible, this all points to an increased efficiency in the company's ability to use resources. Thus, ESG could be seen as a long-term source of benefit.

However, a short-term effect can also be found. Various studies uncover supporting evidence of ESG as a potential source of alpha and a means to improve the immediate efficiency of a company. However, which aspects of ESG contribute in this regard remains a lingering question. More problematically, some studies suggest that while some form of ESG alpha may exist, no single ESG matrix is consistently capable of accurately capturing it (Berg et al., 2022). This is due to measurement error, as individual ESG ratings are fallible to bias. Instead, if investors wish to capture this ESG alpha, a more delicate process of active ESG integration into their investment methodology may be necessary.

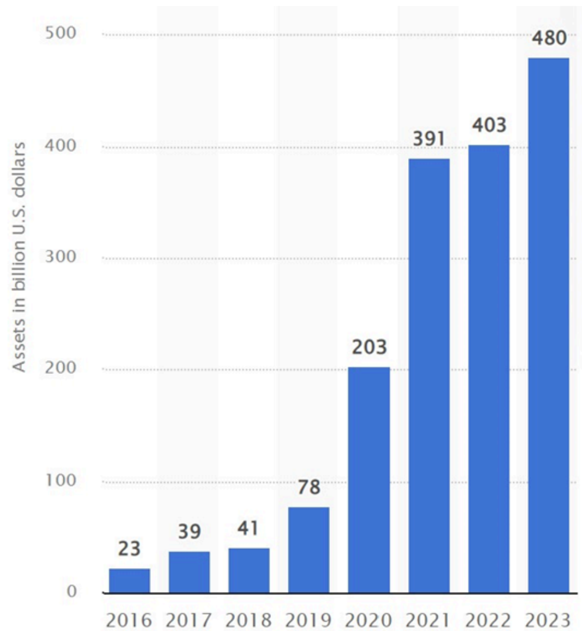
Overall, the above summary suggests the all-encompassing relevance of ESG. Yet, it is also helpful to make a distinction on how ESG information is used by investors. Most notably, ESG scores themselves serve as an indicator of performance. This includes the overall score and various sub-scores. However, there is notable value in considering the changes in ESG scores of individual firms, which avoid overly relying on potentially problematic inter-company comparisons.

Retail Traders Meet ESG

Now that we have an understanding as to how and why ESG translates to equity value, it is finally time to consider the relevance of retail traders.

Interestingly enough, retail investors may play a key role in enabling the added value of ESG. Specifically, research by Liu & Wan (2023) suggests that it is precisely the neglect by retail investors that has driven ESG alpha. The paper points to a strategy wherein excess returns can be made by buying stocks with high ESG ratings and shorting those with low ESG ratings. Yet, if retail traders begin to incorporate ESG into their evaluation, this ESG alpha vanishes or even turns negative. It is also noteworthy that this study only used data between 2009 and 2020. Consequently, it only marginally accounts for today's levels of interest in ESG from retail traders.

Figure 3: Global Investment in ESG ETFs over the years (in $)



Source: Statista (2023)

At this point, it is important to acknowledge the financial motivations of retail investors when it comes to ESG investment. As noted by Li et al. (2024), retail traders are ultimately concerned with financial materiality when interpreting ESG related news. While this does not negate the presence of non-financial motivations, it does suggest limits to its impact. In more concrete terms, it means that retail investors on average play the same game as institutional investors, wherein the final goal is to use ESG to outperform the market.

Of course, this does not necessarily imply the end of ESG as a source of alpha. As suggested previously, ESG investing is much more complex. One cannot simply invest based on ESG ratings from a single rating agency and expect to outperform the market. This may now be truer than ever. Instead, we will next consider in what ways ESG investing must change to accommodate the increased interest from retail investors by moving beyond mere ESG scores.

Difficulty in Formulating a Short-run ESG Strategy

The ESG score typically referred to by investors is actually the outcome of a long and sometimes neglected process. In-fact, the first indication on the current ESG status of firms comes from ESG disclosures released by firms. Yet, retail investors typically fail to make active use of this initial information. Moss et al. (2020) use trading app data to suggest that while retail investors trade quickly on non-ESG disclosures, the same is not observed for ESG disclosures. Even more strikingly, further analysis hints that this is actually due to mere neglect rather than complete inability to interpret ESG disclosure reports. Simply put, there is less perceived urgency from retail investors to use the latest ESG data. This suggests that there is potential for institutional investors to benefit by acting on ESG disclosures before rating agencies incorporate it into their assessments.

Moreover, even when ESG disclosures are processed by rating agencies, not all the findings will be picked up by retail investors. These agencies will employ differing report formats when summarizing their findings. This may subsequently impact whether and how investors use these reports. In particular, Bazrafshan (2023) finds that retail investors are increasingly likely to make use of ESG reporting as summary reports become less detailed. Not only that, but there is also a reverse effect present. As institutional investors have more capacity to make use of complex reports, they are less likely to act on overly simple ESG reporting. With many trading platforms aiming to make relevant information more accessible and easier to interpret, this could see a shift in the use of ESG scores.

The combination of these two mechanisms gives us the first indication about the future difficulty of using ESG. If investors hope to outperform the market, it will become key that they act on the latest ESG disclosures rather than just individual ratings. Not only will disclosures allow investors to act earlier than the rest of the market, but they will include information on specific value drivers. Moreover, the potential of ESG disclosures is bolstered by legislative demand for ESG disclosure. Many countries are formulating legislation to require further ESG disclosures from firms (Fillmann & Kendrick, 2023). While this will complicate analysis of this data, it will simultaneously benefit those with the capacity to utilize it to its full potential.

ESG as a Source of Ongoing Value

As these developments are increasingly linked to firm fundamentals, one may shift their attention to ESG as a long-term source of benefit. Yet, even here the rise of retail traders may have its implications.

Most strikingly, there is some support for the idea that ESG may enable predictable mispricing. Cao et al. (2023) find that when socially responsible funds invest in stocks, these stocks become increasingly less responsive to indicators of mispricing. The effect has only emerged in later years as the implementation of ESG has gained prominence. However, the study data only reaches until 2016 and is therefore unable to account for the latest developments at the heart of our analysis. As many retail traders tend to incorporate both ESG and fundamental data in a somewhat surface level way, one could expect a similar effect emerging. In this case, we would see an even greater distortion as rising numbers of retail investors begin to impact prices.

Overall, these lasting impacts of ESG may serve as an argument for more considerate ESG Integration. In other words, it is key that individual ESG subcomponents are utilized separately for their particular relevance. According to Cappucci (2018), it may even be the case that naive ESG integration ultimately leads to lower returns as its costs outweigh the benefits. Instead, full integration is needed to effectively make use of ESG data. Within the framework of our study, this could be explained by the improving ESG scores becoming priced in due to increasing demand. Simultaneously, potential costs emerge due to increased price inefficiency of stocks with ESG scores. In contrast, ESG integration can potentially pick up on more subtle ESG value drivers that are not necessarily reflected in the overall ESG score. As these features go on unnoticed by the market and gradually materialize, investors will be able to reap the rewards.

Conclusion

To sum up, ESG remains as a value driver, even if its proper integration into trading strategy is likely to become more challenging. The immediate benefit of high ESG ratings will gradually decrease due to demand from retail traders. At the same time, if one goes beyond the singular ESG score, ESG disclosures offer plentiful information to inform the analysis of a company. As such, the ability of investors to benefit from ESG will increasingly hinge on its delicate understanding. By effectively using the whole range of available ESG data, one can better assess the state of the company and how the pricing of its stock is likely to develop.

As a final point, we have to acknowledge some limits of this research. Most of the referenced ESG studies rely on U.S. data, and the observed rise in retail trade is also notably more pronounced in the U.S. Since many retail traders prefer to partake in the equity markets of their home country, this leaves the door open for considerable heterogeneity between countries.

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