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Discussion of "Do Sustainability Ratings Induce ESG Window-Dressing by Mutual Funds"

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Overview

- Institutional background
- Research question
- Hypothesis development
- Empirical implementation

Institutional Background

- What is window dressing in the mutual fund industry?

"An alleged agency problem in the mutual fund industry involves managers altering or distorting their portfolios in an attempt to mislead investors about their true ability by disclosing disproportionately higher (lower) holdings in stocks that have done well (poorly) over a reporting period." from Agarwal, Gay, Ling (2014)

- Why focus on ESG rating window dressing?
  - Investor attention towards ESG issues in the recent decade.
  - Evidence that average investors put positive value on sustainability (Hartzmark and Sussman 2019).
    - Morningstar first published easy-to-access sustainability ratings in March 2016.
    - US mutual funds with extreme high or low ESG ratings experience significant fund flows.
  - Aggregate confusion on ESG ratings and little regulation on ESG funds.

Research Question

- Do mutual fund managers engage in ESG rating window dressing?
  - Is the RQ interesting?
    - Yes, a new setting of window dressing in the mutual fund industry.
    - Suggestion:

    (1) highlight existing mixed evidence and renewed interest (Xin, Yeung, and Zhang 2024 JAR);

    (2) more explicitly argue increased incentives for window dressing pertaining to ESG ratings.
  - Is the RQ important?
    - Yes, regulatory attention and ESG backlash.
    - Suggestion: better motivate the paper to reflect the change in attitudes towards ESG investment.

Hypothesis Development

- What are the incentives for (not) window dressing?
  - Higher net fund inflows, higher management fees
  - Career concerns: Are fund managers good at stock selection?
  - Higher trading costs
  - Being caught by investors/regulators
- What do investors want?
  - Expect high returns for firms (with high ESG scores)
  - Care about ESG issues intrinsically
- Short-term vs. long-term incentives
  - What happens if investors undo the window dressing in the long-run?
  - Do mutual fund managers trade-off short-term and long-term gains?
- Suggestions:

(1) clearly outline the benefits and costs of ESG rating window dressing;

(2) Discuss the interaction between managers and investors and its consequences.

Empirical Implementation

- More analyses exploring the costs and benefits of window dressing:
  - Managerial ability (e.g.,12-month moving average of monthly return gap)
  - Costs of manipulation increase in the later sample period?
- Why not examine the incentives of window dressing before and after 2016?
- More analyses exploring the consequences of window dressing:
  - What are the trading costs of window dressing?
  - Short-term vs. long-term consequences: higher fund collapse rate?
- What about financial performance-based window dressing?
- Is Morningstar rating the only signal that investors care about mutual funds' ESG commitment?
  - PRI signatures?

Empirical Implementation (continued)

- Other empirical issues:
  - Why does the MSCI-based ESG β gap decrease after March 2016?
  - More pronounced effect for the final quarter of the year?
  - Placebo tests using passive funds?
  - Institutional vs. individual shares?
  - Does the change in rating methodology around October 2019 matter?
  - Drop firm-level return analysis?
  - Use the fiscal quarter-end throughout all analyses?

Summary

- An interesting and timely paper.
- Articulate the incentives of mutual fund managers and the interaction with investors.
- Consolidate the tests and focus on P1(a).
- Further develop tests that examine the long-term consequences.
- Good luck with the paper!