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FINANCIAL LITERACY FOR GREEN INVESTMENT: Do green households hold green investments?

BACKGROUND AND MOTIVATION

Climate change and sustainable investment are top of mind for financial market participants around the world, with Environmental, Social and Governance (ESG) considerations becoming increasingly important drivers of investment. Ultimately, these trends pose questions about the interdependencies between socially responsible behavior on the part of the corporate sector, on the one hand, and the investment decisions made by private households on the other.

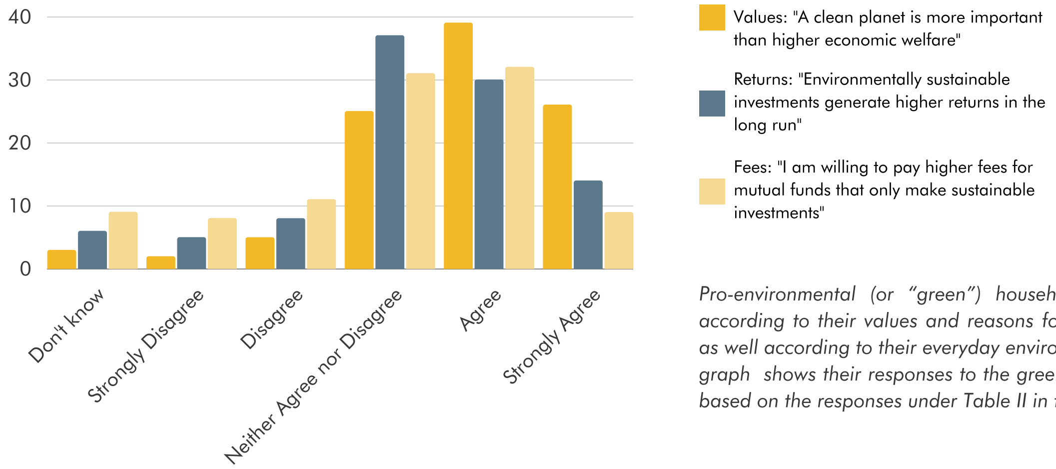
To better understand the impact of ESG preferences on capital market outcomes and firms' behavior, a number of recent studies have empirically tested whether sustainability-aligned investors actually do express their pro-ESG preferences through their portfolio choice decisions. Focusing specifically on environmental considerations, the researchers posed the question whether green households make green financial decisions.

RESEARCH METHOD

To answer this question, 2018 saw the researchers launch an online survey in collaboration with Statistics Sweden. Sent to Swedish households representing 20,000 individuals, the survey's goal was to measure ESG-related investment preferences and behaviors. Almost 4,000 valid responses were received. The responses were then matched with official demographic, individual pension and stock holding data. These statistical comparisons consequently enabled the researchers to relate pro-environmental attitudes and values to actual retirement savings behavior and direct stock holdings.

FINDINGS

The research revealed that pro-environment households are not more likely to hold pro-environment portfolios. There are two key factors driving this result. The first is financial disengagement. The second factor is the presence of informational constraints.



Pro-environmental (or "green") households were categorized according to their values and reasons for their pro-ESG stance, as well according to their everyday environmental behaviors. This graph shows their responses to the green preference indicators, based on the responses under Table II in the paper.

Financial Disengagement

Households that exhibit strong pro-environmental behaviors and beliefs show less financial engagement and a general disinterest in financial matters. Individuals who attach high priority to environmental considerations are around 10% less likely than others to hold stock directly, even when controlling for demographic factors that affect stock market participation like wealth and age. The magnitude of this effect is significant compared to other demographic variables.

In the mandatory pension system in Sweden, a national, tax-shielded scheme similar to the corporate-sponsored 401(k) plans in the US, such households are 20% less likely than others to check their retirement balance. They are also less likely to make an active allocation decision, taking the default allocation option instead. The Swedish default fund is an index fund that includes sizable positions in heavy-polluting firms. From this perspective, inertia may therefore lead to suboptimal choices for green investors.

Informational Constraints

Making green investment decisions involves added layers of informational complexity. These factors prevent less financially sophisticated individuals from expressing their green preferences through their portfolio holdings. For example, among those who make an active choice in their retirement portfolios, environmentally oriented investors are more likely to buy mutual funds with pro-environmental sounding names. Except for those with high financial literacy, they are generally not more likely to buy funds that are labeled as ESG-compliant in the more complex financial statements that households receive every year.

These same households say they recycle more than their neighbors, and say they are willing to pay more for green products. This environmental engagement simply does not to cross over into the realm of financial engagement. The financial disengagement that is documented among the environmentally engaged households is a challenge for the "people's capitalism" concept that underpins many discussions concerning the market's ability to capture pro-social preferences.

IMPLICATIONS FOR RESEARCH AND PRACTICE

These findings are striking in part because average levels of both environmental and financial engagement in Sweden are high by international standards. When focused on high engagement subsamples, there is clear evidence consistent with the predictions of recent theoretical models. That being said, financial engagement is low among most environmentally engaged households, suggesting that the economic mechanisms at work in these models may have limited practical traction. Financial sophistication is a necessary pre-condition for this information to steer capital towards more sustainable uses. For instance, less financially sophisticated investors may be unaware of the potential for polluting companies to adapt to new technologies and to transform going forward.

Implications for Further Theoretical Research

An important topic for future work is incorporating the following into models in which investors harbor environmentally informed preferences.

- Limited participation in the financial market,
- Limited understanding and experience with finance, or financial sophistication and,
- Financial intermediaries (such as fund managers) who cater to their constituents' preferences

Implications for Policy and the Financial Market

Policy makers, regulators, and financial market participants are currently in a debate over how much ESG-related information should be made available to market participants. The paper speaks to three key areas:

- Shifting responsibility
  The task of gathering and processing ESG-related information could be put into the hands of financial intermediaries, such as advisors and fund managers, rather than leaving this to individual shareholders. Intermediaries have an important role in overcoming information asymmetries by gathering and matching investor preferences to portfolios with multi-dimensional goals.

- Addressing informational constraints
  Lowering the informational hurdle will likely lead to an uptake of funds that advertise their sustainability focus among individuals with a strong, pro-social value orientation.

- Consumer protection
  The combination of low financial sophistication and strong willingness to pay for green financial products puts green consumers at a disadvantage compared to industry participants. New certifications and labels must be credibly measured, evaluated and enforced.

AUTHORS AND REFERENCES

Anderson, A. and Robinson, D. T. (2021). "Financial Literacy in the Age of Green Investment". The Review of Finance. Forthcoming.