ESG Investing: 
A Chance to Reduce Systemic Risk

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Abstract

We consider a network of equity mutual funds characterized by different levels of compliance with Environmental, Social, and Governance (ESG) aspects. We measure the impact of portfolio liquidation in a stress scenario on funds with different ESG ratings. Fire-sales spillover from portfolio liquidation propagates from one fund to another through indirect contagion mediated by common asset holdings. The analysis is carried out quarterly from March 2016 to June 2018 using daily data from different sources at fund and firm level. Our estimation strategy relies on a network analysis where funds are not taken as stand-alone entities but are interconnected components of a unified system. We find evidence that the relative market value loss of the highest ESG ranked funds is lower than the loss experienced by the lowest ESG ranked counterpart. Results are robust when controlling for size and for feedback effects. Our model gives new insights to both asset managers and policy makers to exploit the aggregate effect of portfolio diversification related to the system as a whole. Our analysis shows that ESG investing makes the system more resilient to contagion in case of financial distress.

Keywords: ESG investing, Systemic Risk, Market Impact, Network, Indirect Contagion

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