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HOW CAN I TELL IF THIS ESG FUND DIGS DEEP ON SUSTAINABILITY OR IS JUST GREENWASHING?

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Sustainable investing is hot, and when Wall Street sees a trend, it wants a piece of the action.

How hot? In 2020, US SIF Foundation, which measures this type of investing, said 33% of U.S. assets under professional management use environmental, social and governance criteria when investing. That's $17 trillion, or one in three U.S. investing dollars.

No wonder fund issuers are furiously trying to capture those dollars. Morningstar said in July that 25 funds with sustainable mandates launched in the U.S. in the second quarter of 2021, the second-highest number ever issued. As of June 30, there were 437 open-end mutual funds and exchange-traded funds dedicated to this investing style, according to the research firm. How do you know if your fund is really an ESG fund or just a green marketing ploy? Roll up your sleeves, as more than any other investment style, ESG requires you to know

what you want, what you're willing to pay and what the fund will deliver.

ESG investing adds a layer of squishiness to traditional financial analysis because the heart of it is investing according to your values, and everyone's values are different. What's greenwashing to me might be fine for you. It's much more nuanced than buying a low-fee fund that tracks the S&P 500 index.

Here are eight questions to ask yourself so you can decide whether an ESG fund is legit or is just greenwashing.

1. What values are important to you?
Know thyself first. Some investors want to focus on one pillar of ESG, such as the environment. Others want a fund where there's a broad consideration of all three. Ranking the E, S, and G matters because funds may hold companies you don't like, and no company is perfect. For example, if you want a clean-tech company that has strong product safety measures and treats workers well, then Tesla may be a dealbreaker, and you have to decide whether you can nonetheless accept it in a fund.

Consider the type of investor you are to figure out what kind of investment you are looking for – a broad market fund that avoids fossil fuels completely or a narrow niche fund betting on the sometimes-risky companies that might benefit from an energy transition? There's a lot to consider.

2. Can I own a cheap index fund and still be ESG?
It depends on what you want. Sector-neutral ESG index funds try to mimic the broader market to deliver market-like returns while holding those stocks that they believe have the highest total ESG score. The word "total" is doing the heavy lifting here.

The fund company lays out the criteria and methodology, and the index provider selects the holdings using third-party ESG scoring metrics from firms like MSCI or Sustainalytics.

These sector-neutral funds will own companies in "dirty" sectors such as energy or industrials, such as Exxon Mobil. For some ESG skeptics, this greenwashing at worst, a marketing ploy at best.

Others disagree. Todd Rosenbluth, director of ETF and mutual fund research at CFRA Research, says sector-neutral ESG ETFs may own polluting energy companies because the firms' scores on social (such as paying workers well) or corporate governance (like a diverse board) may be strong enough to offset a weak environmental score.

Go beyond the holdings and dig into the prospectus to understand the fund's methodology. Does it screen out certain companies, such as those that make alcohol, weapons or tobacco? Does it include certain types of companies and how do they measure sustainability? The fund should explain how it sets the criteria behind the methodology. From there you can decide if the fund is greenwashing or represents the best in every sector.

"ESG covers a lot of ground and its easy to end up with something that is not as narrowly focused on what matters to you as an investor and thus looks as if you're getting a greenwashed product that isn't as ESG-oriented as you want it to be. The wonderful thing about ETFs is that you can look inside the portfolio before buying it," Rosenbluth says.

3. Are you willing to pay managers to advocate for sustainability?
A criticism of index ESG funds, especially the sector-neutral funds, is they are "light-touch" funds because they're simply a list of high-scoring ESG companies; the portfolio managers don't do anything with that data, such as engage in shareholder advocacy and may not vote at shareholder meetings with ESG in mind. That makes them cheap, perhaps costing 0.10% annually to own, or not much more than the lowest-cost index funds.

Traditionally, sustainable investing centered on actively managed mutual funds where portfolio managers selected companies and engaged with boards to make their operations more sustainable and a higher-quality company, hopefully improving the bottom line over time. That work doesn't come cheap. An actively managed mutual fund may cost at least 0.50% annually, and oftentimes more.

4. Can an ESG fund really be ESG if it holds fossil fuels?
Even sustainability-focused investors argue about this. Many traditional sustainable fund issuers won't own any fossil-fuel producers or utilities that use fossil fuels. That can go as far as not owning a company like NextEra Energy NEE, +0.20% because the utility still uses some fossil fuels to generate electricity while building out renewable energy.

But some sustainable investing fund issuers specifically target utilities and fossil-fuel producers to encourage these companies to move to renewable energy faster than they would on their own. Funds with these advocacy plans, also called stewardship, often score low on ESG metrics. ESG ratings firms don't consider stewardship because right now it's impossible to incorporate it into the simple single-number ESG score. A manager's intention should be explained in the fund's prospectus or the firm's sustainability philosophy and is another reason why ESG investing is nuanced.

5. How can I tell if an ESG fund was rebranded?
A lot of fund issuers are rebranding or repurposing lackluster funds into ESG offerings, says Bob Smith, chief investment officer and president of Sage Advisory, an

ESG advisory service. Morningstar noted in the second quarter of 2021 four existing funds were repurposed to incorporate sustainability. The largest was the $855 million Palmer Square Income Plus PSYPX, , which changed its strategy to align with the UN Global Compact's Principles and Sustainable Development Goals. A change in strategy means the past performance is less relevant.

Whether your fund was spit-shined to reflect ESG is tricky to uncover. Rosenbluth says funds can quietly change strategies and it happens more often than people realize. Changes in names or strategies should appear in a semiannual or annual report.

It may not be all smoke and mirrors, though. He notes portfolio managers who screen for high-quality companies usually consider strong corporate governance as a criteria. That's an ESG characteristic; it's just that the manager may not have called it ESG in the past.

6. How seriously does the fund issuer take sustainability and how does it apply ESG criteria?
It's sometimes hard to tell if a dud of a fund got an ESG makeover, so research a fund issuer's ESG commitment. Poke around the firm's website to see if it has dedicated ESG experts and read about the firm's approach to responsible investing, Sage's Smith says. Look at the firm's stewardship and how it fits into the investment process. Read any research reports or blog posts they publish on sustainability.

Firms with strong ESG commitments make it easy to find for investors to find it. Look for sustainability reports that detail the results of stewardship, proxy votes, carbon footprint and other metrics.

7. When should I expect results from shareholder advocacy?
Greg Wait, adviser at Riverwater Partners, who specializes in ESG, says shareholder advocacy takes years to have an impact. Don't expect overnight success . View ESG as a long-term investment style.

8. Will this fund beat the market?
No one has a crystal ball. ESG funds usually select high-quality companies and that can mean higher performance over time. However, that question gets back to the type of fund it is. The point of a sector-neutral index fund is to post similar returns to a broad-based benchmark.

A highly concentrated, actively managed fund comes with its own risk. An actively managed fund that excludes fossil-fuel companies will beat the market will traditional energy does poorly, but could lag when oil is hot. Like any actively managed fund, you're relying on manager skill to produce returns.