Chapter 10
Assessing the Performance of ESG Mutual Funds and Traditional Funds in Emerging Economies

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ABSTRACT

This study investigates the performance of Environmental, Social, and Governance (ESG) mutual funds compared to conventional funds in the Indian financial market. The objective is to determine if ESG funds can match or surpass the financial

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performance of traditional funds. The methodology includes evaluating performance using the Carhart Four-Factor Model, Jensen's Alpha, Treynor Ratio, and Sharpe Ratio. Additionally, entropy measures—Shannon Entropy, Rényi Entropy, and Approximate Entropy—are employed to assess the volatility and complexity of fund returns. Findings indicate that while conventional funds often deliver higher raw returns, ESG funds excel in risk-adjusted performance, evidenced by higher Alpha and more favourable Treynor and Sharpe Ratios. Entropy analysis reveals that ESG funds exhibit higher volatility and complexity, as elevated Shannon, Rényi, and Approximate Entropy values indicate greater potential for significant returns and increased risk.

1. INTRODUCTION

ESG fund investing has become a trendsetter in the 21st century, capturing the attention and interest of savvy investors worldwide (Thomas et al., 2024). Institutional investors across the globe have already shown considerable interest in ESG investing, leading to fund inflows of $1.921 trillion in 2021 (Lee et al., 2023). Also, access to a growing number of ESG-profiled mutual funds allowed retail investors to consider sustainability factors when making investment decisions (Quirici, 2023). Over the years, ESG funds have demonstrated solid performance despite the substantial variations among them. ESG mutual funds are equity funds of those companies that operate sustainably, thus aligning with UN sustainability initiatives. Even though ESG factors are non–financial, these funds tend to impact the returns of long-term investments (Thomas et al., 2024). When traditional funds focus only on the return aspect, ESG funds propagate the idea of sustainability. Recently, certain US ESG-equity mutual funds have showcased consistent outperformance compared to their conventional counterparts (Raghunandan & Rajgopal, 2022). According to the Sustainable Reality Report 2023, performance sustainable funds have surpassed traditional funds, with a median return of 6.9% for sustainable funds and only 3.8% for the latter (Morgan Stanley, 2023).

ESG investing emerged as a popular investment trend due to the increasing interest of the public in the impact of corporate actions on its stakeholders and society (Curtis et al., 2021). Investing in sustainable mutual funds is often presented as a means of making a socially and financially responsible contribution to society or generating long-term profit (Sandberg & Sjöström, 2021). Capotă et al. (2022) compared conventional and ESG funds; results suggest that investors are ready to return to ESG or environmental funds that have previously had low returns, thus enabling sustainable funds to offer a more reliable source of financing for the green transition. To optimize the performance of ESG investing strategies, it is suggested

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