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Why Do Investors Pay Higher Fees for Sustainable Investments? The role of financial literacy

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At a glance

- The growing supply of sustainable investments, along with increased media attention and EU regulations (like the MiFID II amendments of 2021[1] and the introduction of the SFDR[2]), are bringing more retail investors into contact with sustainable investment products, regardless of their motives.
- Consequently, retail investors face an additional layer of complexity in their investment process, making decisions more challenging and potentially leading to various issues.
- Building on the knowledge that retail investors often overlook the importance of fees, Engler, Gutsche, and Smeets (2024) examine the role of financial literacy on fee sensitivity for sustainable investments among individual investors in five EU countries (France, Germany, the Netherlands, Poland, and Spain).
- The study reveals that financially literate investors are more fee-sensitive, while less financially literate investors tend to pay higher fees. Financially illiterate investors tend to i) overlook fees and ii) mistakenly believe that more expensive funds will outperform after fees.
- The authors show that this problem also exists with conventional investments, but is exacerbated by the added layer of sustainability.
- Investors in Germany and the Netherlands, where average financial literacy is highest, show the greatest sensitivity to fees.
- Therefore, financial regulation must recognize and enhance the role of financial literacy in protecting investors, while taking into account potential country differences.

[1] The Commission Delegated Regulation 2021/1253 amending Delegated Regulation (EU) 2017/565. For empirical evidence and an assessment of the effectiveness of these amendments to the Markets in Financial Instruments Directive II (MiFID II) see also the Policy Brief No. xxx / 2024.

[2] The Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088).

Introduction

The growing supply of sustainable investments, increased media and public attention, and regulatory measures (e.g. MiFID II, SFDR) are bringing more and more individual (i.e., retail) investors into contact with sustainable investments, and sustainable equity funds in particular, regardless of their investment motives. This can be seen as positive from a policy perspective, as individual investors can also contribute to the transition to a low-carbon economy[3], but it can also pose additional challenges for many individual investors, especially financially illiterate investors.

The development of many new financial products and services poses significant challenges, particularly for individual investors with low levels of financial literacy (e.g. Lusardi and Mitchell, 2014). These investors are therefore likely to be particularly affected by the added complexity of sustainable investing. Research shows that knowledge of sustainable investing is limited (e.g. Filippini et al., 2024). It is also known that retail investors often underestimate the importance of fees when making investment decisions or misunderstand their effects on financial returns (Sirri and Tufano, 1998; Hortacsu and Syverson, 2004; Barber, Odean, and Zheng, 2005; Choi, Laibson, and Madrian, 2010; Barahona, 2020). Empirical studies show that fees for sustainable investments are often higher than for comparable conventional investments (Aragon et al., 2022; Baker et al., 2022).

There is a risk that investors, particularly those with limited financial literacy, will pay excessive fees for sustainable investments. Understanding this dynamic is crucial for consumer protection. If investors are paying higher fees not because of a conscious decision to invest sustainably, but because of inattention or misconceptions about fees, they may be vulnerable to exploitation. Examining the role of financial literacy in investors' fee sensitivity is therefore essential to ensure that the growing market for sustainable investments does not disadvantage less informed consumers.

[3] For an overview of impact channels of investment funds see Wilkens et al. (2024), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4205546.

This policy brief summarizes the results of a study in which Engler, Gutsche and Smeets (2024) investigate the extent to which financial literacy influences individuals' fee sensitivity to sustainable investments. Given that EU regulation affects retail investors in all EU countries and that there may be cross-country differences (e.g., in financial literacy), the study examines investor behavior in five EU countries, namely France, Germany, the Netherlands, Poland and Spain. The results of this study are important for understanding the extent to which retail investors, especially those with low financial literacy, need to be protected.

Why do investors pay higher Fees for Sustainable Investments?

Research approach

To investigate these research questions, Engler, Gutsche, and Smeets (2024) conducted three subsequent behavioral economic experiments. Such experiments are used to identify the underlying mechanisms of individual decisions (such as investment decisions) that cannot be revealed by purely observational data, such as capital market observations.

The main experiment was part of an online survey of 5,162 household financial decision makers conducted in 2021 in collaboration with a professional market research institute. The study was carried out simultaneously in five EU countries (France, Germany, the Netherlands, Poland, and Spain) with approximately 1,000 respondents per country. In the experiment, participants allocated money between sustainable and conventional MSCI World exchange traded funds (ETFs). To capture investors' fee sensitivity, each participant was presented with different fee scenarios in random order. To ensure that participants' choices were consequential and that the experimental results generalize to real-life behavior, the investment decisions in the experiment were incentivized. Individual financial literacy was measured using, among other measures, a financial literacy test (Lusardi and Mitchell, 2008, 2011).

To test the robustness of the results in the main experiment and to learn more about the channels through which financial literacy affects sensitivity to fees, the main experiment was complemented with two similar follow-up experiments. For these experiments, 451 and 901 investors living in Germany were recruited via the online platform Prolific. Compared to the main experiment, some aspects of the design were changed and specific questions were added to the questionnaire to better explain the results of the main experiment.

Research results

The findings confirm that financial literacy plays a key role in individual investment decisions, especially in how investors factor in fees:

- **Financial literacy drives fee sensitivity**. Across all five countries, financial literacy emerged as the most significant factor influencing fee sensitivity in sustainable investments. Investors with higher financial literacy reduce their sustainable investments when fees rise, while those with lower literacy are less fee-sensitive or may even increase sustainable investments despite higher fees.
- **Fee sensitivity differs across countries.** The sensitivity to higher fees on sustainable funds varies across the five European countries considered and is highest in Germany and the Netherlands.
- **Country differences can be explained by different levels in financial literacy.** Financial literacy largely explains cross-country differences in fee sensitivity, with German and Dutch investors having the highest average literacy.
- **Key channels are limited attention and the "high price heuristic."** Investors with limited financial literacy i) end to overlook fees and ii) mistakenly believe that higher-fee funds will outperform lower-fee ones, even after fees are deducted. Just as consumers without wine knowledge may choose an expensive wine, assuming that a higher price signals better quality.
- **Adding the dimension of sustainability exacerbates the issue.** Limited fee sensitivity among low-literacy investors is evident for both conventional and sustainable funds, but the added layer of sustainability worsens the issue.

Interpretation of data

Our findings have significant implications for financial regulation. The EU's MiFID II amendment, which came into force in August 2022, requires institutions to ask clients about sustainable investment preferences, but there are concerns that this could be exploited to justify higher fees (ESMA, 2022). Empirical evidence shows that fees for sustainable investments are often higher than for comparable conventional ones (Aragon et al., 2022; Baker et al., 2022).

The findings from Engler, Gutsche, and Smeets (2024) suggest that this is a particular concern for individuals with low financial literacy. These individuals do not make a conscious choice to pay higher fees because they want to contribute to a better world, but they simply do not understand the impact of higher fees for their net returns. Country differences are mainly driven by variations in financial literacy. Therefore, regulation will likely have different consequences in the various EU countries, depending on the average financial literacy. Especially investors in countries with lower average financial literacy are at greater risk of being charged high fees and exploited by financial institutions or advisors.

Policy recommendations

- **Improve individual investors' awareness of fees:** Regulators should work towards individual investors paying more attention to fees. However, simply increasing the visibility of the fees will not be enough. Rather, several measures should be bundled (such as improving the presentation of fees in sales prospectuses, increasing transparency and disclosure, and increasing knowledge about the relevance of fees when buying investment products).
- **Improve transparency and disclosure, but also the presentation of fees:** Regulators should enforce stricter fee disclosure requirements for investment products in general, ensuring that investors are fully informed about what these fees mean for their returns. This could be done by a stronger emphasis on the example calculations in the corresponding key investor information documents and by making those examples more accessible for investors, particularly those with less experience and financial literacy.
- **Promote long-term financial literacy programs**: Another option for improving perceptions and knowledge about fees is long-term financial literacy programs. However, policymakers should be aware that such programs do not tend to produce quick results and that the success of such programs has varied widely in the past.

- **Monitor sustainable investment fees**: Regulators should closely monitor fee structures in sustainable investments, especially in countries where financial literacy is lower. This will help protect less informed investors from exploitative pricing practices.

Implications and future steps

This policy brief emphasizes that financial literacy is the key determinant of fee sensitivity in sustainable investments. As sustainable investing continues to grow, ensuring fair fee structures and improving investor knowledge will be critical to ensure equal access to sustainable investment opportunities across the EU. Regulatory efforts should focus on improving financial literacy and protecting less informed investors from overpaying for sustainable investments. Future work can identify how specific financial education programs could be designed across countries to help investors to better understand the importance of fees.

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About the project

The Sustainable Finance Research Platform is a joint project between five German research institutions conducting research on different aspects of Sustainable Finance, e.g. sustainable investments, sustainability risks and chances, and sustainability reporting. With their independent research, the project partners aim to support stakeholders in politics, the financial sector, and the real economy in understanding and shaping the central role of capital markets in achieving a net-zero economy. The researchers involved answer social, political, and business-related questions, provide established and new research findings, and participate in political and public debate. They also want to establish sustainable finance as a topic in the German research landscape and secure connections with international institutes and processes.

More information can be found on the project's website wpsf.de/en/.

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