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## Investor Psychology and the ESG Boom: A Behavioral Finance Perspective

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### ABSTRACT

The sustainable post-pandemic surge in sustainable and environmental, social, and governance (ESG) investing was a combination of a sincere act of ethical investment and the increasing power of behavioral biases.

The present review paper examines the influence of moral-psychological dynamics, namely moral licensing, framing, the halo effect, and narrative contagion, on the ESG investment behavior through 2020-2025. Based on the information provided by Morningstar, Refinitiv, and OECD, it discovers that the sustainability-related decisions of investors were influenced equally by the narrative and impression as they were by the quantifiable effect. The highest inflows of ESG funds occurred in 2021, amounting to 510 billion, and then declined sharply due to the 2022 energy crisis, a trend that is typical of effect-driven herding. It discusses the effect of ESG narratives on investor segmentation, sentiment, and policy design and finds that behavioral interventions, including the use of simplified disclosure forms, visual scoring, and nudges to transparency, can result in more moral intent and financial rationality being aligned.

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### 1. Introduction

Among the most rapid changes in the global financial preferences that occurred in the years after the COVID-19 pandemic, the mainstreaming of sustainable investing should be mentioned. By 2024, ESG funds under management had assets to the tune of over 3 trillion globally (Morningstar, 2024), which amounts to about 15 percent of total mutual funds in the world. Shareholders gradually developed a more



ethical view of their financial actions in terms of individual or institutional ethics. However, according to behavioral finance, good intentions may be in the company of cognitive distortions.

The present paper builds on the findings of behavioral economics in the general post-pandemic market environment to delve into the psychological processes involved in ESG investing. It discusses the role of identity, emotion, and moral storytelling in sustainable finance decision-making. The study does not concentrate on market performance or regulation but puts an emphasis on the behavioral architecture of participation in ESG- how perception and narrative motivate capital allocation.

## **2. Literature Review**

The traditional focus of behavioral finance is the discussion of irrationality due to heuristics and biases (Barberis and Thaler, 2003). These deviations are enhanced by moral and emotional aspects in ESG markets. According to Merritt et al. (2010), moral licensing is a paradoxical perception that doing a good act will allow oneself to take more risky behavior or inconsistent behavior in the future. When making investment choices, ESG funds make investors feel morally covered, even in situations when the rest of their portfolios are inconsistent with sustainability principles. Framing effects have an impact on the way ESG information is framed. Tversky and Kahneman (1981) have illustrated that presentation is very important in making choices. In the same way, there is a strong response of investors to positively framed sustainability statements (low carbon impact) compared to neutral financial statements.

This bias is further intensified by the halo effect, which implies that when companies or funds are identified as being responsible for the environment, it is believed to have better management or profitability (Statman and Glushkov 2009). These trends are supported by empirical evidence. Briere and Peillex (2023) found green herding among European fund managers, and OECD (2024) surveys of investors found that 62 percent of ESG investors were unable to clearly define what their funds are selecting. This literature makes ESG finance a psychological ecosystem, not just based on ethics but identity, affect, and perception.

## **3. Market Dynamics And Behavioral Indicators**

The growth of the ESG market in the period between 2020 and 2025 can be split into three behavioural stages, including moral enthusiasm (2020-2021), narrative correction (2022), and rational consolidation (2023-2025).



In Phase 1 (2020-2021), the inflows of ESG funds increased by 46 percent per year, and the world funds increased to over 2.5 trillion. The peak of investor sentiment came in mid-2021, with 74 percent of investors surveyed by Morningstar saying that sustainability was more important than returns.

The turning point was phase 2 (2022). Capital has started to leave renewable and clean-tech industries as the cost of energy shot up by 41 percent (Bloomberg, 2024). The outflows of ESG funds amounted to close to 180 billion dollars, which portray the failure of the over-optimistic stories. The emotions were emotional exhaustion and disappointment as the social-media sentiment towards ESG declined by 38 percent than the situation at the time of the past year.

Growth was normalised (partially) to 6 percent per year by Phase 3 (2023-2025). By mid 2025, ESG assets had reached 3.3 trillion, and inflow volatility had dropped by 40 percent compared with its peak of 2021. The transformation is an example of a psychological change from idealistic excitement to a more analytical and evidence-based interaction.

#### **4. Behavioral Mechanisms Behind ESG Narratives**

Narrative contagion, the viral transmission of moral and emotional stories of investment, has been the defining behavioral engine of the ESG phenomenon. In contrast to the classical herding, which is motivated by the numbers, ESG herding is narrative motivated: investors act in a coherent way not because the price changes but because of the similarity of moral frames.

##### **4.1 Identity Reinforcement And Value Alignment**

About 70 percent of millennials and Gen Z investors will say that ESG investing is an extension of personal identity (OECD, 2024). This is behavioral in nature, because people desire identity reinforcement where they would wish there to be consistency between financial decisions and self conception. Investors with elevated environmental identity scores keep ESG assets 1.8 times longer than others, even in drawdown times, which is a demonstration of commitment over the maximization of rationality.

##### **4.2 Emotional Contagion And Media Echos**

Sentiment analysis of 3.4 million ESG-related tweets (2020-2024) by Refinitiv reveals that such emotional words as future, responsible, and green impact are most frequently used in the times of bull markets. The positivity of social-media and ESG fund inflows had a correlation of 0.71. These mood



swings spread hope, which was catalyzing fast, coordinated purchasing. The reversals were validated when sentiment deteriorated after 2022 and investors fled at a rapid rate.

### 4.3 Moral Signalling And Impact Illusion

The visibility of sustainability initiatives is equated with impact by the investors, a biased term known as impact illusion. To illustrate, the companies that had active ESG marketing campaigns earned their capital inflows 60 percent more than their competitors, but their average carbon-reduction scores were 8 percent better (Refinitiv ESG, 2024). This shows that substituting substance with signaling takes place. These can be addressed by simplified outcome measures, such as standardized carbon or diversity disclosures, to address perception gaps.

## 5. Investor Segmentation And Sentiment Patterns

The ESG market behaviour of investors is heterogeneous yet psychologically predictable. OECD surveys and Morningstar fund flows data analysis show three types of behavioral archetypes:

- Ethical Integrators ( $\approx 45\%$ ) -Driven by moral payoff and long-term value fit. They show minimal turnover and are the least receptive to short term performance.
- Trend Followers (approximately 35-37 percent) - they are driven by the media hype and the power of the story they follow; they will enter a market when the media optimism is high, and they will leave the market when the market is becoming volatile.
- Rational Adopters ( $\approx 20\%$ ) – Protection ESG as a risk diversifier are quantitatively scored and not emotional.

Although they seem to be rational, institutional investors are also susceptible to reputational herding. According to the BIS (2024) statistics, 63 percent of managers with large assets changed ESG allocations after competitors had rebalanced their allocations, even though there was no new information. This shows that institutional ESG flows are controlled by social benchmarking and not pure analysis.

These generational differences are also impressive. Gen Z investors (22 percent of new ESG entrants by 2024) were twice as likely to have heard about sustainable investing through social media influencers as financial advisers. The sentiment analysis of Reddit r/investing and TikTok posts indicates that ESG



discussions are expressed in moral terms; words such as good, right, and future are used four times more often than financial terminology such as return and volatility.

This kind of linguistic framing explains the shift between an analytical and ethical investment discourse, and this proves sustainability in finance to be a social identity economy.

## **6. Recalibrating ESG Markets Through Behavioral Design**

Behavioral understanding can also be used to create more successful ESG market design, which will reconcile the ethical motivation and rational assessment.

### **6.1 Simplified Scoring And Cognitive Ease**

Retail investors are usually bombarded with complex ESG rating methodologies. According to the surveys conducted by OECD (2024), only one in four was able to interpret the scales of the ESG score correctly. When metrics were simplified (three visual bands: green (top quartile), amber (mid), and red (low)), more people understood the metrics, and as a result, there was less dependability on fund labels. Behavior design, therefore, facilitates cognitive efficacy and trust.

### **6.2 Choice Architecture And Investor Nudges**

Behavioral cues can be employed by digital platforms to support informed decision-making. An example of this is the 41 percent of users updating their choice to more balanced portfolios after being prompted on an ESG fund to buy by a pop-up showing the top holdings and volatility range of the fund (Morningstar Experimental Study, 2024). Likewise, presenting the carbon intensity of portfolios as an intuitive unit, e.g., number of kilograms of CO<sub>2</sub> offset per 10,000 invested, made more people engage without making them less risk-aware.

### **6.3 Monitoring Narrative Intensity As A Risk Signal**

Bubbles that are driven by the narratives can be detected through behavioral data streams. The frequency of ESG keywords in large news outlets indicates that once ESG shares in total financial coverage rise more than 2.5 percent, fund inflows of the next quarter tend to increase by 40 percent, which is usually followed by price corrections. By incorporating this type of narrative-intensity indicator into risk models, speculative overextending can be anticipated.

### **6.4 Behavioral Literacy And Education**



Reducing moral licensing could be achieved by adding behavioral literacy of investor-education programs. In the case when participants were told about typical ESG biases before picking the portfolio, diversification grew by 19 percent, whereas turnover decreased by 23 percent (OECD Behavioral Lab, 2024). Therefore, behavioral education serves as a control supplement to financial disclosure.

## 7. Future Research Directions

Potential opportunities are in:

- Behavioral resilience - are investors learning the lessons of ESG volatility or coming back to cycles of optimism?
- Cultural framing- the comparison of the moral / narrative power of Western and Asian sustainable-finance frameworks.
- The significance of algorithmic amplification - the spread of ESG themes by AI-based recommendation engines.
- Distortion of impact measurement - the research on the interpretation of non-financial measures expressed in an emotional way.
- Testing of policy behaviorally - field experiments of investor reaction to the redesign of disclosure.

## 8. Conclusion

ESG investing displays the ethical psychology of contemporary finance - the sphere where virtue and volatility go together. Sustainable finance growth after the pandemic was pushed by group feeling and narrative contagion as opposed to logical thinking. However, the same behavioral principles that were used to exacerbate an irrational exuberance can be used to create a more sensible design.

The policymakers and asset managers can make the ethical aspiration and economic discipline meet by implementing behavioral science to the ESG disclosure, scoring, and communication. The next stage of sustainable finance must not be branding but must shift to quantitative behavioral effect - transparency minimizing moral overconfidence, and informed choice, a sign of maturity, not marketing.

Investor education should also be revised to behavioral literacy, without which it will be impossible to see through framing, narrative bias, and moral licensing in those cases when they must make a judgment



on the spot. Sustainable investing must create a compromise between fact and compassion to make it the sustainable pillar of the world economy.

Lastly, the markets of ESG become the expression of the value system of society in behavioral terms. They keep in mind that markets are not machine systems and remind us that it is a social organism, which is affected by perception, trust, or common purpose. The future of sustainable finance will not be predetermined by the view that the investors have, but by thinking, and they can strike a balance between conscience and cognition in building the financial systems of tomorrow.

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