A REVIEW OF ESG INTEGRATION & RETURN OF FINANCIAL INSTRUMENTS IN VARIOUS MARKET SEGMENT AND SOCIETIES

Sumit Kumar, Indian Institute of Management, Kozhikode

ABSTRACT

This paper's goal and objective is to investigate the response of investment management businesses to sustainable investing through ESG integration. This report examines the level of ESG integration in major global market segments across geographies, industries, and sectors. In the established economy, ESG integration has provided favorable investment returns, however in the emerging market sector, this result is not statistically significant. On the one hand, it examines the role of global organizations in fostering sustainable investment awareness, and on the other, it considers the regulatory aspects of sustainable investment decision-making. To evaluate the sustainability of investment management, a thorough analysis of investment instruments and their ESG-integrated returns has been provided. To provide an all-encompassing view of the ESG integration approach, the perspective of ESG detractors has also been covered. We conclude that ESG Integration in Investment portfolio is a Thematic investment which generates positive returns in certain segments of the market, but the result is not conclusive as law across the globe.

Keywords: ESG Integration, Climate Finance, COP 26, Green Bonds, Social Bonds, Sustainable Bonds.

INTRODUCTION

E (Environment), S (Social), G (Governance) issues in Investment

A clean environmental record, equality, and sustainability are essential facets of financial investment. From an investment perspective, environment, social, and governance (ESG) factors are key drivers of portfolio risk and return. Based on the studies on ESG issues in investment, it is evident investment managers should incorporate these issues in their investment decisions. This is because a significant percentage of the studies indicate a positive association between ESG integration and economic performance. Syed (2017) conducted a study on the incorporation of ESG principle in the decision-making procedures of fund managers. Data was compiled using questionnaires completed by finance managers based in France and the United Kingdom. Generally, the results were varied. However, the study concluded that both environment & social responsibility (ESR) and corporate governance (CG) will promote better management of investment risks and subsequently foster long-term shareholder value.

OECD (2017) examined how asset managers, insurance firms, and pension funds counter ESG-based risks and the opportunities in their investment portfolios. The data was collected through face-to-face interviews, the circulation of surveys to regulators, and desk research. The

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research concluded that ESG components shape investment yields through their effect on economic performance. Furthermore, these ESG factors pose a huge risk to financial market stability and broader economic growth.

Duuren et al. (2017) investigated ESG adoption and the investment management process. They used an international survey filled by fund managers. They observed that the majority of the finance managers utilized ESG information in their investment procedure. Fund managers are using ESG information for risk management and red flagging. Mervelskemper and Streit (2017) conducted a study on the direction and the extent that the organization's ESG performance is valued by financial market investors. Overall, ESG performance is more valuable when an ESG report is published. Overall, ESG reporting is linked to superior outcomes.

A recent study by Landau et al. (2020) on integrated reporting of ESG and financial data confirmed that the superiority of ESG reports is material to market valuation. Sultana et al. (2018) conducted research on ESG and investment decision in Bangladesh. A questionnaire survey filled by individual investors in both the DSE and CSE provided data for assessment. The research concluded that the adoption and implementation of ESG policies ultimately foster sustainable investment returns, which paves way for sustainable development.

Amel-Zadeh, & Serafeim (2017) conducted research on why and how venture capitalist apply ESG data. The sample of the survey data stemmed from senior investment professionals who consider ESG information financially material to investment performance. Nonetheless, the study concluded that investment professionals use ESG information for varied purposes including financial reasons and risk assessment among others. Henisz et al. (2019) support the fact that a strong ESG proposition, paves the way for higher value creation. This includes outstanding growth, cost minimization, regulatory and legal interference, capacity uplift, and investment and asset streamlining. Sridharan (2018) carried out a study on the top metrics and reporting structure that investors observe while managing their portfolio investments. Overall, the results show that ESG metrics are different across sectors. However, the issue of governance was consistent across all sectors. Nonetheless, the environmental and social risks are crucial to economic performance.

Friede et al. (2015) combined the findings of roughly 2200 studies to establish the relationship between corporate financial performance (CFP) and the ESG criteria. The majority of the studies reported positive findings. According to this comprehensive overview of academic research, there is a large non-negative association between CFP and ESG.

ESG Based Investments, Pillars of ESGs, Main Factors

ESG-based investments are transforming the investment sector because their returns are higher and sustainable. Governance is often considered the most important ESG pillar, however, the environment and social pillars are steadily being embraced by firms. Sharma et al. (2020) conducted a study on the components of ESG disclosure on Indian companies. The results reveal the extent of ESG disclosures to the companies' reports. Indian companies are steadily adopting ESG reporting to address stakeholder concerns. Naffa and Fain (2020) conducted performance measurement of ESG-themed megatrend investments in global equity markets using pure factor portfolios methodology. The analysis covered several themes such as food security, energy efficiency, and disruptive technologies among others. Time-series regression was utilized to

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derive the findings, which concluded that there is a neutral relationship between market performance and ESG. Therefore, ESG based investments have a low level of idiosyncratic risk.

Yue et al. (2020) performed a study to assess the economic returns and the performance of both traditional and sustainable funds. A sample of 30 traditional and 30 sustainable funds was utilized using methods such as standard deviations, annual returns, and Sharpe ratios among others. The study concluded that socially responsible funds are less risky relative to traditional finances. Nonetheless, the study did not find credible evidence to link sustainable funds with higher returns. Lepetit and Sekine. (2020) conducted a study on the coronavirus and ESG investing as well as the emergence of the social pillar. The findings show the financial materiality of integrating ESG criteria in investment decisions. The recent period and market turmoil show that the outperformance of the social pillar is closely related to increased investor inversion to risk.

Ouhaddou (2020) conducted a study on socially responsible investments to compare the performance of traditional indices with the performance of ESG indices. The data was collected over 18 months ending August 2020. Ratios were used to rank samples based on performance. Overall, ESG stock market indices experienced high growth. The research concluded that entities with higher ESG metrics are less exposed to systematic risks. ESG indices were more resilient to market fluctuations. Ionescu et al. (2019) carried out a study on the effects of ESG components on the market value of firms from the travel and tourism sector. The factor of governance seemed to exhibit the greatest impact on market value regardless of the location. ESG factors can be applied to predict economic performance.

Zaccone and Pedrini (2020) conducted a study on ESG factor integration into private equity. The findings revealed that private equity firms approached ESG integration to manage risks and to increase market value. Firms are missing the opportunity for value creation. Crespi and Migliavacca (2020) conducted a study on the factors of ESG rating in the financial industry. In terms of trend, the results show that ESG scores of financial entities are growing linearly. The findings also confirmed that ESG pillars follow independent patterns. Semenova and Hassel (2013) conducted comprehensive research on the added value of ESG performance and sustainable and responsible investment on the company and portfolio levels. They found that ESG factors affect both the risk profile and financial performance directly. Hvidkjær (2017) carried out a systematic review of ESG considerations and their effects on the value of the investment portfolio. Overall, stocks with higher ESG ratings reported higher future returns. However, there was a negative association between the stock market and certain types of ESG initiatives.

Global Perspective of ESG Investment

Different regions across the world have different perspectives of ESG investment. Nonetheless, ESG practices are prevalent in Europe, North America, South America, Africa, Middle East, Asia, and Australia. The majority of the studies show a positive association between ESG investment and higher risk-adjusted returns. Kotsantonis and Bufalari (2019) researched the relationship between corporate financial performance and ESG in the commercial banking sector. This research was supported by Deloitte, the Global Alliance for Banking on Values (GABV), and the European Investment Bank. The results support the hypothesis that a focus on material ESG issues coincides with higher risk-adjusted returns.

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Aboud and Diab (n.d.) conducted a study on the impact of ESG disclosures on the market value of Egyptian firms. They concluded that companies listed on the ESG index reflected higher firm value relative to the unlisted companies. Furthermore, the results indicate a positive relationship between the quality of ESG and firm value. The findings support the economic benefits associated with ESG disclosures. In a similar study by Yoon et al. (2018) on whether ESG performance enhances firm value in Korea, a positive relationship was subsequently identified. They found that CSR practices had a significant impact on a company's market value.

Grisales-Duque and Caracuel-Aguilera (2019) conducted a study to assess whether a company's economic performance is linked to superior ESG scores in emerging markets of multinationals in Latin America. Linear regression was applied to analyze data from 104 multinationals. The results revealed a negative association between economic performance and the ESG score. Balatbat et al. (2012) also studied the impact of ESG practices on the economic performance of firms listed in the Australian Securities Exchange. The findings indicate a weak negative association between ESG scores and economic performance. Furthermore, the portfolio returns of ESG focused firms were found to be lower relative to their traditional counterparts.

Hawkamah (2014) conducted a review of ESG practices in the Middle East and North African (MENA) region. The performance of the ESG index supports the hypothesis that ESG scores can impact financial performance. This is either through better risk control or better exploration of business opportunities. According to a report by the CFA Institute (2019) on ESG integration in Europe, the Middle East, and Africa. The findings concluded that ESG integration is more prevalent in equity investment relative to fixed income. On the contrary, Lean et al. (2015) established little proof of performance persistence in both the European and North American SRI funds. However, SRI funds outperformed the market benchmarks in both regions.

According to Liang and Renneboog (2019), SFWs that disclose their ESG scores have a higher value-weighted ESG score relative to their counterparts. This is critical because ESG scores is an investment determinant that is positively associated with corporate financial performance. Jain et al. (2019) conducted a comparative study on whether sustainable investment yields better financial results. They concluded that there is no notable distinction between the performance of traditional indices and sustainable indices.

Role of Global Organizations UN, World Bank, SRI, IFC, Paris Climate Accord

Global organizations have a huge role to play in regards to ESG adoption. They have the capacity to conduct further studies on the ESG based investments to promote their understanding and subsequent adoption. Overall, these organizations have contributed significantly to ESG practices. Ortas et al. (2015) investigated ESG and the economic performance impact on firms that implement the United Nations Global Compact (UNGC) in Japan, France, and Spain. The findings revealed that firms that adopt UNGC witnessed advancement in ESG performance. Also, the study revealed positive linkages between the financial performance of UNGC-committed firms and financial performance. There is a need for a comprehensive framework for promoting social and environmental sustainability in the UN system (UN, 2012). Political commitment is necessary for this initiative to move forward.

The World Bank commissioned a report on the integration of ESG components into fixed income investment (Inderst and Stewart, 2018). The ultimate goal is to foster procedures for including the ESG criteria in investment decisions and to divest funds towards socially

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responsible investments. The findings suggest that incorporating ESG contributes to more sustainable financial gains. According to Baietti et al. (2012), the demand for green investment is significant. However, the financial shortfall is staggering.

Gerard (2018) conducted a critical review of ESG and socially responsible investment (SRI). The findings show that higher CSR translates to lower risks, high equity returns, and higher corporate value. This hypothesis is supported by Bidoggia et al. (2016) primarily on the motivations for investing in SRI ESG portfolios, which include value creation, financial and economic reasons. Furthermore, socially responsible investment is a potential solution to ecological and social issues (Talan and Sharma, 2019). It can influence greater accountability in the financial markets. In India, SRI is in its developing phase.

IFC (2018) commissioned an empirical study to establish the link between economic performance and corporate governance. The findings revealed a strong correlation between financial performance and the quality of corporate governance. Furthermore, the data shows that investing in firms with strong corporate governance is linked to higher performance and better average credit risk rating. According to the Paris Agreement, corporate environmental efforts such as ESG should be considered as one of the criteria for investment (UNFCCC, 2019). ESG investment has grown significantly in Japan. Competition for ESG funds is expected to grow in the future. Based on the Paris Agreement of 2015, the EU enacted the sustainable finance disclosure regulation (Deasy et al., 2020). This policy sets out obligation frameworks but does not shed light on how exactly to comply.

ESG Based Laws, Rules, and Regulations across Various Regions

Despite ESG being an emerging trend, countries have already formulated comprehensive policies to foster their adoption. One of the most common policies concerns ESG disclosures on company reports. Overall, the quality of ESG based laws promotes value creation. ESG information disclosure is associated with corporate sustainability performance, which is a strong competitive advantage. In the Indian context, it is mandatory to disclose corporate governance in the annual and sustainability reports (Sharma and Thurkal, 2015). However, it is voluntary to disclosure the environmental and social activities. Alsayegh et al. (2020) posit that disclosure of ESG adoption strengthens sustainability performance among Asian firms. The research indicates that economic sustainable performance is strongly linked to social and environmental performance.

Similar research was conducted by Camilleri (2015) on ESG disclosures in Europe. The research concluded that the majority of the EU nations are opting for a mix of both mandatory and voluntary regulations to foster ESG disclosures. Furthermore, the findings show that when European firms respond to regulatory pressures all the stakeholders get to benefit. Mejia-Escobar et al. (2020) carried out a study on the current status and insights on sustainable financial products (SFP) in the Latin American financial sector. The results show that ESG policies have encouraged the establishment of both green and SFP. For instance, Brazil established the green protocol in 2008. According to Kolbel et al. (2020) sustainable investing fosters good business processes. Nonetheless, it is improbable to achieve long-term transformation without supplementary ESG based policies. Oncioiu et al. (2020) investigated the role of ESG disclosures in financial transparency. The results show that ESG reporting is a means of communicating with stakeholders. Furthermore, ESG disclosures foster financial transparency.

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Schumacher et al. (2020) highlight the growing importance of more rigid reporting and disclosure standards in Japan. Sustainable finance and investments have the potential to aid the move towards a sustainable economy. The aim of the EU regulation on sustainability-related disclosures is to foster transparency in ESG matters (Maleva-Otto, et al., 2020). Certain companies will be required to make certain disclosures and to implement policies. A public-private approach to ESG disclosure is ultimately unavoidable (Harper and Park, 2020). This conclusion is drawn from the approaches ESG disclosures adopted in the United States, China, Hong Kong, UK, Brazil, South Africa, and the EU. The Hong Kong government is taking the lead in fostering ESG as part of its economic agenda (KPMG, 2020). This includes the introduction of ESG-focused listing requirements among others.

The issue of gender diversity on ESG performance is not widely debated despite its significant impact. Overall, greater gender diversity was shown to have a positive effect on the ESG metric. Romano et al. (2020) conducted a study on ESG performance and the gender diversity of the BoD. The research aimed to assess how the gender configuration of the BoD impacts corporate sustainability. The assessment was conducted on a sample of non-fiscal firms in Italy. The findings indicate that greater gender diversity influences ESG score positively. Birindelli, et al. (2018) support the conclusion that gender diversity affects ESG performance but only up to a certain threshold. This study aims to investigate the relationship between sustainability performance and the composition of the board.

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