ESG INVESTING

An Introduction: Understanding Responsible Investments (RI) and its inclusion into mainstream Finance

Sustainable Investment Club

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“While traditional economic theory sees policy as fixing markets, inclusive and sustainable growth require active market creation and shaping not only fixing.

What is the role of the direction of innovation in steering growth to fulfil key objectives, such as those underlying the Sustainable Development Goals?

MARIANA MAZZUCATO

Sustainable Investment Club

Before we start

Once upon a time, ethical or socially conscious investors were considered a curiosity within the realm of mainstream finance. A well-intentioned caucus whose environmental, social, and governmental concerns were considered as niche by the majority. That period is long over.

Concurrently, ESG consideration is increasingly being included into financial management. ESG factors are being included into investment analysis and decision-making processes by asset owners and investment managers. Investors are now explicitly using ESG factor analysis to improve profits and better manage risks, thanks to the rise of proponents of responsible investment such as the United Nations Principles for Responsible Investment (PRI). Integration has grown more commonplace as a result of societal and client pressure as well as the accumulating proof of the direct financial benefits resulting from the inclusion of ESG analyses.

At the SIC we believe that responsible investments and its dynamic inclusion into mainstream finance represent crucial instruments for tackling climate change, social injustice and fostering meaningful and sustainable innovations. Therefore, we are convinced that this topic should not remain a concern for seasoned professionals but shall rather be thematized and explained early on.

As such, we are proud to welcome you to the first edition of our Introduction to ESG investing!
Our guide aims to define and situate ESG Investing within the broader framework of Responsible Investing (RI), as well as clarify its components, namely, environmental, social, and governmental. Furthermore, this introduction also explores how ESG analyses and valuations are conducted as well as its integration into the financial decision-making process. Ultimately, we will briefly discuss the limits of ESG investing and what future approaches may look like.

Olivier Clivaz
President SIC FS22

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About the Sustainable Investment Club

The Sustainable investment Club (SIC) has been founded in 2020 at the University of St.Gallen (HSG) as an initiative to promote sustainability within the financial sector and to create awareness around this topic among the students.

With the SIC, we have set the goal of changing the status quo and increasing the students' awareness on the topics of Sustainability and Finance

Imprint

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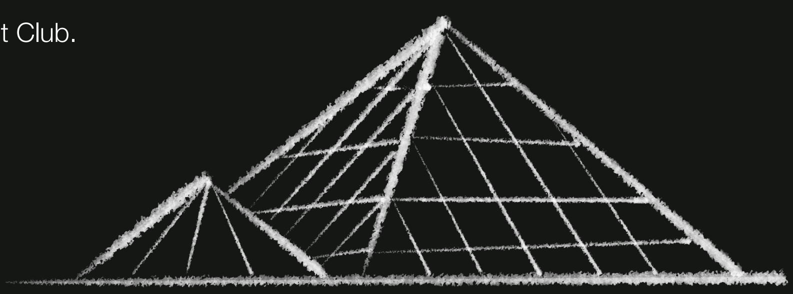

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Defining ESG Investing

According to the CFA Institute and the OECD, ESG Investing is defined as "*an approach to managing assets where investors explicitly incorporate environmental, social and governance (ESG) factors in their investment decisions with the long-term return of an investment portfolio in mind*." [1]

Therefore, ESG investing aims to identify, evaluate and ultimately integrate social, environmental, and economic risks and opportunities into a given financial decision-making process. Nonetheless, the classification of E, S, and G concerns currently lacks a common criterion, as no universal standard has been defined, and they may therefore overlap. followingly, these concerns are assigned based on the unique characteristics, preferences and properties of investors, enterprises, and their stakeholders. [2]

One key underlying assumption behind ESG investing is that the generation of long-term sustainable returns is dependent on stable, well-functioning and well-governed social, environmental, and economic systems. Consequently, (1) social and environmental as well as governance issues may impact the risk, volatility, and long-term return of securities (as well as markets); (2) and investments can have both a positive and negative impact on society and the environment. [2]

This conclusion represents an important premise since this demonstration of causality legitimates the economic benefit of including ESG factors in financial decision-making process by illustrating its effects on the economy.

In other terms, since ESG factors may impact future returns, it is considered as economically relevant and thus needs to be included in economical value.

Example of typical ESG issues (considerations)

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate change	Over-consumption	Bribery & Corruption
Waste	Child labour	Executive compensation
Resource depletion	Modern slavery	Diversity, culture & structure
Pollution	Working conditions	Ethical lobbying
Deforestation	Employee relations	Taxation (Tax strategy)
Power Generation	Human rights	Trade associations

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Responsible Investments part I

Responsible Investments and ESG Investing

ESG investing is a subset of a group of strategies collectively referred to as responsible investment or RI for short. While ESG investing is concerned with how ESG issues can impact the long-term return of assets and securities, other responsible investment approaches can also take into account non-financial value creation and reflect stakeholder values in an investment strategy, like impact and social investing or to some extent philanthropy. [4]

Therefore, Responsible investment represents an umbrella term for the different methods which investors can consider ESG within a security selection process or while balancing portfolios. As a result, it can supplement conventional methods of financial analysis and portfolio construction and combine financial and non-financial outcomes.

Furthermore, all common forms of responsible investment are ultimately related to portfolio construction, excepting engagement, which aims to identify whether and how an investor tries to encourage and influence an issuer's behaviour on ESG matters. Nonetheless, there is no standardized nor clearly delimitated classification of the responsible investment approaches/types, which often leads to overlap and more generally confusion. [4]

Philanthropy		**Social Impact Investing**		**RI**	**Mainstream Finance**
Traditional philanthropy	Venture philathropy	Social investing	Impact investing	ESG investing	Commercial investments
		Use of ESG metrics & methodologies			
Address societal challenges through the provision of grants	Address societal challenges with venture investment approaches	Investment with a focus on social and/or environmental outcome and some expected financial return	Investment with an intent to have a measurable environmental and/or social return	Enhance long-term value by using ESG factors to mitigate risks and identify growth opportunities	Limited or no regard for ESG practices
Social return only	Social return focused	Social return and sub-market financial return	Social return and adequate financial market rate	Financial market return focused on long-term value	Financial market return only

Purpose driven ← **Financial return driven**

Responsible Investments part II

Other investment approaches

As mentioned, Responsible Investment represents an umbrella term for a variety of investment approaches that essentially differ from common commercial investments. Responsible investing involves, at the very least, reducing risky ESG activities in order to preserve value. In order to achieve this, it takes into account how investing in and engaging with assets and investees can have an impact on society and the environment, as well as how ESG may affect the risk-adjusted return of an asset and the stability of an economy.

Socially responsible investment & Best-in-class investments [4]

The term "socially responsible investment" (SRI) describes strategies that consider social and environmental factors while appraising businesses. Investors that use SRI typically evaluate companies using a set of predetermined standards, frequently in conjunction with sector-specific weightings. Within the investment universe, a bar is set for qualifying based either on the entire universe or on a sector-by-sector basis. Using this data, a list of SRI-qualified businesses is initially compiled. Best-in-class investments, thematic funds, high-conviction funds, or quantitative investment strategies can all be employed in conjunction with SRI rating.

Followingly, Best-in-class investing involves choosing just those businesses that surpass a predetermined ranking bar, which is created utilizing ESG factors within each sector or industry. Accordingly, companies are scored on a variety of factors that are weighted according to the sector while the portfolio represents the aggregated and assembled list of qualified companies. Nonetheless, it shall be mentioned that not all best-in-class funds are considered to be 'responsible investments'!

Best-in-class investing is frequently utilized in investment strategies that aim to preserve specific index characteristics because of its all-sector approach. In these situations, security selection targets businesses with higher ESG ratings while attempting to preserve regional and sectoral diversification and a profile comparable to the underlying market cap index.

Sustainable investments [4]

Sustainable investment characterizes the choice of assets that, in some aspects, promote a sustainable economy, i.e., an asset that minimizes the depletion of natural and social resources. For the purpose of taking typical ESG issues into consideration, it is a broad word that can be utilized in a variety of ways. Best-in-class and/or ESG integration, which takes into account how ESG concerns affect a security's risk and return profile, may be included. Additionally, it is used to characterize businesses that have a favourable influence or will profit from long-term macrotrends. A plan that excludes activities deemed incompatible with long-term environmental and social sustainability, such as coal mining or oil exploration in the Arctic, is also referred to as a "sustainable investment."

Responsible Investments part III

Green investment [4]

Green investment refers to the strategic allocation of capital to assets that mitigate:

- climate change
- biodiversity loss
- resource inefficiency
- other environmental challenges

These can include

- low-carbon power generation
- smart grids;
- pollution control;
- recycling;
- waste management

Consequently, Green Investing can be seen as a broad subset of thematic investing and/or impact investing. Within green investments, green bonds are a sort of fixed-income instrument frequently used to raise capital for climate and environmental projects.

Thematic investment [4]

Selecting businesses that fall within a sustainability-related subject, such as clean technology, sustainable agriculture, healthcare, or climate change mitigation, is known as thematic investing. Thematic funds choose businesses from a range of industries that are pertinent to the subject. For instance, a smart city fund might invest in businesses that provide services or goods for electric vehicles, mass transit, smart grid technologies, renewable energy, and/or green buildings. But keep in mind that not all thematic funds are regarded as ethical or best-in-class purchases. Being one is influenced by the ESG traits of the investee firms as well as the fund's subject.

Impact investment [4]

Impact investing is the practice of making investments specifically with the goal of producing a positive, quantifiable social and/or environmental impact in addition to a financial return (which differentiates it from philanthropy). These are frequently linked to direct investments in things like real estate, private debt, and private equity. Impact investing has, nevertheless, become more widely accepted in the public markets in recent years. One can make impact investments in both emerging and developed areas. By funding initiatives and businesses that might include:

- offer access to basic services, including housing, healthcare and education
- promote availability of low-carbon energy
- support minority-owned businesses
- conserve natural resources

The investment offer is typically built on the measurement and tracking of the agreed-upon impact. Impact investors expect a range of financial returns. Some investors purposefully make investments with returns below market rates in order to achieve their strategic goals. Others aim for market-competitive and market-beating returns, which are occasionally mandated by fiduciary duty.

Responsible Investments part IV

Faith-based investments [5]

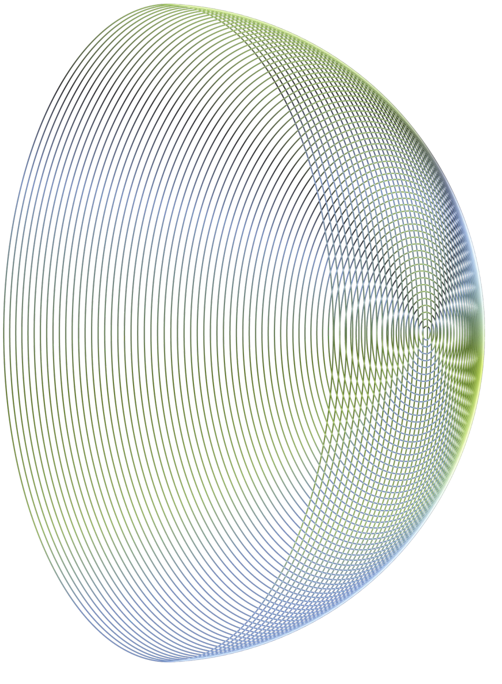
The terms "ethical" (also called "value-driven") and "faith-based" refer to investing in accordance with certain principles, frequently using negative screening to avoid investing in companies whose products and services are deemed morally objectionable by the investor or certain religions, as well as international declarations, conventions, and voluntary agreements. The usual exclusions are:

- tobacco
- alcohol
- pornography
- weapons
- nuclear power

Faith-based investors have a history of engaging in shareholder activism to alter the behaviour of investee corporations, from pious individuals to big religious organizations. Building a portfolio with a focus on screening out the negative, or avoiding "sin stocks" or other assets at odds with their principles, is another well-liked technique. Followingly, Investors who want to put their money to work in accordance with Christian principles try to stay away from companies that facilitate abortion, contraceptives or embryonic stem-cell research; or are involved in the production and sales of weapons. Similarly, Investors seeking to follow Islamic religious principles cannot invest in firms that profit from alcohol, pornography or gambling, own investments that pay interest, liaise with firms that earn a substantial part of their revenue from interest nor invest in pork-related businesses. [5]

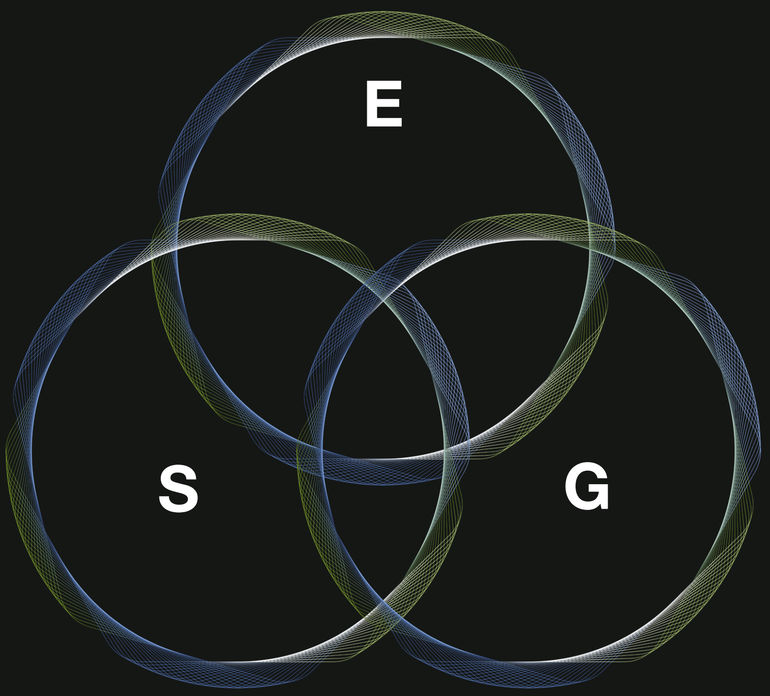
Shareholder engagement [3, 6]

The term "shareholder engagement" refers to active ownership by investors who strive to sway a company's ESG policies through discussions with corporate officers or votes at shareholder meetings (in the case of equity). It is considered as a strategy to encourage businesses to operate more responsibly that complements the responsible investing strategies already described. Its effectiveness typically depends on:



- the level of involvement (individual or group ownership)
- the effectiveness of the engagement discussion and technique
- whether the investor has warned the company that divestiture is a potential consequence

the ESG spheres



The Intertwined perspective of the BNS Framework

"This is the moment when we must come together to save this planet. Let us resolve that we will not leave our children a world where the oceans rise and famine spreads and terrible storms devastate our lands."

Barack Obama, *former President of the United States*

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E for Environment

Introduction to "Environment"

The 'E' in ESG refers to a wide variety of environmental elements that have a significant financial influence on investments. Worldwide, environmental risks are becoming more prominent and raising more concern. Since 2016, environmental risks have dominated the ranks in the World Economic Forum's Global Risks Report, with biodiversity loss moving into the top five risks in 2020. Environmental risks include extreme weather, natural disasters, and the failure of climate action. Although the COVID-19 pandemic has made infectious diseases one of the top five global hazards in the 2021 edition, four of the top five risks by likelihood (compared to five out of five in 2020) and three of the top five by effect were environmental-related. In contrast, no environmental concerns appeared in the top five until 2010. This striking disparity is evidence of how quickly sustainability is moving up the global agenda. [1,7,8,9]

Systemic correlation between Businesses and Environment

The understanding of important environmental factors as they relate to business and investment is largely focused on particular problems, such as climate change and the unsustainable use and production of natural resources, as well as the detrimental effects that businesses, consumption patterns, and investment demand are having on the condition of natural capital stocks. Less is understood, however, about how monetary and commercial activities are dependent on ecological services and natural resources. These negative effects (sometimes referred to as pricing "negative externalities") have not been completely accounted for in the expenses of doing business since it is difficult to value and measure natural resources. Significant market disruptions may result if such expenses are fully internalized by corporations or their investors. [10]

Assessing materiality and accounting for it

Material environmental challenges are elements that could significantly affect a company's business model and value drivers, such as operating and capital expenditure, revenue growth, profitability, and risk, in both a positive and a negative way. Materiality is not static; it varies as the market, laws, and attitudes of the public do. As a result, investor efforts to evaluate the significant financial effects brought on by environmental hazards have started to broaden in terms of analytical depth and sophistication. Nonetheless, using a variety of financial methods and models, environmental hazards can be successfully incorporated into business analysis and investment decision-making processes. According to a G20 Green Finance Study, financial institutions need to combine two types of approaches to assess environmental risks: [11,12,13,14]

1. understanding environmental factors that may pose risks to financial assets and liabilities (for example, the wrong pricing of a pollution liability or natural disaster insurance policy could be a risk to liability, if the event probability is underestimated), and how such risks may evolve over time; and

2. translating environmental risk factors into quantitative measures of financial risk that can, in turn, inform firms' risk management and investment decisions.

S for Social

S

Introduction to the Social sphere

From a business and investment standpoint, social considerations are important and are increasingly taken into account while doing investment analysis and making investment decisions. Investors frequently demand businesses to handle these challenges in a best-in-class manner (i.e., by outperforming its competitors on a number of crucial concerns pertaining to its industry, such as controlling its influence on local communities or occupational health and safety). Other times, a societal problem may become the center of a lucrative investment opportunity (e.g. gender equality funds). Companies are being put under more and more pressure to interact with their stakeholders in an honest, open, and responsive manner. [15,16]

Assessing and applying the materiality of social factors

Understanding materiality at the regional and industrial levels should be the first step in determining which social issues are relevant from the perspective of investments. Once this is established, the exposure of the company can be evaluated by examining the industry it operates in, the main nations or regions it operates in, the locations of its important suppliers, factories, and clients, as well as the primary tax jurisdictions.[16]

Identifying the potential effects of societal trends and circumstances on investee companies operating in various sectors and nations could be the first step in a materiality or risk evaluation. For instance, some industries, including the mining and oil and gas sectors, are more prone to human rights abuses or health and safety concerns.
A company's typical risk assessment should include this materiality analysis. Non-financial risks, like social hazards, should be considered because they could materially affect the performance of the assets. [16,17]

Aside from risks, certain businesses or industries may also offer investment possibilities because they anticipate social changes and modify their business plans to capitalize on them rather than suffer from them. [16,17]

Ratio analyses and financial modeling

Quantifying the potential effects of social element scenarios and include them in the investment's ratio analysis and financial modeling is highly helpful. Analysts may elect to increase the discount rate to reflect a larger risk profile if a firm does not handle social aspects correctly, in addition to particular effects on predictions of future revenues, costs, and potential liabilities in a company's financial analysis. [16,17]

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G for Governance

Introduction to the Governance sphere

Corporate governance refers to the structure and method used to monitor a company's operations and management. This idea of directing and controlling is included into governance. The size, complexity, and distribution of ownership of corporations have all increased the complexity of corporate governance. As a result, the roll of the board of directors' has grown in significance. The board is in charge of representing the company's owners and holding management teams accountable for operating the company in the owners' best interests. Whether or not sound corporate governance principles are followed will determine how effective the board is. The principles guiding these concepts have evolved through time and have been formalized in corporate governance codes. Investors are increasingly asking businesses to reveal their corporate governance frameworks and procedures so that outside investors may gauge where the business sits in terms of good governance. [18,19]

Shareholder engagement and minority shareholder protection

Shareholder engagement is an ongoing conversation between businesses and their customers in which the latter voice their concerns in a direct manner (which often include ESG matters). As a result of engagement, board members are more likely to be held responsible for their decisions, which should eventually lead to better decision-making.

A significant concern for minority shareholders is ensuring that they are not taken advantage of by the dominant or controlling shareholders, which institutional investors will almost always be. Minority protections are frequently included in corporate laws, listing regulations, and other official safeguards. These are frequently supported by corporate governance regulations, but because the problems are so fundamental (they have to do with preventing the exploitation of minorities and protecting their ownership rights), most nations have underlying legal protections for them. [20]

Pre-emption rights are yet another essential component of shareholder protection. These rights guarantee that a shareholder can continue to hold a role in the business. A firm should not issue shares without allowing current shareholders the ability to purchase a sufficient amount in order to keep their present shareholding, which is a fundamental tenant of company rules in many countries (with the exception of the USA, for example). Pre-emptive rights are so named because they are given priority over possible outside investors. Because of the existence of these rights, big equity raises by firms are frequently referred to as "rights issues." [19,20,21]

Incorporating Governance into the investment process

Different fund managers employ governance factors in different ways while making investment decisions. It is frequently referred to as quality of management, which, despite its name, is never simply an assessment of the CEO and CFO but rather of the entire team and the governance structure by which they oversee the company and (hopefully) drive its success. For many, it is a threshold assessment, a formal minimum criterion before they will consider making an investment at any price. [20,21]

ESG analysis & valuation

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Integrating ESG Part I

Approaches for integrating ESG

First of all, it is crucial to highlight that ESG analysis can be qualitative or quantitative. Therefore, how these analyses are integrated can also be quantitative (e.g. impact on financial models or valuation) or completely qualitative (for instance, adding an opinion on management quality to the investment thesis). Some methods, like scorecards, where a qualitative judgment is converted into a quantitative score, could be viewed as a combination of the two methods. These strategies (passive, systematic, fundamental, active, or activist) and asset classes are all covered by these tools and methodologies. Certain tools frequently have a strategy- or asset class-specific focus. [22,23,24]

Qualitative ESG analysis

Qualitative ESG analysis is likely to be used in investment processes that are based on company-specific research, fundamental analysis and stock-picking. [23,24]

A) Analyse

To assess a company's capacity to handle specific ESG concerns, investment teams analyse ESG data.

B) Combine

By relating specific elements of the company's ESG risk management approach to various value drivers (such as costs, revenues, profits, and CapEx requirements), they combine this perspective with their financial research.

C) Integrate

Then, by changing model assumptions like growth, profitability, or capital expenses, analysts and portfolio managers try to incorporate their judgment in a defined method.

For various asset classes, specific qualitative methodologies might be better suited (or weighted differently). For instance, a determination about management incentives (a component of G analysis) might be given more weight in the public and private equity sectors, less weight in the fixed income sector, and no weight at all in the sovereign bond sector.[23,24]

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Integrating ESG Part II

Quantitative ESG analysis

Investment procedures that employ quantitative models to find lucrative investment possibilities are likely to apply quantitative ESG analysis. In these situations, the ESG data is frequently combined into an ESG component (also known as an ESG score), which is then included in the quant models. This could be a filter that establishes the investing universe or a quant model that modifies valuations according to various criteria (including ESG). [23,24,25]

Quantitative, systematic and thematic approaches

At the research stage, quantitative practitioners may evaluate ESG aspects utilizing a third-party database, or a combination of third-party data and internal proprietary data. Instead of using individual company assessments, this is often done with massive databases of stocks or bonds, however some companies do use individual company assessments to get their own proprietary rankings. The data collection may resemble that of basic investors, but it frequently involves larger datasets. A global dataset, for instance, can have 2,000–4,000 organizations, each with 100 data points.

ESG factors are frequently included alongside other variables including value, size, momentum, growth, and volatility by quantitative factor investors. Some of these elements might come from independent models. [23,24,25]

ESG data are taken into account during their investment operations, and adjustments to the weights of securities, up to and including zero, may be made. For example, a high rating on an environmental factor could be desired. To understand how ESG elements could affect financial performance over time and then weight those ESG aspects correctly, systematic methodologies can try to discover correlations.

Accordingly, thematic funds may evaluate compliance with priority topics, some of which may be ESG-related, such as gender or the environment. Either a material opportunity mapping method or the use of ESG data to appropriately alter weights can be used to accomplish this. [23,24,26]

Artificial Intelligence (AI) and algorithms

The current ESG data on firms is largely unorganized. Part of that unstructured dataset is being attempted to give structure and numerical value using artificial intelligence (AI) and machine learning methods. Some professionals: [23,24,26]

- focus on using AI techniques to measure ESG performance tied to measures developed by the Sustainable Accounting Standards Board (SASB)
- attempt to provide immediate access to scores based on material ESG events as they occur
- focus on intangible ESG factors, such as corporate culture, that may drive company value

Other quantitative approaches and natural language processing (NLP) are anticipated to advance over time.

Terminology confusion

Due of the various interpretations investors assign to the term "quantitative," combining this information might be confusing. It frequently appears when a numerical score is given to describe an analytical technique. However, it can also be used to refer to a group of investing strategies that primarily rely on the characteristics of securities such as stocks, bonds, derivatives, or other security factors. [23,24,26]

Quantitative investing, also referred to as "quant" investing or "systematic investing," is a type of investment strategy. It may involve techniques like:

- high-frequency trading
- use of algorithms based on news or factors and statistical arbitrage
- trend-following
- risk parity
- use of beta strategies

The method often makes extensive use of mathematical modeling, computational capacity, and data analysis—possibly even methods for machine and natural language learning. Some businesses utilize these strategies exclusively, while others use them to support human decision-making. [23,24,25]

Non-numerical qualitative kinds of analysis frequently rely on human judgment. However, technological advancements are erasing these limitations. Examples of how machine learning uses these qualitative words in a quantitative way include scanning management commentary from meeting transcripts and employing natural language processing.[23]

ESG approaches with both qualitative and quantitative components are frequently utilized in fundamental active strategies, which employ human judgment and are typically not categorized as quantitative investments. In a similar vein, ESG ratings data used in quantitative investment methods may be based on qualitative human assessment.

Overall, ESG methods may be categorized as quantitative, qualitative, or as combining both. Investment tactics are often grouped into: [23,24,25,26]

- quantitative (systematic, algorithmic)
- fundamental
- active
- passive
- beta

Investors frequently use the term "quantitative," however it has different connotations when referring to general investment strategies and procedures rather than specialized ESG integration methods.

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ESG analysis toolbox

Regardless of whether ESG analysis is classified as qualitative or quantitative, investors use a variety of tools. These instruments and ESG analysis components may consist of:

Red flag indicators. Securities having a high ESG risk are either excluded or flagged for further investigation. For instance, a business with a majority-independent board may be identified for intense inspection of managerial incentives or may simply be removed from the universe of investable companies. [23,24,25]

Company questionnaires and management interviews. For instance, the investor may ask the corporation for specific information if management aspects or other important ESG information are not covered in enough detail. Alternately, the investor can have a predefined list of common ESG data they request. When investors and corporations gather to discuss the most important ESG concerns, these questionnaires are also used in conjunction with the normal company meetings. [23,24,25]

Checks with outside experts. For example, an investor might speak with important thought leaders in the industry or other corporate stakeholders, such as clients, vendors, or regulators. These could be supplemented with interviews, surveys, or outside sources like expert networks. [23,24,25]

Watch lists. These might include securities that have been added to a watchlist with a high ESG risk for monitoring or securities that have been added to a watchlist with a high ESG opportunity for potential investment. For instance, after an investor has evaluated the ESG risks and possibilities, the investor creates a news or stock price watchlist and monitors it for stock price entry levels or changes in ESG events. A corporation with a high E risk score, for instance, might be kept up to date on any changes to carbon tax laws. [23,24,25]

Internal ESG research. This could be based on a range of methods and information sources. The results of proprietary ESG research and analysis are presented as scores, rankings, or reports. Proprietary ESG research or scores may also be developed, and the study may draw on a number of data sources. Additionally, research could include: [23,27]

- materiality frameworks
- ESG-integrated research notes
- research dashboards
- strengths, weaknesses, opportunities and threats (SWOT) analysis with ESG factors
- scenario analysis
- relative rankings

External ESG research. Where on the sell-side, ESG specialists or third-party databases may all be used; and a materiality framework is created. [23,24,25,27]

Challenges and criticism

Comparability and materiality

ESG rating agencies have various methods and evaluations, making it difficult to compare the ratings. ESG ratings do not correlate with bond credit ratings, and neither do the scoring methodologies used by the various agencies. Analysts' assessments of ESG materiality may vary. Many ESG phrases have varying definitions and are challenging for non-experts to understand. It can be challenging to gauge the impact's magnitude and there is uncertainty on how ESG elements will interact with financial performance over time where materiality can be determined. [23,24,27]

Integration

Many quantitative ESG variables are not agreed upon, and the data is relatively short term as a result of the various third-party databases. Additionally, it is unclear how much the ESG variables might correspond with other recognized quantitative factors like "quality," "value," or "momentum." This means index tilting tactics might not accurately reflect the desired factors. There are numerous teams of ESG analysts at investing businesses. This can move ESG expertise away from investment decision makers and therefore, provide a challenge to integration. The only recent concentration on this topic, for example, at the level of business schools, may be the reason why ESG analysts are more junior and thus, their opinions and challenges are given less weight. [23,24,25,26]

Investment firm culture

It can be difficult for teams and within organizations when there are still many investing professionals who do not integrate ESG or who think it has little financial impact. A firm's worldwide nature may make it difficult to incorporate culturally diverse attitudes toward ESG variables globally across the firm, or a firm may not have sufficient resources to purchase third-party ESG data. ESG integration varies considerably across asset classes, making it challenging to be consistent or to explain inside a corporation. Even within firms, there may be a lack of comparability or a disagreement of opinion due to investors' propensity to assign different weights or degrees of materiality to certain elements. [23,24,25,26]

Common criticism

- Too inclusive of poor companies. ESG mutual funds and exchange-traded funds (ETFs) often hold investments in companies that may be acknowledged as ‘bad actors’ in one or more of the ESG spaces
- Dubious assessment criteria. The criteria used for selecting ESG factors are too subjective and can reflect narrow or conflicting ideological or political viewpoints. Non-material or socio-political factors may be over-emphasised. Materiality assessments might be considered flawed.
- Quality of data. The information used for selecting ESG factors often comes (unaudited or assured) from the companies themselves. This complicates the ability to verify, compare and standardise this information.
- Potential lack of emphasis of long-term improvements. Some financial advisers screen investments first for performance and only after that for ESG factors. This initial emphasis on performance can exclude companies with high ESG practices that focus on longer-term performance. [23,24,25,26]

Some closing thoughts

Some detractors contend that there is insufficient or conflicting evidence supporting the benefits of ESG. These detractors contend that the evaluation period for ESG is too brief to demonstrate advantages. Critics also cite instances when sectors that are frequently omitted, like cigarettes, perform well as proof that ESG reduces value.

Furthermore, a Journal of Finance paper (2021) originating from the University of Chicago, examined over 20,000 mutual funds representing over $8 trillion in investor deposits (based on their Morningstar sustainability ratings). Even while the funds with the highest sustainability ratings received more investment than the funds with the lowest ratings, none of these funds outperformed the funds with the lowest ratings in terms of performance. [28]

This is not a surprising fact since truly sustainable investment should inherently contribute in more ways than just in monetary terms. As such, the performance of a given ESG fund cannot be solely estimated in terms of financial returns but in a variety of value generating metrics that truly reflects the value of such an investment.

Followingly, as the performance of ESG investments is generally valued in terms of financial returns by investors, the whole concept of assessing a variety of quantitative and qualitative factors seems obsolete, as these do not transcend the simple financial metric. Consecutively, ESG investments should mainly highlight the “non-monetary” characteristics and ultimately explain why these aspects should be considered as return on investment.

As the ESG practice is positioned between mainstream finance and impact investing, it can be argued that it will not sustain in the future as the value proposal is not clearly defined. At the moment, ESG investing promises financial returns consistent with the current market environment while also delivering a “sustainable” return, which seems contradictory in the long term.

As a conclusion, ESG investing can be regarded as a necessary step towards a broader discussion on the topic of value generation. Ultimately, the inclusion of ESG aspects in the investment process will raise questions about the validity of its concept, but more importantly it will highlight our environmental and social challenges in the public discussion.

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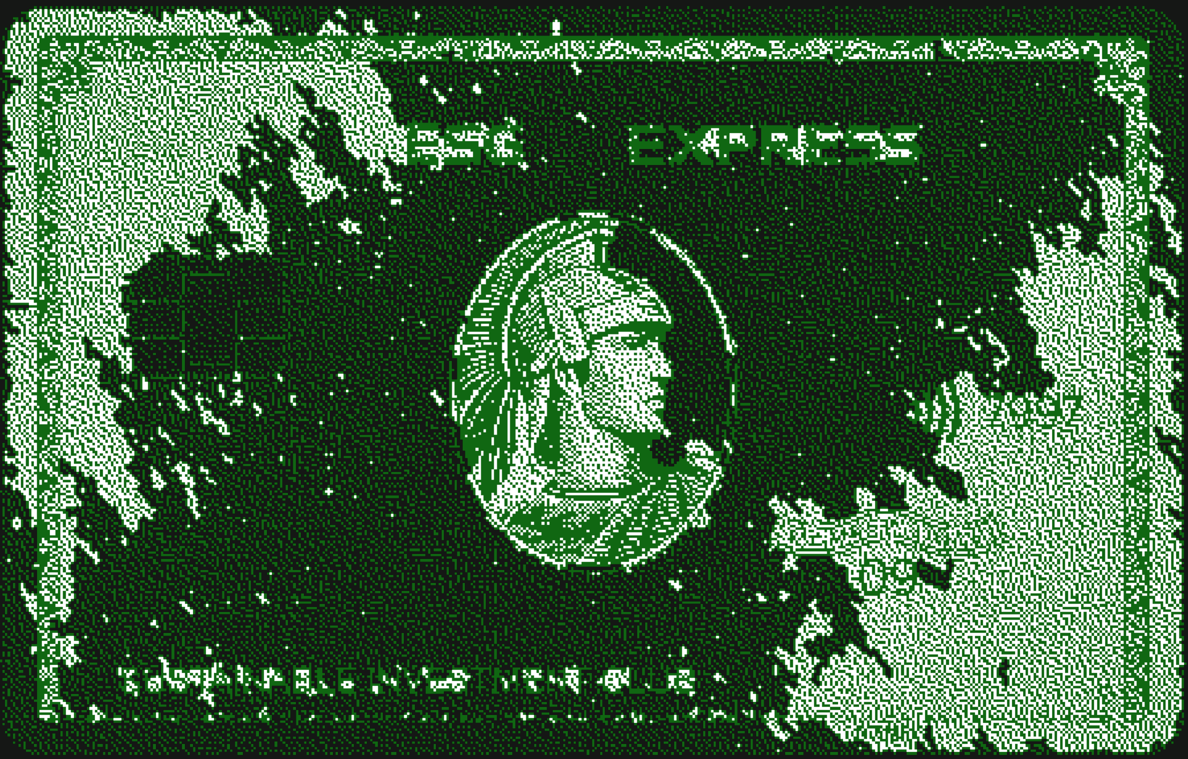
ESG INVESTING

An Introduction: Understanding Responsible Investments (RI) and its inclusion into mainstream Finance



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