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Dilemma of ESG Development: Investors' Perspectives

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Abstract: Rising concerns around environmental and social issues have led to a heightened investor focus on the ESG performance of corporations. This attention underscores the increasing relevance of ESG considerations in the decision-making processes of investors. However, as ESG investments have risen in popularity, there has also been an increase in contradictory voices. The purpose of this article is to analyze the intricate landscape of ESG investments from the perspective of investors. It aims to shed light on the implications of corporate ESG responses and how investors incorporate ESG parameters into their investment portfolios. The study reveals specific challenges namely: (1) Corporations incurring short-term costs for making transformations affecting their stability, consequently leading to possible reductions in investors' short-term returns; (2) Corporations potentially misleading investors through greenwashing strategies to enhance their ESG portrayal; (3) Requiring investors to possess comprehensive industry knowledge when incorporating ESG in risk assessment thereby adding to time constraints; (4) Existing discrepancies in ESG disclosure standards leading to inconsistencies in ESG ratings given by different agencies; (5) Tracing corporate ESG performance being complicated by its strong links to both the size and financial performance of the corporation; (6) Incorporating ESG factors into investment portfolios could introduce tracking errors and potentially compromise portfolio diversification. Therefore, it is necessary to advocate stricter regulations around ESG disclosures, refining reporting standards to enhance transparency and comparability. Additionally, there is a call for further research to better comprehend the intricate relationship between ESG and financial performance.

Keywords: ESG Performance, Sustainable investment, ESG disclosure, Greenwashing

1. Introduction

The term "ESG" was first introduced in January 2004, when UN Secretary-General Kofi Annan reached out to the CEOs of major financial institutions. He invited them to participate in an initiative aimed at incorporating ESG factors into capital markets. This initiative resulted in the publication of a report called "Who Cares Wins," which is credited with popularizing the term "ESG." It encourages financial institutions to integrate ESG factors into the capital market [1]. Then, companies will disclose their ESG performance in response to investors' requests. To draw in investors, companies will make every effort to enhance their performance in environmental, social, and governance (ESG) standards, which will then make a significant contribution to the world.

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However, the reality is different. On one hand, many companies adopt disclosure standards that benefit themselves due to the lack of unified ESG disclosure standards. This is done to make their ESG performance appear more perfect [2]. Moreover, companies tend to overstate and engage in greenwashing as a result of inadequate auditing. Conversely, taking into account ESG factors necessitates that investors exclude numerous stocks from their portfolios. Such as the energy sector and tobacco, these investments will not only reduce profits in the short term but also cause high tracking errors [3]. Besides, per the principles, investors should spend time and money on engagement [4]. Many investors are unwilling to do that and feel skeptical about ESG [5].

The International Sustainability Standards Board (ISSB) released the first two IFRS Sustainability Disclosure Standards on June 26, 2023 [6]. The first standard, IFRS S1, mandates organizations to divulge details regarding their sustainability-related governance, strategic planning, and risk management, as well as the metrics and objectives that underpin their handling of sustainability-related risks and opportunities. The second, IFRS S2, obliges businesses to report on how they administer, and address risks and opportunities tied to climate change, following similar governance, strategy, risk management, metrics, and target-focused structures. These standards are slated for implementation in 2024, allowing investors to gain insight into standardized climate and financial sustainability data from the 2024 reporting cycle onward, starting with disclosures in 2025. The release of these standards is anticipated to facilitate globally consistent sustainability reporting amongst enterprises of varying geographical locations.

Nevertheless, the effectiveness of these standards remains to be seen as a unified disclosure standard is just one of the many factors in the development of ESG. There are still several factors that prevent ESG development. Therefore, this article seeks to explore the challenges in advancing ESG from investors' perspectives. Then, propose potential directions for future development in ESG investment.

2. Why Consider ESG

2.1. Meeting Faith and Ethical Requirements

The history of ESG investment harks back to moral and faith-based investing [7]. This investment approach was traditionally predicated on negative screening, where investors deliberately steer clear of companies whose products or services conflicted with their ethical or religious convictions. Typical sectors from which investors would exclude their investments included industries such as tobacco, alcohol, adult entertainment, arms manufacturing, and other entities violating international conventions.

To influence and change company policies, organizations and individuals with strong ethical values have engaged in proactive shareholder activism and excluded others. Their goal is to ensure that their investments and ethical mandates are aligned. One example of the need for such activism is the Rana Plaza disaster, which tragically resulted in a death toll of 1,134 people. Following the occurrence of this event, the Bangladesh Investor initiative was established in May 2013. This effort represents a collaboration involving 250 institutional investors, collectively managing assets exceeding $4.5 trillion. The main goal is to advocate for a vigorous corporate response to the Rana Plaza incident, which encompasses a commitment to engage with the Accord actively [8]. It is important to note that this ideology is not confined to private investors alone. It has also permeated the investment portfolios of significant religious communities and institutions, that are committed to investing in accordance with their doctrinal teachings.

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2.2. Sustainable Long-Term Returns

Investors who aim for sustainable long-term returns progressively consider ESG factors in their investment decisions. These factors profoundly influence companies' financial performance, making their consideration vital in the decision-making process.

Environmental factors refer to the company's impact on the natural environment. These issues include climate change, resource scarcity, waste management, and pollution. Companies that fail to address these environmental challenges may face financial implications in the form of regulatory fines, reputational damage, and reduced operational efficiency [9]. On the other hand, companies with robust environmental practices are better equipped to manage these risks and secure sustainable long-term returns. These enterprises stand to gain from the burgeoning green economic sector, involving areas like sustainable energy and eco-friendly, regenerative economic practices.

Social factors refer to a company's societal impact, including its treatment of employees and its relationships with local communities. Firms that focus on social commitments, including staff welfare, fostering diversity and inclusivity, and active participation in community initiatives, are better positioned to draw in and keep skilled workers, uphold a favorable reputation, and cultivate enduring, sustainable worth. Poor performance in these areas can result in high employee turnover, reputational damage, and potential legal liabilities, negatively impacting a company’s financial performance and prospects for long-term success [10].

Governance factors relate to the management and oversight of a company, including its board structure, executive compensation, shareholder rights, and ethical conduct [11]. Companies with robust governance structures are likelier to make ethical decisions, ensure accountability, and manage risks effectively. They are also better positioned to protect shareholder interests and achieve sustainable growth. In contrast, poor governance can lead to unethical business practices, financial irregularities, and increased risk, undermining investor confidence and the company’s long-term financial performance [12].

In conclusion, the comprehensive integration of ESG factors into investment strategies can help investors identify companies well-positioned to succeed over the long term. As ESG factors continue to gain recognition in financial markets, investors increasingly seek transparent, reliable ESG data and standardized evaluation frameworks to assess a company's ESG performance effectively.

3. The Impact of Corporate-Level Challenges on Investors

3.1. Short-Term Costs

When companies embark on improving their ESG initiatives, they may experience short-term financial costs that can impact their overall performance. The integration of ESG practices often involves the investment in new technologies, employee training, and the development of new business strategies. For instance, a company looking to reduce its carbon footprint may need to invest in energy-efficient equipment or renewable energy sources, which can be expensive. Moreover, the old assets will turn into stranded assets, which means this transition will cause a negative impact on the company's financial position [9]. Furthermore, companies have to invest in employee training programs due to the change in assets.

Transitioning to sustainable practices can incur notable immediate expenses and pose economic adjustments. Industries may need to navigate substantial fluctuations in asset worth or face increased operational costs [13]. For instance, with strict alignment to the Paris Agreement's objectives, a majority of global fossil fuel reserves would be unutilizable, affecting the valuation of financial holdings in the fossil fuel industry held by banking and insurance sectors. Furthermore, sectors producing energy-intensive products such as automobiles, vessels, and aircraft, as well as those

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involved in manufacturing basic materials like steel and cement, may encounter the repercussions of a shift towards an eco-friendly economy. Initially, this shift is likely to dampen investment earnings and could profoundly alter the composition and performance of investment portfolios.

3.2. Greenwashing

The lack of standardized reporting frameworks for ESG information is another significant challenge for companies. Despite the publication of the first international ESG disclosure framework by ISSB, it remains voluntary. Firms often employ a variety of approaches and indicators when disclosing their performance on ESG criteria. This diversity can create challenges for investors who are trying to assess and measure the ESG endeavors of different companies side by side. This lack of standardization increases the complexity and cost of data collection and analysis for investors and opens the door for "greenwashing."

Greenwashing refers to presenting a company's activities as more environmentally friendly or socially responsible than they are. Companies may engage in greenwashing to attract ESG-conscious investors and consumers without making substantial commitments to sustainability [14]. This misleading representation poses a significant challenge for investors, who rely on accurate and verified information to assess a company's commitment to ESG principles [15].

Moreover, many companies face difficulties in disclosing comprehensive and accurate ESG information. Some do not disclose ESG information, while others provide incomplete or inconsistent data. This lack of transparency hinders investors' ability to evaluate ESG performance and make investment decisions effectively. It also undermines the company's credibility and could lead to reputational risk.

3.3. Risk Evaluation

Evaluating the risks associated with a company's ESG practices is a complex task that requires a deep understanding of its operations and the industry in which it operates [16]. Investors need to consider a wide range of factors, including the company's exposure to environmental risks, labor practices, governance structures, and compliance with relevant laws and regulations.

Moreover, the risks associated with ESG practices can vary significantly across industries [17]. For example, companies in the energy sector may face higher environmental risks, while companies in the technology sector may face higher social risks related to data privacy and cybersecurity. Therefore, a one-size-fits-all approach to ESG risk evaluation may not be appropriate. This necessitates investors to possess a deep understanding of the industries encompassed within their investment portfolio. This is very time-consuming and difficult to achieve.

4. Investment Portfolio-Level Challenges

4.1. Inadequate ESG Data

Integrating ESG factors into investment decision-making presents several challenges, with the primary one being the predominantly qualitative nature of ESG data. Companies often disclose ESG data qualitatively and unstructuredly, making it difficult for investors to effectively incorporate these factors into their investment strategies.

Several rating agencies have developed standards to convert qualitative data into structured ESG ratings to address this issue. However, the correlation between these ratings is minimal or negative, indicating a lack of consistency in the rating methodologies employed by different agencies [18]. Investors looking to include ESG considerations in their investment decisions face considerable obstacles as a result of this inconsistent approach.

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Moreover, obtaining these structured ratings requires significant resources, including human and technical resources, as well as data and tools, which may be scarce or expensive. The integration of ESG elements into financial decision-making is further hampered by the paucity of standardized and trustworthy ESG data. Many companies do not disclose comprehensive ESG information, making it difficult for investors to assess their performance in these areas. This lack of transparency creates challenges for investors seeking to incorporate ESG considerations into their investment strategies. Without access to reliable data, investors are unable to accurately evaluate companies' ESG risks and opportunities, leading to potential misjudgments and suboptimal investment decisions.

In addition to the limited availability of ESG data, another challenge in integrating ESG factors is the lack of comparability. Different companies use varying reporting frameworks and metrics, making it challenging for investors to compare and benchmark their ESG performance. This lack of standardization hampers the identification of best practices or the tracking of progress over time. Therefore, to make informed investment decisions and assess the long-term sustainability of companies, investors need access to consistent and comparable ESG data.

4.2. Difficulty in Measuring the Financial Impact

Incorporating ESG considerations into the process of making investment choices brings about the difficulty of quantifying the economic implications of these factors. Despite growing evidence that the integration of ESG considerations can contribute to improved long-term financial performance, quantifying the precise economic effects of individual ESG factors is a complex and challenging task.

There are several reasons for this difficulty. Firstly, ESG factors often demonstrate a high degree of correlation with other financial factors, making it challenging to isolate the specific financial impact of ESG factors [19]. This makes it difficult to attribute observed financial outcomes to specific ESG factors and to draw definitive conclusions about the financial implications of ESG integration.

Secondly, the companies that disclose ESG reports are typically large-scale, industry-leading entities [20]. This introduces an element of bias as these companies may perform better financially due to their industry leadership and more significant resources rather than their ESG practices. This makes it challenging to differentiate between the financial performance attributable to a company's ESG practices and that which is attributable to its size or industry position. This highlights the need for investors to have access to robust tools and frameworks that can accurately measure the financial implications of incorporating ESG factors into their decision-making process. Investors can genuinely assess the financial value of ESG integration and make informed investment decisions only with such tools.

4.3. High Tracking Error and Low Diversification

Screening, divestment, and thematic investment strategies involve "tilting" the portfolio toward desired ESG characteristics by over- or underweighting sectors or companies that perform well or poorly in those areas [21]. Institutional investors may feel this conflicts with their obligation to invest prudently because it involves straying from established market benchmarks. This increases the tracking error, a key measure of active risk widely used in the industry due to operational management decisions versus the model made by the portfolio manager [3].

Such market-wide impacts can influence investors' strategic asset allocation and long-term investment strategy. While studies have raised concerns regarding the effectiveness of conventional risk management tactics like diversification and hedging, the adoption of ESG considerations into investment strategies confronts obstacles including the restricted access to and inconsistency of ESG information, the absence of uniform assessment models, and the complexities involved in assessing the economic consequences of ESG elements. Addressing these challenges requires collaborative efforts from regulators, companies, and investors to promote transparency, standardization, and the development of reliable tools and frameworks for evaluating ESG performance.

5. Conclusion

In conclusion, while ESG investing has grown tremendously in recent years, developing ESG practices still faces significant challenges: (1) The short-term costs incurred by a company for transformation can lead to instability and a decrease in short-term investment returns for investors. (2) To embellish its ESG performance, a company may use greenwashing, thereby misleading investors' judgments. (3) Incorporating ESG into risk assessment requires investors to understand each industry, which is more time-consuming. (4) There is a lack of unified ESG disclosure standards, resulting in a low correlation in ESG scores by rating agencies. (5) The ESG performance of a company is strongly correlated with its size and financial performance, which makes it difficult to trace back to its performance. (6) Incorporating ESG factors into the investment portfolio can cause tracking errors and reduce portfolio diversification.

To mitigate these issues and promote the development of ESG, this paper proposes the following recommendations: (1) governments should take measures to regulate ESG disclosure to prevent greenwashing. This will not only facilitate the comparability of ESG data but also encourage greater participation from companies that may be reluctant to disclose ESG information due to potential reputational or financial implications. (2) Although ISSB issued its Sustainability Disclosure Standards, more work is needed to refine these frameworks and ensure that companies and investors widely adopt them. (3) Additional investigation is needed to determine a direct connection between ESG variables and financial returns on investments.

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