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Literature Review on the Impact of ESG on Financial Decision-Making

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Abstract: The integration of Environmental, Social, and Governance (ESG) factors into investment decision-making has gained significant attention in recent years. This paper investigates the impact of ESG factors on financial decision-making through the methods of literature review and theoretical analysis. It reviews the theoretical foundations of ESG investment, exploring its relationship with some financial models such as Modern Portfolio Theory (MPT) and multi-factor asset pricing models, and examines the role of ESG disclosures in shaping investor behavior, with a focus on both individual and institutional investors. Furthermore, the study analyzes the mechanisms through which ESG factors influence corporate financial performance and risk management, highlighting their impact on cost of capital, credit ratings, and firm valuation. In addition, the paper discusses regulatory frameworks and government policies that drive ESG adoption in global financial markets. As a result, this thesis finds that ESG factors generally have a positive correlation with corporate management decisions and investors' investment behaviors. The findings underscore the growing importance of ESG in corporate strategy and investment practices, reinforcing its role in promoting sustainable and responsible financial markets.

Keywords: ESG Performance, Risk Management, Investment Decision-Making, Financial Performance

1. Introduction

In recent years, with corporate social responsibility and sustainable development, more and more companies have been incorporating the Environmental, Social, and Governance (ESG) factors into their financial performance, and many countries have begun to require relevant companies to disclose ESG information. The ESG factors have aroused the investors' and researchers' attention in the investment strategies. There have been over 210,000 research studies analyzing the relationship between ESG rating and corporate finance, especially in ESG influence on financial decision-making. Some researchers added ESG factors into the asset pricing models and optimized the original models. Some studies found that ESG factors not only reflect a firm's long-term development potential but may also affect its capital cost, market risk, and investor expectations. However, there is a lack of literature to sort out the impact of ESG factors on the entire financial market. This paper analyzes ESG factors from multiple perspectives, including finance and corporate performance, and sorts out the impact of these three factors on investment decisions. It aims to systematically review the existing literature to examine how ESG factors influence investment decision-making, summarize both theoretical and empirical findings, and highlight the

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influence of ESG factors in financial performance and risk management. This paper summarizes some unanswered questions and makes some constructive suggestions for further research in the future.

2. Theoretical foundations of ESG in investment decisions

2.1. Integration of investment theories with ESG

Traditional Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM) primarily emphasize the relationship between financial indicators and the risk-return trade-off. Some research added the ESG factors in MPT, CAMP, and Fama-French Multi-factor Model and showed ESG factors play a significant role in explaining the risk-adjusted return of assets.

2.1.1. The modern portfolio theory (MPT) and ESG factors

Harry Markowitz published an explanation of the Modern Portfolio Theory in 1952. It was designed to mathematically optimize a portfolio to achieve maximum potential returns for investors at a specific level of risk. Some research showed that many investors take the ESG factors into account to evaluate the Socially Responsible Investment (SRI) data. Susan N. Gray explored the findings about the implications of SRI on the final returns. And she claimed that some studies reported using the MPT may lead the investors to focus more on the short-term volatility and less on the fundamentals as well as the long-term growth potential of assets. However, ESG factors have more implications on long-term performance than short-term. Focusing on the short-term one can be problematic [1]. So simply incorporating ESG factors into the MPT model is not desirable, and more processing is needed to make the model more effective.

2.1.2. Assert pricing models with ESG variables

Rui Albuquerque, Art Durnev and Yrjo Koskinen offered an asset pricing model to analyze firms' choices of corporate social responsibility impacts on their systematic risk [2]. They found that firms with robust corporate social responsibility (CSR) performance tend to benefit from lower capital costs, suggesting strong ESG performance may mitigate financing risks and thus influence investment decisions. Khan, Serafeim, and Yoon argued that only the "material" ESG factors—those that are closely aligned with a company's core business—can significantly affect firm performance [3]. This insight has motivated researchers to integrate ESG factors into conventional asset pricing models.

Then, Ashwin Kumar N C, Smith C, Badis L, et al. established a new quantitative model to analyze the relationship between the ESG performance and the stock return [4]. They found that incorporating ESG factors into investment decisions results in higher risk-adjusted returns and can also greatly improve the efficiency of low-risk investment strategies, especially in pension funds. From all the research, it can be observed that ESG factors influence the investors' decisions, the stock return as well as the firm performance. And the firms having good ESG performance will probably attract more investors' interest.

2.2. A behavioral finance perspective & institutional theory and market efficiency

From the perspective of behavioral finance, investors' decisions are influenced not only by rational analysis but also by emotions, cognitive biases, and social responsibility considerations. Statman and Glushkov explored the risk and return characteristics of socially responsible investing (SRI) and found that investors tend to support companies with strong social responsibility, even as they pursue financial returns [5]. Furthermore, Ioannou and Serafeim demonstrated that analysts

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incorporate ESG performance into their investment recommendations, thereby influencing market expectations and investor behavior [6]. This suggests that ESG factors are not only relevant to long-term corporate sustainability but also play an immediate role in shaping market sentiment and stock valuation. And the study showed that the market actors who are in higher reputation or have more experience will probably be the quickest to adjust their investment strategies based on policy changes, such as those related to CSR.

Institutional investors, such as pension funds and sovereign wealth funds, play a crucial role in driving ESG investments. Ioannou, and Serafeim investigated the impact of mandatory corporate sustainability reporting on firm behavior and found that improved disclosure reduces information asymmetry, thereby enhancing market efficiency [7]. And Eccles and Klimenko discussed the ongoing "investor revolution," noting that institutional investors are increasingly incorporating ESG factors into their decision-making processes. Even some activist hedge funds are also turning to sustainable investing, such as JANA Partners and ValueAct Capital [8]. In the research of F Lopez-de-Silanes, JA McCahery, and PC Pudsched, it was found that institutional investors tend to favor companies with high ESG ratings, as these companies are believed to offer more sustainable and less risky investment opportunities. Among the three factors, the government factor has the most pronounced impact on investment portfolios and is the only one that exhibits a positive correlation [9]. All these studies showed that ESG factors influence both the individual and institutional investors' strategies.

3. Mechanisms through which ESG influences investment decisions

3.1. Financial performance perspective

Several studies have examined the impact of ESG ratings on corporate financial performance. Friede, Busch, and Bassen conducted a meta-analysis of over 2,000 empirical studies and found a positive correlation between ESG and financial performance [10]. The study concluded that about 90% of the analyzed studies have shown that ESG ratings have a positive effect on corporate market performance, and less than 10% have found that ESG ratings have a negative effect on returns. When companies implement ESG strategies, operating costs fall, especially in areas such as energy, waste management and employee productivity, which ultimately improves overall profitability.

Moreover, Verheyden, Eccles, and Feiner argued that ESG integration leads to lower capital costs and higher profitability over the long term [11]. The authors claimed that companies with high ESG ratings attract more long-term investors (such as pension funds and sovereign wealth funds), and since these investors are more interested in the long-term value of sustainable development, they are less sensitive to short-term market fluctuations, thereby reducing the cost of equity capital for companies. It can be seen that the ESG factors will have impacts on the cost of the firms' operating or equity capital. These firms that execute these factors into strategies may probably have better financial performance.

3.2. Risk management perspective

3.2.1. ESG role in reducing operational and regulatory risks

Companies with strong ESG practices exhibit lower exposure to regulatory fines, lawsuits, and reputational damage. Eccles, Ioannou, and Serafeim demonstrated that firms with robust ESG policies tend to achieve superior financial performance due to enhanced operational efficiency, lower capital costs, and improved stakeholder relationships and the sustainable firms experience lower risk exposure, leading to better long-term financial stability [12]. Meanwhile, these firms outperform peers in risk-adjusted returns due to better governance and stakeholder engagement.

And highly sustainable companies usually have stable operating performance, so their stock returns are less volatile, which may affect the valuation of executive stock options to some extent. However, executives are not only concerned about short-term option gains, but also about the long-term value and sound development of the enterprise. As a key factor in the long-term sustainability of a company, ESG factors not only help reduce operational risk, but also enhance market trust and improve shareholder returns. As a result, executives may optimize corporate decisions by focusing on ESG factors to enhance long-term value, while indirectly affecting stock return performance and their own wealth growth. Zhang Fangzhao, Pan Wanying and Fu Hui said that corporate ESG responsibility performance can better reduce the impact of exogenous negative shocks and bring about better stock market performance [13]. In conclusion, as ESG regulation has an important impact on the long-term stability of a company, executives often strengthen the management of ESG factors to optimize corporate governance, improve compliance, and reduce operational and regulatory risks.

3.2.2. ESG ratings and their impact on credit ratings and bond yields

Higher ESG ratings often correlate with lower credit risk and reduced bond yield spreads. This relationship is supported by empirical findings such as those from Zerbib, which demonstrate that firms with superior ESG performance tend to benefit from lower cost of debt financing due to reduced perceived default risk. ESG scores can influence how investors consider a company's environmental performance, for example [14]. Some investors are willing to hold green bonds with lower yields due to environmental preferences, and tend to choose companies with higher ESG scores. Research suggests that this may allow these companies' bonds to enjoy certain pricing advantages, such as relatively low funding costs. Conversely, firms with poor ESG performance often face elevated borrowing costs, as investors demand higher risk premiums to compensate for potential environmental liabilities, regulatory scrutiny, and reputational risks. These financial implications highlight how ESG considerations are becoming increasingly central to corporate credit assessments and capital market dynamics.

3.3. Policy and regulatory factors

The ESG score provides a comprehensive overview of a company's sustainability, and more and more countries and governments require companies to disclose ESG information. For example, the European Union's Sustainable Financial Disclosure Regulation (SFDR), which on 30 June 2023 requires all financial market participants to publish reports on the adverse impact of sustainable development, has promoted transparency and the integration of ESGs. In 2022, the U.S. Securities and Exchange Commission (SEC) proposed ESG disclosure rules. The proposed climate-related disclosure rules require listed firms to disclose carbon emissions, climate risks and ESG strategies. Meanwhile, the promote public firms need to focus on how climate change affects financial performance and increase investors' awareness of ESG risks. From all the strategies, it can be seen that the policy-driven incentives further drive capital allocation towards sustainable investments.

4. Conclusion

This paper mainly discusses the impact of ESG factors on investment decisions and corporate financial performance, and analyzes and summarizes the role of ESG information disclosure from the perspective of individual investors and institutional investors. From the perspectives of corporate managers and investors, the influence of ESG on investment decision-making and its role in risk management are elaborated. In addition, by integrating existing policies, the significance of ESG ratings in the capital market is demonstrated, and the trend towards sustainable development

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transformation is analyzed. Through a review and summary of existing literature, it is found that the impact of ESG ratings on enterprises is becoming increasingly significant. Executives need to incorporate ESG factors into cost management and strategic decision-making, while investors, especially institutional investors, are more inclined to invest in companies with higher ESG ratings and sustainable development capabilities. However, this paper is mainly based on a literature review and lacks an in-depth empirical analysis of the relationship between ESG ratings and corporate operating performance, due to the absence of data support. This limitation provides further space for future research. Future research can refine ESG assessment models and enhance the integration of sustainability principles into global financial markets.

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