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Sustainability Management: A Review of ESG Principles and Policies in Investment

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Abstract: Since numerous nations commit to achieving carbon neutrality by 2050, there is a need to examine the implications of Environmental, Social, and Governance (ESG) principles on investment decisions. This research emphases on the violation of investment principles regarding ESG factors, specifically in relation to the maximisation of shareholders' wealth. Additionally, this paper explores the reasons behind banks considering the cessation of investments in corporations that have pledged to cut carbon emissions, despite the evidence of a positive correlation between sustainable management and stock performance. Moreover, there are concerns among many that ESG practises may be fraudulent and merely a form of greenwashing, lacking the ability to convince shareholders to consider sustainability. In this study, the primary challenges that arise in relation to ESG factors are considered, and the author also assesses the insufficient outcomes in this field that necessitate additional investigation into the actual effectiveness of ESG in promoting sustainability. ESG framework offers long-term benefits to both shareholders and stakeholders, as opposed to focusing on short-term outcomes and results. It is essential to demonstrate the significance of ESG practises and results in order to prove their value to investors. While ESG firms are more likely to withstand challenging circumstances, they may not necessarily outperform other stocks in a thriving macroeconomy.

Keywords: ESG, Greenwashing, Investing, Sustainability, Stakeholder Capitalism

1. Introduction

In the 21st century, nations and governing bodies frequently disagree on monetary and fiscal policies that impact the market and the overall macroeconomy. However, they will collaborate on environmental conservation efforts. Thus, Pigou has demonstrated that negative externalities can be harmful to the environment, the implementation of corrective taxes can diminish such behaviours in the past, and Environmental, Social, and Governance (ESG) principles and policies can be one of the many solutions to impact the environment in a friendly way [1]. ESG principles are currently seeing significant opposition from government entities, investment banks, and individuals who claim that ESG principles contradict with investing principles and that their motivating factors are unrelated to sustainable management. The ESG reporting rate experienced a significant decrease from 41% to 31% in the past year, as companies lack motivation to disclose voluntarily. However, the growing popularity of ESG funds indicates that capitalism must undergo a transformation for ESG to firmly establish itself in the financial sector. With over 3000 institutional investors endorsing the Principles

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of Responsible Management (PRI), it is imperative that ESG principles transition from being "voluntary" to "mandatory" in order for investors to truly implement them. On this basis, this paper first examines the relevance of ESG in investment and its potential for generating higher returns. Secondly, the impact of environmental ratings on the investment industry is explored. Lastly, the author discusses how ESG can serve as a valuable tool for investors in making consistent long-term adjustments. The primary objective of this publication is to enhance readers' comprehension of both the beneficial and detrimental aspects of ESG. By doing so, it aims to encourage readers to critically evaluate their own understanding of ESG and provide individuals with a basis to substantiate their perspectives on the influential role of ESG in the investing sector.

2. A Critical Review of Both Sides of ESG Ratings in Investment

The concept of ESG investment was first proposed in a 2004 report by the United Nations. The report highlighted that ESG investing has the potential to generate higher returns and, more crucially, increase awareness about sustainability within the financial industry. This concept is in line with the objective of maximising value for all stakeholders rather than solely focusing on increasing profits for shareholders. Stakeholder capitalism is thought to contravene fiduciary duty, which says that managers must adhere to a contractual obligation to operate in the best interests of a beneficiary. Many detractors argue that ESG practises may result in "greenwashing," since fund managers sometimes attribute their high turnover ratio to ESG value investing. This allows them to absolve themselves of accountability, which is why they promote ESG practices. Consequently, the widespread phenomenon reached its zenith in 2022 but has since experienced a downturn due to various criticisms.

2.1. Greenwashing in ESG

ESG faces significant jeopardy when it breaches governmental regulations. Investors and the public are fully cognizant of the detrimental impact on the economy that can arise from the improper use of ESG. As an illustration, Oprah, an activist for the environment, endorsed Dr. Oz, a television personality and politician. Dr. Mehmet Oz allegedly caused the death of more than 300 dogs, 31 pigs, and 661 rabbits and rodents while working as a lead investigator at a laboratory of Columbia University [2]. Oprah Winfrey and Dwayne Johnson established The People's Fund of Maui at a later time, urging the working class to contribute in response to the catastrophic wildfire that occurred in August 2023. Nevertheless, considering the total wealth of these two influential figures exceeds $2.8 billion, their demand for public aid has been met with doubt. It was subsequently revealed that they own over 1000 acres of land in Maui, while numerous residents of Maui faced difficulties in obtaining genuine assistance from their foundation [3]. Another instance is the Volkswagen emissions scandal, in which the corporation emitted up to 35 times higher levels of harmful nitrogen oxides on the road than what was officially reported in testing for 11 million vehicles. This led to a settlement compensation of over $21 billion [4].

2.2. Stakeholder Capitalism vs. Shareholder Capitalism

Presently, certain critics assert that the environmental component of the ESG sector is highly quantitative. However, the social and governance aspects are more subjective and challenging to assess. This is because firms' ESG reports are still voluntary rather than mandated. Consequently, many unethical enterprises choose not to provide any essential information regarding their ESG practises. Hence, it is challenging to evaluate the efficacy and administration of corporations. Lund argued that determining whether a firm is concealing its political spending is challenging, yet often businesses do not receive a zero ESG score [5]. Nodoph found that 58% of executives in top-level

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management believe in the engagement of their own organisations in greenwashing. This percentage surged to 68% particularly in the United States [6]. Stakeholder capitalism faces a new issue when shareholders withdraw their investments when the emphasis shifts towards social value opposed than shareholder value. There has been a negative reaction when ESG becomes overly politicised, leading several state governments to withdraw their investments from Blackrock due to the high costs associated with it, as an ESG fund has culminated in a 41% rise in fees compared to a non-ESG fund [7]. Corporate leaders should not be obligated to provide value to stakeholders, even if they use stakeholder rhetoric. Accordingly, individuals who genuinely consider stakeholder concerns should refrain from depending on corporate executives to address these problems. Instead, they should prioritise advocating for governmental reforms that would safeguard stakeholders across several domains. Those who are worried about climate danger or employee welfare should acknowledge that corporate discourse on the subject is unlikely to make a significant contribution to addressing those issues. The study conducted by Bebchuk et al. determined that the COVID-19 pandemic has exposed the shortcomings of stakeholder capitalism, which should make anybody who is enticed by its deceptive potential reconsider their stance [8]. Ultimately, ESG investment has not demonstrated advantages for investors or for the environment. However, better ESG ratings do increase the likelihood of investors allocating funds with a heightened focus on sustainability.

3. A Review of Environmental Protection with Economic Incentives

3.1. The Magnitude of ESG

Despite facing numerous criticisms involving potential fraud and concerns, the amount of money being invested in accordance with ESG principles is progressively increasing. It is projected to grow at a rate of 15%, which is half the rate observed in the preceding five years. As a result, the assets under management (AUM) in the ESG sector could potentially reach nearly one-third of the estimated worldwide total of $140.5 trillion by 2025. Bloomberg's forecast indicates that the value of ESG assets is envisioned to soar to $53 trillion by the end of 2025, exceeding the previous figure of $37.8 trillion in 2021. The value surged to $30.6 trillion in 2018, a significant rise from $22.8 trillion in 2016 [9].

3.2. The Significance of Environmental Factors in ESG Ratings

Firstly, for an organisation to attain high E scores, an enterprise must have demonstrated strong performance in multiple categories including obtaining accreditation for their environmental management system, implementing water conservation, improving energy efficiency, minimising waste gas emissions, and limiting accidental waste and spills. According to Broadstock et al. [10], these efforts aid in reducing long-term environmental concerns and establishing an efficient and adaptable organisation. Consequently, the significance of ESG ratings is increasing, since numerous investors will determine their investment decisions based on these ratings. MSCI is a prominent leader in the field of ESG. The ratings, including the MSCI implied temperature rise, are designed to align with the Paris Agreement of 2015. This agreement aims to limit the global temperature increase to below 2 degrees Celsius by the year 2100 [11]. Therefore, the MSCI implied temperature rise is a vital consideration in the environmental sector of ESG. Additionally, when a corporation prioritises profit over environmental concerns, consumers are more inclined to discontinue their purchases, leading to a financial setback. In addition, research has shown that products that make ESG-related claims have experienced an average cumulative growth of 28 percent over the past five years, compared to 20 percent for items that do not make such claims [12]. However, Talan and Sharma contend that ensuring a difference in the environmental aspect of ESG does not influence investment choices, and the MSCI ESG Intangible Value Assessment (IVA) database shows no notable disparity

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in performance between sustainable indices and traditional conventional indices [13]. Nevertheless, several nations incur a sunk cost in implementing economic incentives to safeguard the environment, with developing countries prioritising infrastructure, healthcare, and education above assessing their environmental preservation efforts. Hence, there is still potential for enhancing new policy instruments and procedures like ESG, which may differ according to the resources and competencies of each government agency. For industrialised nations including China and the United States, adopting simpler resource-efficient and incentive-based policies for environmental conservation could yield better outcomes and implementation. In order to enhance ESG practises in the long term, decision-makers should utilise various strategies to influence politicians to enact necessary measures. This is crucial since for ESG to significantly impact the overall macroeconomy and financial sector, governmental intervention is essential.

4. The Long-Term Efficacy of ESG and Its Proper Implementation

4.1. Utilising ESG as an Assessment Framework Rather than a Regulatory Mechanism

Lisin et al., Fulton et al., and Atz et al. have demonstrated a clear correlation between higher S and G scores and Corporate Financial Performance (CFP) [14-16]. Moreover, a firm's exceptional performance in these areas is vital for maintaining overall financial stability and maximising its ability to resist any unanticipated occurrence, such as the COVID-19 pandemic. ESG can serve as an assessment tool for mitigating idiosyncratic risk, while concrete indicators can enhance a company's ability to withstand unforeseen crises. Furthermore, given the unprecedented level of public consensus, elevated ESG ratings have the potential to raise consumer trust, purchasing behaviour, and satisfaction, which directly impacts a company's financial gains. Democratic lawmakers in the United States are also keen on utilising ESG to benefit both the overall economy and individual investors. They argue that the labour department's proposal to restrict ESG investing would undermine a powerful tool that mobilises trillions of dollars annually to promote positive social change [17]. This assertion is supported by Bloomberg's earlier findings, which estimated an annual growth rate of 15% in this field. However, ESG must avoid excessive political involvement as it has already faced a negative reaction. States heavily reliant on "fossil fuel" industries, such as Kentucky, Louisiana, Florida, Missouri, West Virginia, and Oklahoma, have begun divesting from ESG investments and are even contemplating pressuring financial institutions with ESG policies through coercive tactics [18]. Hence, in order to significantly impact profitability through ESG, it is imperative to utilise it as an assessment framework for the portfolio strategy and promptly eliminate any investments that contradict interests. ESG, being a subjective concept, varies according to individual values. Implementing regulations on personal values can be met with scepticism and seen as encroaching on cynicism. Pineau et al investigated the correlation between ESG issues and the level of credit risk associated with corporations. The research discovered a negative correlation between corporations with ESG ratings and credit risk, as indicated by fewer credit default swap spreads [19]. Welch and Yoon discovered that managers who earn higher ratings from employees address this issue by strategically allocating resources to ESG initiatives in a manner that improves shareholder value [20]. BlackRock and other advocates of ESG principles argue that investing in accordance with these values will ultimately lead to superior long-term returns. However, there is still apprehension regarding the implementation of a pecuniary standard.

4.2. Making Changes Yearly and Differentiating the ESG Rating Between Industries

Ermakova et al. proposed the need to establish a methodology for evaluating the weight of various industries, for instance, a standardised assessment system that can be used by different ESG rating providers [21]. MSCI has established itself as a leading rating supplier in the business, with ownership

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of 40% of the investment industry's spending on ESG data. Bloomberg has claimed that MSCI's ratings have been used to build ESG funds for about 90% of stocks in the S&P 500 [22]. Nevertheless, the majority of ESG ratings lack comprehensive diversification as they adopt a best-in-class methodology, which results in inaccurate information derived from public data at a staggering rate of 75%. Consequently, corporations that oppose ESG principles and have poor ESG ratings are hesitant to provide their ESG data. MSCI, primarily, relies on this ESG disclosure to assign ESG ratings. As a result, firms may provide restricted, unverified, and non-standardized information regarding ESG matters, while multiple researchers frequently assert that the outcomes are ambiguous, inconclusive, or contradictory. Khan et al. investigated the elements that determine ESG ratings and concluded that industry-specific factors have a substantial impact on ESG ratings. Hence, it is imperative to calibrate ESG ratings based on industry materiality in order to achieve a more precise evaluation [23]. Nazarova et al. discovered that the impact of ESG ratings on the Tobin coefficient, which serves as a proxy for firm value, varies among industries in developed and developing countries. In developed countries and innovative industries, ESG ratings have a positive influence on firm value [24]. However, this prompts the inquiry of whether ESG ratings hold significance in developing countries and other sectors like basic resources and chemicals. ESG funds primarily investing in Tech businesses fail to fulfil the fundamental purpose of ESG, which is to advance sustainability and encourage ethical business practises. Moreover, additional investigation might be undertaken to determine the necessity of industry-specific ESG disclosure criteria in light of the distinct environmental and social hazards involved. There is a requirement for customised ESG ratings specific to various industries, as the existing ratings do not possess sufficient power or impact on investor decision-making.

5. Conclusion

In summary, as Qin proposed, the prediction of stock returns based on ESG ratings is highly dependent on the attention given by investors [25]. However, the investigation conducted by Pineau et al. raises the controversy of whether stock returns are more closely associated with ESG characteristics or economic progress. The prioritisation of long-term responsible investing is crucial for all rational investors to perform their fiduciary obligations and to better align their interests with the greater ambitions of society. To fully use the value-boosting effects of ESG elements, one must possess a comprehensive and profound comprehension of how to incorporate ESG criteria into investment procedures. An important focus for future study is to gain a deeper understanding of how different ESG criteria interact within investment portfolios and to determine the significance of specific ESG sub-criteria for the concept of corporate financial performance (CFP). These insights will provide additional clarity on the factors that influence ESG performance and its long-term positive effects.

In addition, Horn and Glück have demonstrated that companies with good ESG performance, which are rewarded with rating upgrades, can effectively diminish downside risk, systematic risk, and idiosyncratic risk [26,27]. Nevertheless, the successful adoption of ESG necessitates gradual modifications and execution, including the elimination of greenwashing and the cessation of regulatory practises. Furthermore, the implementation of ESG practises should be coordinated, and economic incentives may be taken into account when companies provide ESG disclosures. ESG should prioritise avoiding excessive influence from institutional investors rather than customers. The aforementioned is because 64% of managers utilise ESG to mitigate investment risks, while 44% do so in response to client and investor demands, rather than just for environmental conservation purposes. ESG evaluations should prioritise companies that actively seek to change it, rather than those that maintain the current state of affairs. Otherwise, the impact of ESG on sustainability will remain limited, since non-ESG stocks can simply be transferred between investors without being

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eliminated from the market. Greater emphasis should be placed on assessing the long-term ESG impact of research, as sustainability is inherently a time-intensive endeavour. Additional investigation can be undertaken to analyse the diverse influence of ESG ratings in different countries. Empirical evidence suggests that ESG ratings have little impact on stock returns in certain markets, whereas a non-linear correlation has been identified between stock performance and high-ESG funds. Furthermore, it is worth considering whether companies that are not involved in environmental harm or conservation, such as those in the education sector, are included in the empirical data applied to calculate ESG ratings. Also, ESG should be established as a norm to support environmental conservation, rather than solely serving as a tool for investors to mitigate investment risks. Finally, for ESG to truly influence the global economy, it must transition from its current state of incompleteness, infeasibility, irrelevance, and lack of enforceability. This transformation will need a lengthy process, but time is not working against us.

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