ESG INVESTING: A CRITICAL OVERVIEW

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ABSTRACT

The aim of this paper is to study and critically evaluate ESG Investing and Sustainable Finance which is developed by the instrument called ESG Rating. The intent of this study is to understand the concept, importance, scope, components, shortcomings and future of ESG Investing in India. The Increasing adverse effects of climatic conditions and their unpredictable nature have forced the world to adapt to these changes and mitigate their aftermath by focusing on the global impact. Apart from studying this concept, the focus has been to understand the evolution of finance to implement this investing practice. To study how Environmental, Social and Governance concerns are affecting businesses and the financial market.

Keywords- Investing, Finance, Environment, Social and Governance, Sustainability.

INTRODUCTION

Environmental, **S**ocial and (Corporate) **G**overnance better known as **ESG**, is an intangible key evaluating factor for socially responsible and aware investors. In recent times, Investors are stepping up by focusing on these non-financial factors of social and environmental concerns as a part of their analysis to identify selective investments with growth opportunities and pin down material risks associated with the decisions. Sustainable Financing, Impact Investing, mission-related investing, Sustainable investing, these terms are interchangeably used with ESG Investing. With ever changing times and desperate climatic conditions, a need for such proposals and investing criteria emerged and paved its growth, which has been majorly driven by responsible investors' aspiration to have an impact on the society and environment along with the economic benefits of investing. This growth is a net result of a bigger trend cycle which is being observed around the globe to factor in the efforts to contribute to a global cause and in turn improve environmental status. Even though ESG Metrics is not a standard practice during financial reporting, there is a substantial increment in the number of companies who choose to disclose ESG metrics either in their annual financial report or in the company's sustainability report.

This Emerging concept is accepted and vastly popularised among young investors due to awareness and sensitization over ESG concerns. According to a survey conducted by Morgan Stanley, 95% of Millennials are interested in ESG Investing. This growth trend is also observed in the case of regular investors and financial institutions, who are factoring in ESG assessments as a key investment decision. The UN Principles of Responsible Investment (UN PRI) has observed an exponential rise in the signatories to over 2300 signatures catered to institutional investors and the survey by Morgan Stanley also states that 85% of individual investors are interested and consider Sustainable Financing while making an investment decision.

LITERATURE REVIEW

ESG investing emerged more than 200 years ago during the Methodist Movement when people protested against companies that manufactured tobacco, weapons, etc. The first sustainable mutual fund was launched in the US by Pax World in 1971. This fund was led by two United Methodist ministers, Jack Corbett and Luther Tyson, who wanted to refrain investing church's money in companies that contributed to the Vietnam War. They wanted to orient their investments with their core values and recommended companies to adhere to a standard of environmental and social responsibility. This mutual fund is active even today. ESG investing was on a fast-track during 2013 and 2014 when the first studies were published which displayed good corporate sustainability practices along with good financial results. Although the concept of ESG emerged in Europe, it has advanced to Canada, Japan, Australia and the USA. Financial markets in India have also entered the umbrella of ESG investing.

A paper by Jacobs, Sinhal and Subramaniam (2010) observed the stock market reaction to the announcement of various types of corporate environmental initiatives, like environmental philanthropy, renewable energy, voluntary emission reductions, eco-friendly products, etc. Their study noted insignificant results, except for voluntary emission reduction, for which it found significantly negative returns consistent with the paper by Fisher-Vanden and Thorburn. For environmental philanthropy, their study found significantly positive returns.

A study by Krüger (2015) focused on the stock market response to 2,116 corporate events which are recognised by KLD as either positive or negative along an ESG element. His study found a considerably negative response to negative ESG events. A paper by Harvey, Liu, and Zhu (2016) underlines that purely data-focused research assumes the risk of correlation mining, which overfits a financial model to a specific dataset to observe various correlations that may not exist when tested out of sample.

As per the results of 1,000 research reports on ESG testing, the correlation between ESG characteristics and financial performance was reported inconclusive. The existing literature found negative, positive, and nearly non-existent correlations between financial performance and ESG, however majority of research reports concluded a positive correlation. The ground for such inconclusive results lies in different underlying ESG data used and the various methodologies applied. As per the paper by Krueger (2015), the various empirical studies that analysed the relationship between ESG and financial performance do not distinguish between causality and correlation. Usually, correlation between ESG and financial variables is interpreted as ESG being the cause and financial value the effect, however the transmission can be interchanged.

COMPONENTS/CRITERIONS OF ESG:

3 key components of **ESG** are – **E**nvironmental, **S**ocial and (corporate) **G**overnance aspects. Since ESG factors are often interrelated, there may be scenarios where identifying and classifying an ESG activity as only an Environmental, social or governance practice might not be feasible. There are no set examples of ESG issues and the list continues since new emerging issues arise constantly.

1. **Environment:** This component essentially targets conservation and preservation of the natural world and its scarce resources. This criterion vitalises whether a company adopts low carbon footprint and follows eco-friendly methods in its functioning. This advocates wise and efficient use of resources. Some factors include-
    - Air and Water pollution
    - Biodiversity Loss
    - Deforestation
    - Waste management
    - Carbon footprint, global warming
    - Climate Change impact
    - Water Scarcity
    - Natural resource conservation

2. Social: This aspect focuses on broad features of social aspects, majorly pivoting around consideration of people and relationships. At the core of any business organisation are its people. Socially developed organisations respect and hub human fostering and growth of its employees and community. This criterion looks at a company's business relationships with its customers, community and business partners. It even observes how a business organisation upholds social good in the wider world, which is not limited to mere scope of business activities. Other factors include-

- Customer Satisfaction
- Gender equality and Diversity
- Human rights
- Employee engagement and satisfaction
- Labour laws
- Community relations

- Data protection and privacy
- Engaging in volunteering work to improve the socio-economic conditions

3. Governance: This criterion elucidates standards for running a company, it considers how the board and management drive positive changes. This also features the transparency and ethical well-being of the company and holds the highest standards of governance consistently. It also takes into account the executive management's behaviour to cater to the needs of various stakeholders- employees, shareholders and customers. This is the base, the foundation through which a company is gauged. Apart from this, other factors include-

- Composition of the Board of Directors
- Audit committee structure
- Lobbying
- Whistle-blowing schemes
- Bribery and corruption
- Political associations and contribution
- Executive compensation
- Engaging in illegal and unfair practices

ESG RATING, INDICES AND ADVISORY

After studying and analysing the criterions and factors involved in ESG components, an investor cannot make an investment decision based on just some factors stated by a company, ESG information alone is not useful unless it is analysed and rated using certain methods and then converted into indices. This rating transforms the raw ESG disclosures into a key index which creates investment products and smooths the process for investors.

There is a huge array of rating practices which ascertains data to be included, weighs metrics systems as per materiality and, culminates subjective data as relative and absolute scores internally and transversely in the industries. Although ESG methodologies and ratings are becoming more vigorous along with increase in number of back testing of scores against performance, still scoring of ESG information largely remains in a state of transition.

Agencies like Bloomberg, Morningstar, Thomson Reuters, ISS, Sustainalytics, RobecoSAM, Apex ESG Solutions and firms more focussed on financial services such as MSCI, etc are engaging in providing detailed review of data and ratings through information provided by firms and outside consultancies and independent surveys. The modus operandi adopted by these institutions are intrinsically different but the final ratings published are used by the investors in the same way and purpose. These ratings issued helps these investors to identify companies that adopt better ESG practices and are sustainably efficient and imprinting a positive impact of an investment or business. Some rating systems are ESG performance-based while some are ESG risk-based.

Table No. 1: ESG criteria- major Index providers

COMPONENTS	Bloomberg	MSCI	Thomson Reuters
ENVIRONMENTAL	Effects from Climatic change Pollution Renewable energy Depletion of Resources Waste disposal Carbon Emissions	Climatic change Pollution and waste generation Environmental opportunities Natural resources	Use of resources Emissions Innovation
SOCIAL	Discrimination Political Supply Chain Diversity Human Rights Contribution Community Relations	Product Liability Stakeholder opposition Human Capital Social Opportunities	Human Rights Community Product Responsibility Workforce
GOVERNANCE	Executive Compensation Takeover Defence Cumulative Voting Staggered boards Shareholders' rights	Corporate Behaviour Corporate Governance	Shareholders CSR Strategy Management
Key Metrics and Sub-metrics	**More than 120**	**34**	**186**

Different agencies/index providers have different ESG criterions for rating purposes. The table above mentions the factors Bloomberg, MSCI and Thomson Reuters take into consideration while preparing an index rating.

Since these ratings are not standardised and regularised, many stakeholders have urged for better standardised reporting measures. Currently 80 exchanges have issued their own reporting guidelines and many more will follow in coming years.

Apex ESG solutions, which is a leading ESG analyst issues ESG metrics and the process it follows to release the rating is discussed below.

ESG Excellence- ESG experts at Apex monitor an organisations' presence at both global and local level.

Client Scoping- At this step, a clarification of need, scope of service and products is done regarding a business of the client.

Data Collection- Data of the business and operations is collected through secure lines and contest primary and secondary information relating to social indicators and indices

Analysis, Rating and Benchmarking- A detailed review is carried out and set against international standards, UN Sustainable Development Goals, sector peers and relevant regulations.

Report Delivery- A customised report is prepared and tailored according to the client's need and is then delivered.

Gap Analysis- A review of the report is done and guidance and recommendations are suggested to eliminate any shortcomings.

SHORT-COMINGS/ CHALLENGES TO ESG INVESTING

ESG investing sounds very optimal and futuristic and it also has definitive facts and figures to back it up, though it hasn't been able to achieve its full potential in the financial domain and like every other aspect it has its own set of challenges and shortcomings to overcome and achieve the goal of sustainable future.

The US SIF Foundation: The Forum for Sustainable and Responsible Investment observed a rise in assets held by investors chosen as per ESG criteria. This increased from $12 trillion in 2018 to $17.1 trillion in 2020. Moreover, according to Sustainalytics the NIFTY 100 ESG Index has outperformed its parent index NIFTY 100, with overall ESG risk rating score at just 24.6 as compared to 27.5 at NIFTY 100.

Various Critics and ESG analysts' have pointed out the fact that ESG investments often lose out to financial gain and profit and in turn this restricts the efficiency of financial markets and businesses. The main focal point of financial markets is to grow investors' wealth and maintain a balance in the economy. The sense of balance and growth is lost when the choices are restricted due to ethical principles and missing out on some good return opportunities. This acknowledges the trade-off between ethical principles and profit motive. Milton Friedman, a leading economist shares the same school of thought and claims that ESG strategies increase un-necessary expenses and dissipate shareholders' and investors profits. He believes that a stock should be evaluated on the company's financial worth and profits.

There are various ESG funds which are performing and yielding return at par with Index funds barring certain companies that can affect your portfolio's end result. For example, if oil stocks proliferate suddenly and if an ESG fund doesn't have those stocks, that fund will be out-performed and thus making it restrictive.

Another challenge ESG investing faces is that of being more expensive than normal Index funds, ESG funds are slightly more expensive then Index funds due to more research and extensive workload. ESG funds require substantial and regular research which can eat up the investor's earnings since the individual has to invest more to be in that fund. Financial Firms often deem ESG approaches as a premium product and charge a higher fee. Moreover, ESG supporters had a fallout when The U.S. Department of Labor guided fiduciaries of employee benefit programs to implement investment strategies based on investment performance rather than ESG concerns, however, this is not the case for personal investments.

Even with these fallouts and challenges, many still believe that pursuing ethical principles and following ESG concerns help a company succeed in the long run. For example, if some corporate deals in bad faith, acts irresponsibly and is careless in environmental aspects, this will likely incur liability and damage the image and reputation of the firm. And as far as it goes for rate of return it is believed that ESG funds will yield return at par with other Index funds over a period of time. Also, there is no concrete proof that ESG funds yield less returns.

ESG IN INDIA AND SCOPE

The success and growth of ESG investing worldwide paved its way towards Indian Markets, after being big globally. Assets under Management (AUM) nearly doubled itself in the last four years amounting to $40.5 trillion in 2020. Since the introduction of Nifty 100 ESG Index in 2011, it has outperformed its parent index with a return of 10.6% as compared to 9.1% of the traditional Nifty 100 Index. This proves a steady growing interest in ESG investing by Indian investors.

The demand and growth for ESG funds in India is experiencing an upward curve and with pandemic hit it all went uphill. The covid crisis turned out to be an inflection point in the minds of Indian investors and the flow of money has remarkably risen into ESG funds says Kaustubh Belapurkar, Director of Fund Research at Morningstar India. Earlier Indian investors did not have many ESG funds options but after October 2020, more than half a dozen asset management companies have introduced ESG-centric fund plans. Major funds include Axis ESG Equity Fund, Quantum India ESG Equity, SBI Magnum Equity Fund (oldest ESG fund in India). Apart from these, ICICI Prudential AMC, Kotak and Aditya Birla have also introduced such funds. Currently, India has two major ESG indices, S&P BSE 100 ESG Index and Nifty 100 ESG Index.

As per Morningstar, in the quarter ended of December 2020 Indian Markets were flooded with a net inflow of ₹3,749 crores into ESG based funds and in March 2021 it saw a net inflow of ₹ 678 crores. Since inflow of capital into ESG funds in India is experiencing a boom, it is very likely that other companies will follow through and exhibit better Environmental, Social and Governance practises.

The reason for the success of ESG funds in India can be explained largely due to more investors becoming socially aware and conscious regarding the ESG components. Moreover, factors such as statutory regulatory requirements have played a vital role to impel companies to be more ESG compliant. There have been many cases where companies and business firms were close down or penalised for not abiding to these regulations, making it clear that severe consequences will follow. Apart from this, many foreign institutional and independent investors are extensively investing in ESG compliant companies and sustainable business models. These lucrative offers have attracted many firms to follow regulations and prospects of Foreign Direct Investment (FDI) have made ESG investing even stronger in India.

As per Nifty reports, it can be concluded that ESG indices are more productive in the post-Covid period than the pre-Covid period. Thus, giving an impression that investors are inclining towards ESG indices post aftermath of Covid. Consequently, ESG portfolio can be accredited as Covid free portfolio. The rising concern for environment friendly methods and Covid pandemic have proved to be the main cause for this boost of ESG funds in India.

FUTURE OF ESG INVESTING IN INDIA

The way ESG has performed in India can be termed as prodigious but if we look at ESG in other parts of the world, we can say that we still have a long way to go, but nonetheless India is moving ahead in this avenue. With regulations becoming more stringent and periodical inspection of regulations moving akin, standards to be ESG compliant are getting robust every day. It is now imperative for firms to follow these regulations and it is better to be on a safer side because serious repercussions will follow if caught. ESG compliant companies in India will also observe a significant rise in market share due to increasing interest by consumers and non-compliant competitors struggling to meet the norms and pass the bar. Following standards and rules will enhance the company’s reputation and credibility by several folds and will also attract investors due to a sustainable future.

ESG FUNDS IN INDIA

Currently India has 10 ESG centric funds and each fund has different attributes. Some funds have an allowance for global stocks, some funds have their own market capital and have different sector preferences and some are passive funds. The ESG Funds in India are SBI Magnum Equity ESG Fund, Axis ESG Equity Fund, Quantum India ESG Equity Fund, Aditya Birla Sun Life ESG Fund, ICICI Prudential ESG Fund, Invesco India ESG Equity Fund, Kotak ESG Opportunities Fund, Mirae Asset ESG Sectors Leaders FoF, Quant ESG Equity Fund and HSBC Global Equity Climate Change Fund.

Table No. 2: ESG Funds in India- performance comparison

Return(%) as on 12th March 2021	SBI Magnum Equity Fund	Axis ESG Equity Fund	Quantum India ESG Equity Fund
3 Months	11.60	8.53	13.63
6 Months	30.52	30.02	35.97
1 Year	49.90	48.04	64.30
5 Years	14.83	-	-

- **SBI Magnum Equity Fund** (repositioned as SBI Magnum Equity ESG Fund) is one of the oldest existing ESG Fund in India. Founded in 1987, this was a partnership between SBI and AMUNDI (France), which is one of the world's leading fund management firms. SBI Magnum Equity Fund was launched in 1991. It has 42 equity holdings (as on 19th March, 2021) and its top holdings include ICICI Bank, HDFC Bank, Infosys, TCS and Tata Motors. As on 31st October 2021, it has invested 95.36% in Equity, 0.05% in Debt and 4.59% in other segments.
- **Axis ESG Equity Fund** is a thematic-ESG mutual fund scheme from Axis mutual fund. It was launched in February 2020. As on 31st October 2021, it has equity holdings in 50 companies with Nestle India, Bajaj Finance, Avenue supermarts, Wipro Ltd. and TCS as its top 5 holdings. It has invested 96.24% funds in equity and 4.09% in debt and 0.33% in other segments.
- **Quantum India ESG Equity Fund** is a thematic-ESG mutual fund scheme from Quantum mutual fund. It was launched in July 2019. As on 31st October 2021, it invested in equity holdings of 45 companies with Infosys Ltd, TCS, Housing Development Finance Corpn. Ltd, Wipro and Marico Ltd as its top 5 holdings. It has invested 94.75% funds in equity, 5.82% in debt and 0.57% in other segments.

CONCLUSION

ESG Investing has come a long way, a step taken to bring balance and responsibility in the corporate world through the finance domain and financial markets. Growing concern for the environment and social domain expedited a fire among concerned and responsible investors and soon started to influence others. It is a great initiative to give back to society and save the planet alongside leading to a sustainable future. It is crucial for every investor, be it small or large, to contribute and be a responsible citizen of the planet. With big scope in ESG investing, institutions have accepted the change and adapted to it by creating a process of converting raw information to definitive ratings and scores, which has certainly helped people to make informed and calculated decisions without harming nature. Even though the process and ratings have shortcomings, still it is competing with the traditional form and outperforming it in certain aspects. We cannot refute that the corporate sector is the backbone of economic activity and striking a balance with right choices and strategies will create economic growth and efficient resource management using sustainable financing.

ESG has and will benefit companies, investors and the society; thereby achieving a triple bottom line and all this could be the "new normal" in the world of finance.

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