The Impacts and Challenges of ESG Investing

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Abstract. With the rise and expansion of responsible and sustainable investing in recent years, ESG investing is one of the categories that has gained momentum. This literature review aims to bring ESG investing and its current state of development to a broader audience. The article first introduces the concepts related to ESG and the ESG ecosystem, demonstrating the current manifestation of the framework in prestigious corporations among different industries with in-depth case studies. In addition to understanding the content and structure of ESG, it is essential to recognize the controversial topics that have been argued in recent years. This article also highlights the current inconsistencies in ESG disclosure and the examination of its financial performance by authoritative bodies to bring a deeper and more contemporary understanding of ESG investing. Lastly, it draws out the improvement solutions that are currently available to refine ESG investing by demonstrating the most up-to-date policy announcements.

1 INTRODUCTION

ESG investing has become a trending topic inside and outside the financial industry. As society's call for a sustainable future for humanity grows, evolvements also occur in the investment field that corresponds and develops with it. Environmental, Social, and Governance (ESG) Investing is a sustainable and responsible investment that encompasses different approaches that address a variety of goals that commit to a sustainable future [1]. It establishes a framework for considering 'E,' 'S,' and 'G' challenges confronting a corporation and scoring them either separately or collectively to determine where they sit relative to each other and triggers investors to consider stocks that better reflect their values.

In this article, we investigated this field and raised several concerns. First, by comparing ESG investing with other traditional investments and the main ways of participating in the market, it clarifies the definition of ESG investing and how it works. By presenting the different categories of investors and the corresponding drivers of the different weights they impose, it shows the fundamental differences between retail and institutional investors, which is a core aspect of understanding the chain of financial intermediation and ESG ecosystem. Third, the article delves into the implementation of specific companies with respect to the three pillars of ESG, examining Apple on the environmental side, Starbucks on the social side, and JPMorgan Chase on the governance side, by identifying the strategies and behaviors of specific companies in addressing ESG issues, the section concludes major criteria for each direction of ESG investing. This is followed by a discussion of the most serious ESG inconsistencies brought about by the superimposition of divergent ESG criteria, different measurement approaches, and selected matrices among the major scoring agencies. To conclude, the paper summarizes the current issues and challenges facing ESG investing, introducing the latest regulation reports and pointing out the solvability of the inconsistencies.

2 What is ESG Investing

Compared to traditional investments, ESG Investing provides a more focused ideology and specific framework than philanthropy, which purely expects social returns, it also aims to ensure expected returns on investment activities. However, unlike conventional financial investing that focuses on the financial return alone, ESG Investing strives to achieve financial market returns in long-term value by generating measurable social return alongside [2]. Both ESG Investing and Social Impacting Investing utilize ESG metrics and methodologies, but the slight difference between them is that ESG Investing has more intent on using E, S, and G factors to mitigate risks by effectively avoiding issues related to these realms and prevent financial and reputational damager, and identify growth possibilities and business opportunities in the three pillars [3].

In general, there are three primary ways for investors to participate in ESG Investing. First, investors choose to conduct an independent screening of company stocks. They use negative or best-in-class screening and set up their exclusive investment portfolio based on personal research outcomes. Second, investors choose to purchase the ESG-themed ETF, which is a strategic lens that places corporations with satisfied ESG ratings as investment potentials to boost the return on a portfolio that reflects positive efforts in E, S, and G issues. Lastly, the investors can consult with their personal financial advisor to create a corresponding portfolio by specifying their investment decisions.
objectives, requirements in financial performances, and value proposition to the advisors.

3 The Market Landscape of ESG Investing

Over the last decade, the number of assets under management that includes some element of ESG evaluation and selection has increased exponentially. Up to this day, the ESG asset has surpassed $35 trillion in 2020, according to Bloomberg Intelligence [4]. In addition, the growth and development of ESG funds have exceeded USD 1 trillion in assets [4].

The drivers underlying the significant rise of ESG Investing are distinctive to different categories of investors. Based on the research on private participants in the ESG, for the Retail investors in the ESG incorporation, 77% of them are choosing ESG Investing due to social or moral considerations, only 14% of investors are due to risk mitigation, and 6% are motivated by financial outperformance [3]. Nevertheless, for institutional investors, according to surveys conducted by BNP in 2019, the most influential segment in the market, both passive and active factors contribute to their engagement in ESG Investing [3]. Except for the regulatory demands, external stakeholder requirements, and board or activist investor pressure as the passive drivers, the spontaneous factors that drive institutional investors to choose ESG Investing rank from high to low: Superior long-term returns, Brand image, lower investment risk, Attraction of new talent, etc. [3]. Looking back at the drivers of the two types of investors, the dominant drivers of institutional investors suggest that they focus more on the financial benefits of ESG investments for optimal risk management and higher long-term returns. Whereas retail investors in ESG integration are more focused on whether the portfolio is consistent with or reflects their beliefs; their considerations are more thematic and less dependent on long-term future returns planning when compared to the institutional investors.

As ESG investment and its approaches become more sophisticated, more institutions and contributors have joined the market and generated systematic changes. In addition to the financial issuers that serve as the foundation and the two types of investors mentioned above, the ESG rating providers and the firms that construct ESG indices have come together and formed the Financial Intermediation Chain as core components. Investors contribute to the ongoing demand for analysis of equity or debt issuers in ESG markets. At the same time, the rating and indices providers apply quantitative methodologies and metrics, providing both references and fund products for a wide range of ESG users, including asset managers, institutional and retail investors, and public authorities like central banks or open debt issuers [3]. Furthermore, the emergence and development of relevant jurisdictions and requirements, disclosure organizations, and standard setters, in turn, play an overseeing and guidance role in the ecosystem [3].

4 How ESG Philosophy Helps Shape Business

ESG users mainly collect data and information from the rating providers as their reference in investment. Therefore, the criteria in terms of E, S, and G factors are the beginning of consideration in the scoring process. In this section, each of the three factors will be provided as a corresponding case study of a corporation, showing how ESG invest works and the concrete manifestation of ESG in the current business world.

4.1 Apple

Apple aims to achieve carbon neutrality across all product categories and footprints by 2030, offering a “laser-focused commitment” to addressing the global business of climate change [5]. Although Apple had a 33% revenue growth in 2022, the net emission remained unchanged, so says Lisa Jackson, Apple’s Vice President of Environment [5]. Based on its 2022 Environmental
progress report, Apple's product philosophy includes Low-carbon Design, Energy Efficiency, Renewable Electricity, Avoidance of direct emissions, and Carbon removal [6]. Deep dive into Apple’s 2022 ESG report, shows more concrete product implementations have already been upheld over time. Its pursuit of achieving product circularity has been achieved through different levels. In terms of sourcing and efficiency, it applies 100% recycled aluminum in the enclosures of its major product lines, uses rare earth elements in its camera, also minimizing packaging usage [6]. Also, after years of developing durable hardware and leveraging software, plus accessible repair services, Apple has enhanced the longevity of products, alleviating the burden of waste for the planet. Furthermore, by sourcing 100 percent renewable electricity and transitioning to clean energy, it has reduced the overall emissions by 40% in the fiscal year 2021 compared with 2015 [5]. Additionally, Apple conducts its Carbon Removal strategy by investing in nature-based solutions like forestry practices and fostering partnerships with international organizations to launch corresponding funds for preserving biodiversity and enhancing the resilience of the ecosystem [6].

Looking back at Apple's environmental strategies and specific measures, several key benchmarks of ESG can be sorted out: Natural source use, Energy Efficiency, Pollution, Carbon emissions and Environmental opportunities are crucial in the ESG criteria for the E factors.

Figure 4. Recycled Aluminum Enclosures in Apple Products (Source: Apple Environmental Progress report)

Figure 5. Circularity for the products (Source: Apple Environmental Progress report)

4.2 Starbucks

The social impact of Starbucks, one of the mainstream coffeehouse brands, has always been noticed and evaluated by the public. According to its 2021 Global Environment and Social Impact Report, Starbucks ensures workforce diversity in the retail stores, corporate, and manufacturing roles [7]. It also has maintained and newly accomplished records in global equity payments, disability inclusion, and civil rights assessments. It has kept 100% pay equity in gender and race since 2018 [7].

Starbucks received a "Best Place to Work" designation in 2015, 2016, 2017, 2019, and 2021 after scoring 100 out of 100 on the Disability Equality Index [7]. In partnership with professionals in the legal field, Starbucks has introduced its third edition of the Civil Rights Assessment, which dictates more advanced inclusion, diversity, and equity. Starbucks shows its commitment to its partners by providing a wide range of welfare like inclusive healthcare, total compensation, and 100% college tuition coverage with partnership universities [7]. Moreover, Starbucks has been conducting Coffee and Farmer Equity (C.A.F.E.) Practices in its supply chain since 2004, which has strict ethical sourcing standards to promote transparent, sustainable farmers and their communities [7].

In the financial year 2021, 95% of Starbucks coffee was ethically sourced and validated under C.A.F.E. Practices [7]. Additionally, Starbucks developed a Digital Traceability tool in 2020 to equip coffee beans with electronic passports, the technology has tracked over 33,000 coffee bags in FY2021 [7].

It can be drawn from the Starbucks approaches that Workforce, Human rights, Diversity, and Supply Chain are the major concerns at the social dimension in ESG criteria.

4.3 JP Morgan Chase

JPMorgan Chase & Co is one of the biggest and most famous private banks in the world, its governance management is especially vital to its stakeholders,
including customers, clients, employees, shareholders, and communities. According to its 2021 ESG report, the board has a Lead Independent Director appointed by the independent directors on an annual basis and facilitates independent Board oversight of management [8]. The board seeks members with a diverse range of expertise, experience, and viewpoints, including gender, race, ethnicity, and nationality. As of April 2022, the Board of Directors in JPMorgan Chase has ten members, four of whom are women and one of whom is Black [8]. Additionally, JPMorgan set up five independent standing committees as in figure 7 from its ESG report, which directly regarding specific affairs. All the directors in the committee constantly receive education programs corresponding to the ESG issues. For instance, the Public Responsibility Committee oversees the Firm's principal policies and procedures relating to political contributions, major lobbying initiatives, and trading association participation related to the Firm's public policy objectives [8]. In addition, the Compensation & Management Development Committee evaluates the overall governance framework and the firmwide ethics and culture; the Audit Committee monitors management's adherence to the Firm's ethical standards, policies, plans, and processes, as well as regulations and laws [8]. Moreover, to ensure the shareholder's rights, JPMorgan has communication branches such as social media platforms, one-on-one meetings, roundtable conferences, employee surveys, and external forums to enhance stakeholder engagement [8].

The Board oversees management directly and through its five standing committees:

- Public Responsibility Committee
- Compensation & Management Development Committee
- Risk Committee
- Audit Committee
- Corporate Governance & Nominating Committee

Figure 7. The Five Independent Boards of JPMorgan (Source: JPMorgan 2021 ESG Report)

From the practices of JPMorgan Chase, the board diversity and independence, as well as shareholder rights and corporate ethics, should be the mainly focused perspective in the Governance factor.

5 Economic Impact & Challenges of ESG

Although the general direction and key criteria in the three pillars E, S, and G factors should be the same, the actual ratings offered by data corporations, even among the major index providers, prominent differences exist in ratings upon the identical firms. This part will discuss the reasons behind the consistency issue in the ESG realm, and how it challenges the future development of ESG investing.

5.1 Inconsistent Definition of ESG

Firstly, the priorities of the sustainable aspects in the ESG pillars among firms have different rankings following their stakeholders’ value propositions and independent assessments. Then the elements in a certain sequence usually settle down the E, S, and G aspects’ main criteria of measurements and are integrated into metrics.

![Figure 8. ESG Criteria by Major Index Providers (Source: Refinitiv, MSCI, Bloomberg, FTSE; OECD assessment.)](image)

Moreover, the differences in rating methodologies, the combined qualitative judgments, and the lack the transparency also considerably contribute to the gap among results disclosure by the providers. For instance, MSCI is more focused on bringing identification and consideration to risk and opportunities into the ESG portfolio. At the same time, Bloomberg shows an evident incline of attention to the environmental and social aspects, and Thompson Reuters uses 400 different metrics, some of which could date back to 2002 [3]. Numerous subtle variations lead to divergent results. Thus, ESG scores offered by major providers vary from one to another. Yet this inconsistency problem raises significant criticism of the resilience of ESG scoring since widely disparate outcomes serve as the vital reference sources of investors' choices [3].

![Figure 9. ESG Ratings and Issuer Credit Ratings (Source: Refinitiv, Bloomberg, MSCI, Yahoo Finance, Moody's, Fitch, S&P; OECD calculations)](image)

Although development among methodologies, metrics, data, and assessments could enhance the sophistication of ESG investing, the wide variation in ESG ratings across institutions may reduce the significance of ESG portfolios as selecting the “best-in-class” firms. Reviews studying the approaches and factors during the scoring process could shed light on the cast differences. For example,
comparison research conducted by OECD between the ESG scoring and the issuers’ credit rating reveals that the latter is much less divergent, further challenging the ESG scorings’ reliability [3]. Furthermore, the comprehensive analysis of Bloomberg, Thomson Reuters, Sustainalytics, and MSCI’s publicly accessible methodology and data utilization reveals the factors and procedures that may lead to rating disparities. They are Framework, factor categories, subcategory metrics, controversy measurement, qualitative expert judgment, indicator weightings, and index transformation [3]. In brief, it is questionable to what degree end-investors can be convinced that ESG investing has improved returns or is in line with any specific societal ideals if high ESG scores of enterprises are heavily dependent on the methodology of providers.

5.2 Unpromising Financial Returns

Now, back to the focus of ESG as the investment approach and strategy, under which are more segmented forms. In general, the approaches are either to exclude certain firms that deviate from ESG standards and value or through the complete integration of ESG consideration into the corporate culture of the investment and the decision-making. While ESG is an overall investment strategy, it includes seeking ESG momentum, which is finding corporations that possess the potential progress of ESG in the future; it also assists in achieving the Sustainable Development Goal (SDG) of the United Nations [3].

Following the emerging ESG investing approaches and strategies, many firms have launched ESG thematic funds and portfolios. Here will spotlight and analyze the financial performance of ESG products in the current market with empirical research.

In the experimental analysis of OECD, they have selected 9 MSCI indices and 6 of which are ESG indices [3]. After computing the Minimum Variance Portfolio and the efficient frontier, the findings indicate that depending on how an ESG index is constructed, different ESG indices have disparate risk and performance characteristics. For example, the ACWI minimum volatility scores the best Sharpe ratio, subtly outperforming most of the ESG equivalents but with a much lower risk [3].

With 4 indices of ESG out of 7, STOXX indices were subjected to the same scrutiny as MSCI indexes. The STOXX Global ESG Impact offers the best Sharpe ratio in this situation, with a more significant projected return and a relatively higher risk in the group [3]. The results show that the performance has subtle differences with a slight standard deviation except for STOXX global ESG leaders.

In addition to the above empirical analysis, studies by the IMF and professional academics show conflicting views and no definitive conclusions on whether ESG indices are performing superior or inferior to their counterparts [3]. The research points out that the choice of an ESG rating provider has the most significant impact on the results. In this respect, the technique does not adequately consider the E, S, or G variables.

6 Challenges & Next Steps, Conclusion

In retrospect, the most significant challenge and crux for the future development of ESG investing come from the divergent purpose between retail and institutional investors, the disparate definitions among organizations, not-unified weights in the three directions that emerged while the development, the different utilization and combinations of measurement methods among rating providers, and the insufficient transparency during the process.

However, the future for ESG investing in solving the inconsistency problem would not be so far. The disclosure and regulations about climate change by U.S. Securities and Exchange Commission (SEC) are expected to be out soon [9]. And the Climate and ESG Task Force, as a precursor rule, has been pointed at the first advisory references for addressing climate and ESG issues [9]. Another federal agency in environmental revelation, the U.S. Federal Trade Commission (FTC), has issued the Green Guides for the oversight of misleading marketing and promotion materials to protect consumers. Furthermore, new metrics and rules for quantifying subjective norms and problems are developing by corporations and relevant organizations [9]. At this point,
Companies should consider how to aptly explain their organization's strategy around climate and environmental justice, natural resources, and local economies as the SEC investigates how to place parameters around ESG reporting [9].

Additionally, the unconvincing financial performance of ESG investing portfolios raises serious questions about its credits and development. Although the performance demonstrated in research would partially result from the above-mentioned inconsistency issue due to different imposed methodologies. Still, there are also voices stating that a link between ESG and financial variables is frequently understood implicitly to suggest that ESG is the cause and financial value is the result, even if the transmission might easily be inverted. Yet, such a statement is another layer of questioning its reliability. However, the future steps to improve the performance can be from specific perspectives on a more micro level—shaping the financial corporations by regulations.

According to the amendments released by SEC in 2022, rules and certain reporting forms have been proposed for registered financial advisors, registered investment companies, and business development companies [10]. To be more detailed, funds focused on the environmental factor should provide the greenhouse gas emissions related to the investment portfolio [10]. The ESG funds and portfolio are required to disclose the specific impacts that they aim to accomplish and report on the current progress. Lastly, certain information, forms, and data should be offered for regulatory, examination, and policymaking use [10]. The proposed amendment represents a boost in the unified direction of ESG by an authoritative government body.

In a nutshell, ESG investing has evolved in recent years to meet the ethical benchmarks of society and to address the issues of ESG orientation. Nevertheless, the ensuing shifts in diversity have brought additional challenges and doubts to the systematization of the ESG profession. However, the progress and development of ESG are in line with the times and are unstoppable. Therefore, concrete improvements are imminent and greater global awareness and popularity are on the horizon.

References

8. JPMorgan Chase. 2021 Environmental Social & Governance Report. (2022)