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The Impact of the Environment, Society and Governance on Sustainable Investments

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I. Introduction

This chapter examines the issue of sustainability, which has become increasingly characteristic for the reputation of companies, directing investors, those who have potential interests in companies, to examine the performance/corporate social responsibility (CSR) relationship through environmental, social, and governance (ESG) metrics (Duque-Grisales & Aguilera-Caracuel, 2021).

This indicator, which is suitable for representing the exposure of firms, and the related management of non-financial risks and opportunities has generated a trend in which "the principles and techniques of accounting and financial management are applied to the governance of people and organizations" (Shore & Wright, 2015, page 428).

The paradigm shift has allowed ESG metrics to focus on financially relevant information for investment performance that can create strategies based on ecological and sustainable models. Green finance, focused on the impact of allocative choices with respect to the environment and elements of ethics and sustainability bases its dimension on choices and financing decisions suitable to allocate money in the best way and at the same time be socially responsible.

The analysis addresses sustainable and responsible investment (SRI) funds and ESG factors, which are considered the three pillars of sustainability (Staub-Bisang, 2012).

The interdependence between the elements, reinforced during the COVID-19 pandemic and related exogenous shock to the economy (Umar et al., 2020) directed investors towards flexible funds with greater resilience than conventional financial market disruptions (Folger-Laronde et al., 2020).

The trend of sustainable investing, relying on funding organizations and products that promote and comply with sustainability and regulatory guidance on decarbonization and climate change, has generated increasing returns and better long-term performance than portfolios that do not incorporate ESG practices (Lieberman, 2020).

With the establishment of the High-Level Expert Group on Sustainable Finance (HLEG) by the European Commission in 2016 to develop functional recommendations for the development of sustainable finance, the Action Plan promoted by the European Commission has gained great importance in managing and direct capital flows towards sustainable investments; weigh and manage growing risks derived from climate change, environmental degradation, and social issues; and identify and guide transparency and long-term vision in economic and financial activities.

Among the European Union (EU) measures, the 2020/852 "Taxonomy Regulation" is applied to financial market participants and companies subject to the Non-Financial Reporting Directive (NFRD) (listed companies and companies of national interest), which are required to report the percentage of turnover and all investment decisions that meet sustainable development criteria.

Another central element is Goal 8, "Decent Work and Economic Growth", of the United Nations 2030 Agenda where sustainable business models and investments with low environmental impact are envisaged.

The mission is to create socially responsible investments that become drivers capable of promoting growth potential, combining qualitative and quantitative factors, and integrating innovation (of product, service, or process) with the theme of sustainability.

To answer the research question, the analysis will focus on the indices that include the overall basket of "ethical and nonethical" products and that of only ethical-sustainable products: MSCI All Country World Index (ACWI)

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and the respective MSCI All Country World Index SRI (ACWI SRI) considered the benchmark of sustainable and responsible investment.

The rest of this chapter is organized as follows. Section 2 reviews the literature. Section 3 presents the characteristics of SRI funds and ESG benchmarks. Section 4 compares the indices over the analysis period (2011–2021) with respect to overall performance and risk/return analysis. Section 5 includes concluding remarks.

II. Literature Review

The implementation of ESG parameters originates from the idea shared by corporate finance that the overriding goal is to maximize shareholder value (Jensen, 2001; Battisti et al., 2020).

Given that stakeholder theory establishes that the interests of a company in the short and long term are influenced by the stakeholders (Freeman, 1999), it becomes evident that it is impossible to evaluate only strictly economic relationships because they no longer embody the main interest to be taken care of.

This assumption gives rise to the theme of CSR as the adoption of business practices based on transparency, ethics, and respect for employees, society, and the environment Rey-Marti, A. et al., 2016; Belyaeva et al., 2020).

CSR is based on sharing annual information about operations, activities, and programs that promote resilient impact on all direct and indirect stakeholders (Chan et al., 2014).

Previous studies suggest that disclosure of CSR information and behaviors can maximize corporate reputation and strengthen investor confidence (Park et al., 2014).

The evolution of practices implemented to meet stakeholder expectations of the environment, society, and shareholders (Fiore et al., 2020) is based on the use of policies and programs designed to develop competencies and competitive advantages in compliance with sustainability trends (Dressler & Paunović, 2019).

ESG ratings are "corporate assessments based on comparative analyses of quality, standars, or performance on environmental, social, or corporate governance issues" (Escrig-Olmedo E, et al., 2019). These ratings are conducted by rating agencies through analysis of non-financial mandatory disclosures, and integrated sustainability reports (Jackson et al., 2019) to provide a composite score on ESG parameter elements.

Although it is shared in the literature that a firm's reputation for adopting ESG practices increases financial performance (Aguilera et al., 2007; Li et al., 2019) as a result of an increased focus on environmental and social issues, benefits on reduced taxation and operational risks suitable for consumer loyalty (Malik, 2015); several studies have raised criticisms about the validity of ESG ratings and how they can impose and define a common framework for measuring social and environmental responsibility (Chelli & Gendron, 2013). The assignment of ratings could construct a dubious social and corporate view, intentionally differentiating one company from another (Eccles & Stroehle, 2018).

In response to this critique, it can be argued that ESG factors are based on concrete, non-arbitrary extra-financial analysis that ensures environment, social issues, and governance, implementing the relatively new concept of "making environmentally and socially friendly investments". This approach is embodied in SRI: "Sustainable and Responsible Investing is a long-term oriented investment approach that integrates ESG factors into the research, analysis, and stock selection process within an investment portfolio. It combines fundamental analysis and engagement with an assessment of ESG factors to better capture long-term returns for investors, and to benefit society by influencing corporate behaviour" (Eurosif, 2018, page 12).

In contrast to traditional economic and financial theories where investment decisions are referred to the logic of risk/return, responsible investment embodies an ethical and social ideal whose theoretical genesis we find in the economics of identity in which individuals make economic choices based on monetary incentives and in reference to their identity and social context (Akerlof & Kranton, 2000, 2005).

III. Characteristics of sustainable and responsible investment funds and environmental, social, and governance parameters

SRI allows for value creation through long-term strategies by integrating ESG analyses with economic and financial analyses (Eurosif, 2018, page 74). These investments are based on seven strategies as shown in Table 1.

Table 1. Sustainable and responsible investment strategies

Strategy	***Description***
Exclusion	Through negative screening, excluding anything that does not meet sustainability and social responsibility criteria (weapons, tobacco, pornography, animal testing).
Integration of ESG	Integration of investments with ESG criteria.
Engagement and voting	Dialogue and confrontation with companies on everything related to sustainability with an intention to influence the behaviour of companies through voting rights in capital participation.
Norm-based screening	Investment choice based on international regulations and standards (OCSE, ONU).
Best in class	The approach of selecting or weighing issuers in a portfolio using ESG criteria by selecting the best within a sector.
Sustainability themed	Selection of assets related to sustainable development.
Impact investing	Selection of investments in entities that are created to generate an economic return and a positive and resilient impact on the socio-economic sector (social bonds, green bonds).

Source: Author's elaboration based on elements acquired from Eurosif (2021).

Those who make sustainable investments base their choices on evaluating ESG parameters. The environmental element is used to measure risks and opportunities as a result of climate change and to evaluate conversion to renewable resources suitable for long-term financial stability; the social element is based on appropriate labour standards, equal opportunity between men and women, human rights, and health and safety; governance addresses gender-neutral board composition, understanding of environmental and social risks, potential financial impacts, audit functions, internal controls, and shareholder rights (Townsed, 2018). ESG factors are composed of three levels:

1. Investment: in which the elements of the parameter are considered in relation to the target companies. Screenings are prepared to assess the business model, the impact the company has in the context in which it operates, the products it sells, and in which markets it operates; all of which must be evaluated following the best practice strategy.
2. Monitoring and reporting: the inputs necessary to assess sustainable performance are considered. Key Performance Indicators (KPIs) representing the target company must be identified within the ESG elements.
3. Exit: allows for an assessment of how ESG factors have been managed giving buyers the opportunity to get an overall picture of the company.

There are differences between SRI and ESG that are presented in Table 2.

Table 2. Differences between sustainable and responsible investment and environmental, social, and governance

sri	***esg***
Investments driven by ethical-moral values	Includes long-term sustainability factors and directs investments towards companies with high potential
Prohibits investing in unethical assets (exclusion strategy)	Does not present investment prohibitions. Assigns values to ESG factors (if values are negative, it does not technically exclude a company from investment but is cause for further consideration)
They are restrictive for investors	Incorporate factors that guide the investor in selecting securities
SRI analysis is driven by moral factors and is different for every investor	ESG analysis is potentially applicable to all investment options

Source: Author's elaboration based on evidence acquired from Commonfund Institute (2018).

Although the elements analyzed present differences, both elements aim to address current ESG issues surrounding climate change, resources, and human rights.

While SRI are concerned with ethical and moral issues specific to investors activated through a top-down approach, ESG criteria are concerned with the risks and opportunities deriving from individual assets, making it possible to grasp their intrinsic quality, activated through a bottom-up approach.

In the following section, the MSCI ACWI and MSCI ACWI SRI indices will be shown and explained. The SRI index follows a mixed approach by combining a top-down framework (based on the exclusion of those that do not meet ethical, sustainability, and social responsibility criteria) with bottom-up evaluations (based on the Best in Class strategy, selecting the best issuers in the portfolio according to ESG criteria).

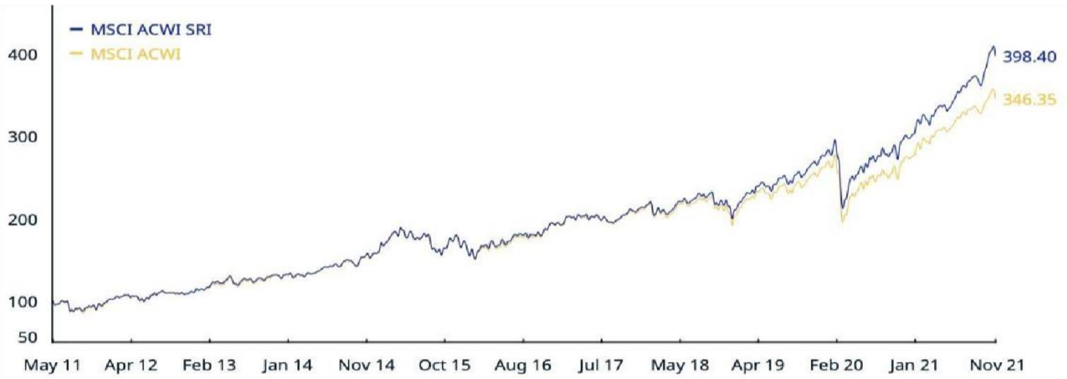
IV. General performance and risk/return analysis MSCI All Country World Index—MSCI All Country World Index SRI

For the analysis, the MSCI ACWI and the respective MSCI ACWI SRI will be considered.

The MSCI ACWI SRI includes large- and mid-cap stocks from 23 developed market countries and 27 emerging market countries, is a capitalization-weighted index that provides exposure to companies with excellent ESG ratings and excludes companies whose products have negative social or environmental impacts.

It represents the benchmark for SRI and is composed of companies with strong sustainability profiles.

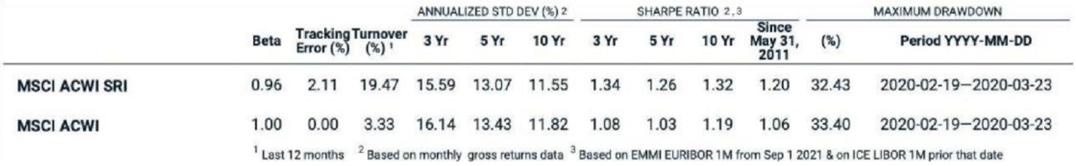
Figure 1. Cumulative index trend (May 2011-November 2021)



Source: MSCI (www.msci.com).

Comparing the two indices over the analyzed 10-year period (2011–2021) in terms of performance between the basket of ethical products (MSCI ACWI SRI) and the basket of all products both ethical and non-ethical we see the ethicalsustainable index show a higher performance than the traditional index.

Figure 2. Risk/Return (May 2011-November 2021)



				ANNUALIZED STD DEV (%) 2			SHARPE RATIO 2,3				MAXIMUM DRAWDOWN	
	Beta	Tracking Error (%)	Turnover (%) 1	3 Yr	5 Yr	10 Yr	3 Yr	5 Yr	10 Yr	Since May 31, 2011	(%)	Period YYYY-MM-DD
MSCI ACWI SRI	0.96	2.11	19.47	15.59	13.07	11.55	1.34	1.26	1.32	1.20	32.43	2020-02-19—2020-03-23
MSCI ACWI	1.00	0.00	3.33	16.14	13.43	11.82	1.08	1.03	1.19	1.06	33.40	2020-02-19—2020-03-23

[1] Last 12 months [2] Based on monthly gross returns data [3] Based on EMMI EURIBOR 1M from Sep 1 2021 & on ICE LIBOR 1M prior that date

Source: MSCI (www.msci.com).

From Figure 2, we can see that in terms of risk/return, the SRI index presents a lower standard deviation and therefore lower volatility, guaranteeing a higher return at 3, 5, and 10 years obtained with less risk (Sharpe index) than the traditional index; furthermore, there is a maximum loss in the period considered which is slightly lower than the traditional index.

V. Conclusion

During the period analyzed, the year 2020 witnessed major shocks to financial markets and the economy in general. The turbulence generated by the COVID-19 pandemic as a result of the global spread of the infection and shocks on both the demand and supply sides generated the collapse of over 30% of financial markets in the second quarter of 2020 (Gormsen & Koijen, 2020). Ethical and sustainable funds have demonstrated greater resilience than the rest of the market. The research question of whether financial performance can be achieved by investing in long-term ethical and sustainable funds can be answered in the affirmative. Responsible, social, and ethical investing is the driving force behind the finance of the future.

The performance comparison between the SRI index and the traditional index shows a higher return for the sustainability index. Those who invest using ESG parameters can achieve higher returns than traditional investments, reflecting on the market their own ideas and ethical principles and respect for the surrounding environment, society, and the future of the world; paving the way for a sustainable finance that is no longer transitory but definitive.

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