CSF Center for Sustainable Finance India

ESG Funds

WHAT ARE ESG FUNDS?

Environmental, social, and governance (ESG) funds are investment vehicles that integrate financial analysis with consideration of ESG factors. This holistic approach aims to identify and invest in companies that demonstrate strong sustainability practices, thereby fostering responsible business conduct and sustainable value creation.

Environmental criteria can encompass a company's Greenhouse gas emission, energy consumption, waste management, pollution levels, natural resource conservation efforts, and treatment of animals. Social criteria evaluate how a company manages its relationships with employees, suppliers, customers, and the communities in which it operates. Governance considerations include aspects such as leadership quality, executive compensation practices, audit transparency, internal controls, and shareholder rights. Investors are attracted to ESG funds as they are expected to generate higher returns and lower investment risk over the long term.

Globally, the concept of ESG investing traces its roots to early 20th-century social investment movements. However, it gained traction in the 2000s, with the introduction of the United Nations Principles for Responsible Investment (UN PRI) in 2006 and the Paris Agreement in 2015. By the end of 2023, ESG funds were managing more than USD 30 trillion in capital globally—close to 20% of total assets under management.

In India, there are only nine ESG funds, managing USD 1.3 billion,[1] which is less than 1% of capital managed by India's mutual funds. This relatively small amount is due to limited awareness and understanding of ESG funds in India, their below-market performance in recent years, and the lack of ESG fund reporting standards.[2]

ARE ESG FUNDS LIVING UP TO EXPECTATIONS?

ROLE IN CLIMATE ACTION

ESG funds are often marketed as green financial instruments — a means of directing capital to mitigate climate change or accelerate the green transition. However, such funds are only designed to consider risks and opportunities related to ESG in stock/bond selection and portfolio management rather than to fund low-carbon technologies that directly mitigate the causes of climate change. Therefore, even carbon-intensive stocks can form a part of an ESG fund if the financial return is commensurate with the risks, including ESG risks.

HAVE ESG FUNDS DELIVERED BETTER RETURNS OR LOWER RISK?

There is no empirical evidence that ESG investing generates better financial returns than conventional funds.[3] In some cases, ESG funds have underperformed against the broader market.[4] There is, however, evidence to suggest that ESG investing is less risky than conventional investing.[5] The findings of various studies suggest that companies with higher ESG scores (given by third parties) or better sustainability practices decrease their systematic risk, lower financial distress risk, and lower crash and idiosyncratic risk. Companies following good ESG practices can reduce stakeholder risk, and these companies' focus on a long-investment horizon approach allows them to reduce systemic risk.

1 https://www.business-standard.com/finance/personal-finance/conservative-investors-with-long-term-goals-may-opt-for-esg-funds-124022900977_1.html

2 https://bfsi.economictimes.indiatimes.com/blog/rejuvenating-indias-esg-investment-landscape/103872998

3 https://pages.stern.nyu.edu/~adamodar/pdfiles/country/ESG.pdf

4 https://www.ft.com/content/5e163c97-8baf-4add-ad5c-d7cb864d50a6

5 https://www.sciencedirect.com/science/article/abs/pii/S1572308921000474

CHALLENGES TO ESG INVESTING

ESG investing faces several challenges, including a lack of standardization of ESG metrics (e.g., weights given to different ESG components such as greenhouse gas emission, water usage, labor practices, executive compensation, etc. for stock selections), which can lead to inconsistencies in fund management and performance measurement. Another significant challenge is greenwashing, where companies make misleading claims about their ESG performance (e.g., overstating the extent or benefits of their environmental practices) to attract investments. The increasing use of ESG ratings, a tool to assess corporations' ESG practices, has also come with challenges, as they are often inconsistent in their measurement and scoring methodologies.

THE WAY FORWARD

ESG funds aim to make the world a better place while matching the objectives of investors; however, various improvements could be made to ensure their intended aims are achieved.

The way forward is for financial regulators to implement strict regulations to prevent greenwashing and to standardize ESG reporting and criteria of ESG funds, and companies raising capital in the stock, bond, and loan market. In addition, cultivating collaborations among governments, NGOs, and the private sector can promote standardization and adoption of ESG principles, enabling ESG funds to achieve their intended goals and, in turn, encouraging funded corporations to adopt sustainable practices.

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4. Financial Times (2023), ESG-friendly US equities have been underperforming. Why?, https://www.ft.com/content/5e163c97-8baf-4add-ad5c-d7cb864d50a6
5. Roy C., Rocco C., Ambrogio D., Marco N. (2021), ESG investing: A chance to reduce systemic risk, Journal of Financial Stability, https://doi.org/10.1016/j.jfs.2021.100887

READING LIST

1. Boffo, R., and R. Patalano (2020), "ESG Investing: Practices, Progress, and Challenges," OECD Paris, www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf
2. Kräussl, Roman; Oladiran, Tobi; Stefanova, Denitsa (2023): A review on ESG investing: Investors' expectations, beliefs, and perceptions, CFS Working Paper Series, No. 694, Goethe University Frankfurt, Center for Financial Studies (CFS), Frankfurt a. M., https://nbn-resolving.de/urn:nbn:de:hebis:30:3-681504
3. Whelan, Tensie; Atz Ulrich, Atz; Holt, Tracy Van; Cla, Casey (2021), ESG Financial Performance, Uncovering the Relationship, Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020, Center for Sustainable Business, NYU Stern, https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf

The Clarifying Concepts series provides short explanations of foundational ideas and terminology in sustainable finance to help professionals from different fields navigate emerging issues.

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