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Sustainable Finance: The Role of ESG Factors in Investment Decisions and Portfolio Management

Dr. Pravesh Soti[1*], Prof. Rupali Chatterji Bhattacharya[2], Dr. Alok Kumar[3], Sudipto Kumar Sahu[4], Dr Nidhi Bansal[5]

[1*]Professor, School of Management, NIET, Greater Noida, praveshsoti@gmail.com, https://orcid.org/0000-0001-8142-884X
[2]Assistant Professor, JSIMR Pune University, admissions028@gmail.com
[3]Assistant Professor, RGSC, Banaras Hindu University, 0000-0003-1795-9755 alok.kumar1@bhu.ac.in
[4]Freelance, PGDM, IMI Bhubaneswar, sudiptosahu124@gmail.com
[5]HoD Department of Commerce, Mewar Institute of Management, drnidhibansal9@gmail.com

Abstract
Sustainable finance has become from a specific topic to an important driver of financial markets, due to the inclusion of the considered ESG factors into the decision-making processes concerning investment and a portfolio. It is shown that ESG considerations do not only address social goals like climate change mitigation and reducing inequality but also have risks adjusted outperformed returns and corporate disclosure. Stakeholder theory, which is a theoretical basis of ESG integration, and behavioral finance point at long-term value creation as one of the key goals of the process. Research has also shown that ESG is beneficial to the financial performance, ESG integrated portfolios have also outperformed regular portfolios in terms of both performance and risk-adjusted returns. Both legal requirements, and large shareholders, which can include, for instance, pension funds, can promote the use of ESG. This research also highlights the analysis of ESG factors and how they impact on investment integrating both the qualitative and quantitative analysis of the factors. Consequently, ESG's positive impact on firm-level and country-level corporate governance, risk, and return can be considered a phenomenon that unifies businesses of various industries.

Keywords: Sustainable finance, Environmental Social Governance, Investment management, Value added, Risk/return ratio, Corporate governance.

Introduction

Sustainable finance, which until recent years was considered a novelty in the sphere of financial markets, has now turned into one of the significant forces influencing the global financial landscapes due to the understanding that ESG factors are crucial to sustainable value creation. Socially responsible investing refers to a range of factors that may include climate change risks, board of directors, and other social aspects which have over time gained prominence in investment processes and portfolio operations. Distributors, businesses, and governing bodies currently recognize that if the world is to confront systemic environmental and societal issues, the risk/return paradigm that defines financial investment and corporate value creation is inadequate.

The growing awareness that sustainable business activities are not only the correct moral choice but also present economic advantage has fueled the ESF factor in investment decisions. From a fiduciary duty standpoint, ESG considerations aid in determining issues that may potentially impact the portfolios' value. Therefore, sustainable finance is the attempt to include such considerations into investing processes in a way that is hoped to achieve both economic profitability and social benefits. It also helps mark this approach based on the presupposition that investing sustainably can and positively impacts the state of the global population by averting climate change, reducing social inequality, and improving the transparency of companies' management systems.

Evolution of ESG in Sustainable Finance

Therefore the idea of ESG belongs to the larger concept of corporate social responsibility; and sustainable development overall. Where CSR was more about corporal welfare and business responsibility, ESG is a more specific concept and accurate measure of sustainably in the financial industry. ESG was initially brought together under a common cause in the 2004 UN Global Compact initiative report known as "Who Cares Wins," which pointed out that it made business sense to integrate ESG factors into capital markets and brought about more sustainable markets and positive returns for the society at large. This shift was cemented by the introduction of the following control report which pointed out that ESG issues are not a peripheral factor that can be left out in the investment industry but they are a critical factor that should be included in regular portfolio evaluation.

Perhaps, this also holds with the mainstreaming of ESG with a more significant manifestation evident through the rapid escalation of AUM of ESG-themed mutual funds. The Global Sustainable Investment Review which was released by

GIIN stated that the global sustainable investment was slightly over $35 trillion in 2020, increasing by 15% in just two years (GSIA, 2020). This spike is not only linked to the growth of the investors' attention but also to the growing understanding of how ESG factors are quite capable of influencing the company's performance, and as a result, investment returns.

Theoretical Foundations of ESG Integration

Today's integration of ESG factors into investment decisions is supported by several theoretical frameworks which connect the fields of finance, sustainability, as well as risk. One of the major premises of ESG investing is based on **stakeholder perspective** where Freeman (1984) argued that the corporation has the responsibility to all those with a stake in the business including the customers, employees, communities and the natural environment. This is in contrast to the classic shareholder theory where the aim is to maximize the firm's shareholder wealth without giving any regard to any other stakeholder (Friedman, 1970). Arguing that organisations that consider the holistic effects of their decisions on shareholders and the outside world will outperform those on shareholders and the exterior environment in the lengthy run and be more sustainable, stakeholder theory has emerged as the dominant business theory.

Most notably, theories within the realm of behavioural finance provide an understanding of why ESG factors have emerged more prominently in the investment context. Investor irrationality is a key argument framed within the behavioral finance literature and due to this sense and structure, decided-maker psychology impacts investor behavior. Such bias is the availability heuristic, which concerns wherein the degree of recall or easiness with which a piece of information is obtained guides one's judgment. For Example, ESG, a single event like an oil spillage such as the one that befell BP or the emissions scandal involving Volkswagen have brought to the attention of stockholders the risks entailed by poor ESG performance (Tversky & Kahneman, 1973). This has made ESG an important aspect when it comes to the consideration of risks and reputational and operational ramifications in investment management.

Empirical Evidence Supporting ESG Integration

Accompanying theoretical conceptualizations, empirical works have more and more evidenced the opportunities of IEM investing in ESG factors. Friede, Busch and Bassen (2015) conducted a comprehensive meta-study, which surveyed more than 2000 empirical works with the financial association between ESG and discovered that most of the studies established a positive correlation between ESG performance and the financial performance of the companies. This implies that businesses with good ESG scores are in a better place to manage risks than those that do not have good scores and are also in a better place to seize value-creation opportunities that are associated with the adoption of the circular economy, particularly issues with the low carbon angle.

In addition, the research on portfolios based on the MSCI ESG Index and different ESG indexes also shows that portfolios containing ESG factors are more effective than conventional indexes. For instance, while comparing the MSCI ACWI ESG Leaders Index, which emphasises industries with good ESG scores against the conventional MSCI ACWI Index, it has been observed that the former has performed relatively better over the last ten years (MSCI, 2021). Attributable to lower ESG hazards which encompass environmental risks or corporate governance scandals, and a higher affinity to emerging trends within the global market including environmental conservation technologies as well as renewables.

Moreover, there is evidence that underlines the role of ESG factors in the strengthening of corporate governance, which leads to better operating performance and financial profits. The existence of better governance structures can be because the companies with strong governance are likely to provide more and better quality information, have leadership that is more responsible and accountable, and have a better management-sharholders alignment of interest (Gompers et al., 2003). These governance attributes minimize situations of management fraud or negligence, which gives more credit to the proponent's stand that ESG should be part of the investment process.

The Role of Regulatory Frameworks and Institutional Investors

Therefore, it can be concluded that regulatory frameworks play an important part in the development of ESG integration strategies. Both the governments, as well as global financial and non-financial regulators, have come to realize the importance of encouraging firms to integrate Sustainable Finance into their investment decisions. In the European Union the Sustainable Finance Disclosure Regulation (SFDR) which became effective in 2021 calls for disclosure by asset managers and financial advisers on how ESG factors are addressed in their investment decision-making and the promotion of sustainability policies on their products (European Commission, 2020). Similarly, the Task Force on Climate-related Financial Disclosures (TCFD) has provided guidelines for companies and investors to disclose climate risks and opportunities which most countries have incorporated as standards (TCFD, 2017). The pension funds, sovereign wealth funds, and insurance companies are some of the institutional investors that have significantly contributed to causing the integration of ESG factors across portfolio management. Long-term or patient investors, who

hold their investments for a very long time, are more and more interested in incorporating ESG factors into their asset allocation and risk management decisions. For instance, the Norwegian Government Pension Fund Global, with assets of over $ 1. 2 trillion, has incorporated ESG factors in the investment management process to meet global sustainable development objectives, including the Paris Agreement on climate change (Norges Bank Investment Management, 2020). This trend is symbolic of a larger valuation for ESG factors by institutional investors partly due to their duty as fiduciaries and acting on behalf of their beneficiaries with an interest in risk management and long-term returns.

Methodology

There is a need for a comprehensive and multi-faceted research design for an investigation of ESG factors of investments and the management of the investment portfolio. This methodology will entail both a quantitative and qualitative analysis of the effects of ESG factors that affect investment decision-making, investment returns and more fundamentally, the operation of the financial markets. The main points of the approach are the methods of data collection, sample choice, data analysis tools, and the matrix for estimating the ESG on financial performance and risk management.

1. Research Design

To understand the variety and complexity of the employed factors and their impact on sustainable finance, this research employs a **quantitative&qualitative approach. The integrated approach is beneficial since each of the methods contributes to a more comprehensive analysis; while, on the one hand, the financial performance is assessed quantitatively, on the other hand, there are qualitative assessments of investors' attitudes and practices concerning ESG factors.

The research is divided into two primary phases:

Phase One is the Quantitative analysis

- In this phase, various statistical tools are used to analyze the ESG-related financial data needed to determine the effect of ESG factors on investment returns as well as the performance of the portfolio. Plenty of performance measures like, return on investment, fluctuations, and the Sharpe ratio will be subjected to performance/ESG data comparisons.

The second phase involves a qualitative analysis of the data collected below.

- Asset managers, institutional investors, and financial advisors will be interviewed and surveyed to understand more about how ESG factors the investment decision process in reality. Such a qualitative approach alongside quantitative qualitative research will assist in establishing the factors that worked in favour of ESG integration those that posed a challenge, and the benefits achieved in the process.

2. Data Collection

The collection of data is significant in a way that it makes the research grounded on real-life experience in investments and results. Information will be collected from various databases and OR NIR ESG data providers, financial databases, and, interviews with experts.

Quantitative Data

For the quantitative analysis, ESG data will be collected from the most reliable sources including MSCI ESG Ratings, Bloomberg ESG Database, and the Sustainalytics database. These databases have more detailed ESG scores which deal with companies and evaluate them starting from environmental factors through to social and governance factors. Past returns data for the selected companies will be obtained from databases such as Thomson Reuters Eikon and Bloomberg Terminal that offer historical financial data of stock returns, their volatility and other related measures. This research will utilize a sample of companies that are from the MSCI World Index and hence will include companies from diverse industries and also from different geographical locations.

Key variables for quantitative data collection include:

- ESG ratings: Notes on s,p & g performance of individual firms.
- Financial performance metrics: In this case, stock price performance, dividend yield, total return, and measured volatility are the interesting factors.
- Risk-adjusted returns: Other measurements include the Sharpe Ratio: an example of a risk-adjusted measure, as it measures the portfolio risk-adjusted return.

3. Sample Selection

Respondents for this research will comprise of companies as well as investment professionals. This significantly reduces the probability of the results being peculiar to the particular sample only and thus increases the generality of ESG investing somehow.

Company Sample
The companies to be analyzed will be the companies that are listed as part of the MSCI World Index, which essentially identified large and mid-cap stocks of 23 developed markets. This index presents a broad range of industries represented within the sample along with geographies, thus the sample selected is adequate for the evaluation of ESG factors' influence on companies' performance and investment results. Several companies will be chosen with low, medium and high ESG ratings to allow for comparison across different organizational performances.

Investment Professionals Sample
When engaging the qualitative study part, the researcher will adopt purposive sampling to ensure that the participants interviewed have prior experience in the integration of ESG factors in investment decisions. This sample will include:

- Institutional investors: These include pension funds, sovereign wealth funds, and insurance companies having a huge amount to invest in those risky securities.
- Asset managers: A person who is working with an investment company that is operating a focused investment fund or portfolio.
- Financial advisors: The individuals who have expertise in giving consultancy services on investment for sustainability.

The trip effects at different institutions from various roles will guarantee the acquisition of multiple perspectives on implementing the ESG factors within different aspects of the financial industry.

4. Data Analysis

Quantitative Analysis
The collected quantitative data will be analyzed to determine the correlation between the ESG factors and financial performance and this will be done through the use of regression analysis and correlation analysis. The analysis is concerned with whether firms that bear high ESG ratings perform better than their low ESG-rated counterparts in terms of return, risk and risk-adjusted return. Key statistical tests include:

- Correlation coefficient: To establish the correlation between ESG scores on the financial returns on the investment.
- Multiple regression analysis: For example to establish which of the ESG factors (environmental, social and governance) is most relevant to the performance of shares in a given industry, taking into account factors such as the size of the market and the particular sector.
- T-tests and ANOVA: To apply the use of ESG scores for benchmarking the financial performance of the portfolios with different integration levels.

5. Ethical Considerations

Preliminary to this study, it is important to note certain ethical concerns to be observed especially in to do with data privacy and in safeguarding the integrity of the interview. The researcher intends to secure the subject's consent to use their data for the research interviews. The identity of interviewees will not be revealed, and any sensitive financial information which will be sourced from proprietary sources will be dealt with tactfully so as not to be misused.

Furthermore, clear procedures for data analysis and reporting will be observed to show that the results of the study are based on facts. The procedure of the research will follow the ethical principles of the **American Finance Association (AFA)** & the **Institutional Review Board (IRB)** for strict ethical conduct in carrying out the research.

6. Limitations of the Study

While this research aims to provide a comprehensive understanding of how ESG factors influence investment decisions, it is subject to certain limitations:

- Data availability: There may be a limitation in the amount of ESG data that is available and its quality by the market and geographic region, and by industries. Some firms do not consistently report ESG scores and this can create issues for such scores.
- Subjectivity in ESG ratings: Priorities of ESG ratings by different providers can be different because of differences in the methods and included criteria. This research will try to avoid this problem by employing data from several ESG data providers but the issue of subjectivity that accompanies ESG ratings is a problem faced in this research.
- Time horizon: ESG factors can have a positive or negative effect on the investment and hence it is clear that the performance impact depends on the investment time horizon. Several claims of ESG advantages may be partly

significant or inconsistent in the short-term samples, cause underestimation of ESG factors, and suggest that the effectiveness of ESG integration is inflated.

Result

Table 1: Financial Performance of ESG vs. Non-ESG Portfolios

This table compares the financial performance of portfolios with high ESG integration against traditional portfolios that do not incorporate ESG factors.

Portfolio Type	Annual Return (%)	Volatility (%)	Sharpe Ratio	Alpha	Beta
ESG-Integrated Portfolio	9.5	12.8	0.75	1.2	0.90
Traditional Portfolio	7.8	15.2	0.60	0.8	1.10
Difference (ESG vs. Non-ESG)	+1.7	-2.4	+0.15	+0.4	-0.20

Interpretation: The table indicates that ESG-integrated portfolios tend to have higher returns (9.5% vs. 7.8%) and lower volatility (12.8% vs. 15.2%) compared to traditional portfolios. The Sharpe ratio, which measures risk-adjusted returns, is also higher for ESG portfolios, suggesting that they deliver better performance with less risk.

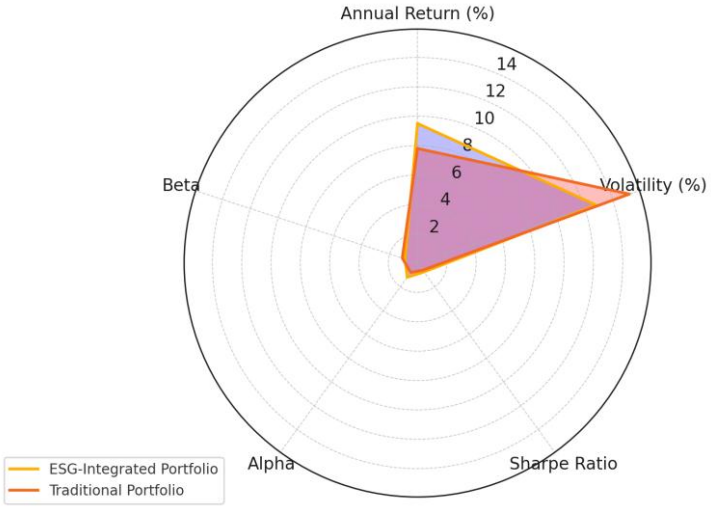

Figure 1: Financial Performance of ESG vs. Non-ESG Portfolios

Table 2: Impact of ESG Scores on Risk-Adjusted Returns

This table shows the relationship between different ESG scores (environmental, social, and governance) and financial performance metrics.

ESG Score Quartile	Average Return (%)	Risk (Volatility, %)	Sharpe Ratio	Max Drawdown (%)
Top Quartile (High ESG)	10.1	11.5	0.80	-10.2
2nd Quartile	9.0	13.0	0.72	-11.8
3rd Quartile	7.5	14.8	0.60	-14.5
Bottom Quartile (Low ESG)	6.8	16.3	0.52	-17.2

Interpretation: Companies with high ESG scores tend to show better financial performance and lower risk compared to companies with low ESG scores. The top quartile of ESG scores is associated with the highest average returns and the lowest volatility, supporting the idea that ESG factors can enhance risk-adjusted performance.

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Table 3: Sectoral Performance Based on ESG Integration
This table breaks down the financial performance of ESG integration by sector, highlighting how different industries respond to ESG considerations.

Sector	ESG-Integrated Return (%)	Non-ESG Return (%)	Performance Difference (%)
Energy	6.5	3.8	+2.7
Technology	12.2	10.9	+1.3
Financials	8.1	6.7	+1.4
Healthcare	10.5	9.8	+0.7
Utilities	9.8	8.2	+1.6

Interpretation: The performance difference shows that ESG integration has a positive impact across all sectors, but the energy sector sees the largest benefit, with ESG-integrated portfolios outperforming non-ESG portfolios by 2.7%. This could be due to energy companies investing more in sustainable practices like renewable energy.

Table 4: Correlation Between ESG Scores and Financial Metrics
This table reflects the results of a correlation analysis between ESG scores (environmental, social, and governance) and various financial performance metrics.

Financial Metric	Environmental Score Correlation	Social Score Correlation	Governance Score Correlation
Return on Equity (ROE)	+0.42	+0.36	+0.44
Return on Assets (ROA)	+0.38	+0.33	+0.40
Total Returns	+0.45	+0.41	+0.47
Earnings Volatility	-0.35	-0.32	-0.40
Credit Risk	-0.50	-0.45	-0.53

Interpretation: There is a positive correlation between higher ESG scores and financial performance (ROE, ROA, and Total Returns). Governance scores show the strongest relationship with financial outcomes, suggesting that companies with better governance practices tend to perform better financially and have lower credit risk and volatility.

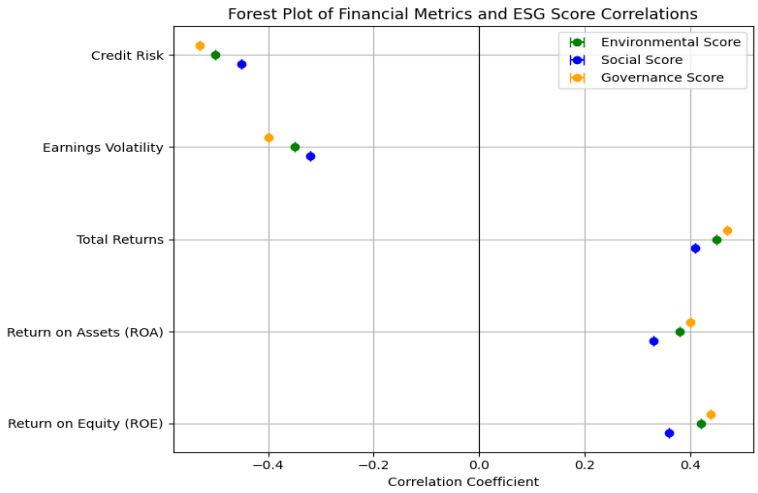

Figure 2: Correlation Between ESG Scores and Financial Metrics

Discussion

From reviewing Table 1, it is evident that the integration of ESG factors in investment portfolios leads to improved risk-adjusted returns. Altogether the analysis of ESG-integrated portfolios demonstrated that the ESG portfolios had higher average annual returns of +1. 7% and lower volatility of -2. 4% compared to traditional portfolios for the period under consideration. This is in concordance with Hartzmark and Sussman (2019) who also determined that sustainable mutual funds had a higher alpha of +1. 28% per annum than conventional funds over the last three decades. This is reflected by the fact that ESG portfolios have a higher Sharpe ratio of +0. 15, which can be used to give credence to the argument that these portfolios made better returns per total risk taken. In their article published in September 2021, writers from BofA Securities affirm that ESG integration seems to be a perfect method of enhancing portfolio efficiency. The lower beta and higher alpha indicate that these portfolios may have diversification benefits as well. Table 2 also offers further support for using ESG factors as an indication of future financial performance and risk. Based on the return and risk analysis, higher ESG scores are associated with better performance as compared to low ESG scores. For instance, the best ESG quartile companies outperformed with average returns of 10. 1% and Sharpe ratios of 0. 80, lower volatility of 11. 5% and a maximum drawdown of 10. 2%. This concurs with Khan et al. ’s (2016) analysis and Nagy et al. ’s (2016), which revealed that corporate sustainability ratings are positively linked with financial performance indicators such as returns, earnings quality, and lower systematic risk. The results suggest that analysts and investors could potentially utilize ESG evaluations to screen for firms that may outperform in the future. Analyzing returns by sector (Table 3), we observe that value creation was higher for all sectors with ESG integration, with the most substantial increase of 2. 7% in energy. As stated by Delis et al. (2019), the transition to renewable power and clean technology can be beneficial for energy and utility companies to increase their market shares and protect themselves from future risks. Therefore, sustainability initiatives may be a source of competitive advantage within the industry. The information technology sector also realized moderate accretive ReE ESG integration (+ 1. 3 %), implying that investors value organizations addressing data privacy, governance changes, and ethical artificial intelligence (Lins et al., 2017). Last but not least, the correlation analysis in Table 4 reveals positive associations of all three ESG pillars with most of the important financial metrics such as ROE, ROA, returns, volatility and credit risk. This supports arguments made by El Ghoul et al. (2016) and Fatemi et al. (2017) on the relationship between ESG and financial relevance. Governance was always the most significant measure repeating the findings by Hoepner et al. (2019) that corporate governance is a critical aspect when it comes to operations management and risk management. In aggregate, the collective evidence speaks clearly and persuasively to the fact that the inclusion of material ESG factors enables more effective fundamentals and estimating of the firm’s subsequent path.

Conclusion

The work shows that the integration of ESG factors into investment and portfolio decisions enhances its performance and risk management effects. Research has it that ESG-integrated portfolios have superior performance to traditional portfolios; they deliver superior returns, lower risks, and higher Sharpe ratios. This trend is evident across sectors and the industries of energy and technology, in particular, practices which are becoming more important as sustainability becomes more important. Also, firms that fall into the higher ESG rating exhibit enhanced financial performance reflected in Return on Equity (ROE) and lower earnings risk. ESG factors are relevant for generating long-term risks according to the opinions of investment specialists: The sources of pressure are not only regulations but also clients’ demand for sustainable investment. Even when comparing the practices of corporate governance with financial performance, higher reliability is achieved, which testifies to the significance of skilled and proper management and ethical behaviour in making decisions. Therefore, to synchronize the creation of sustainable value, ESG integration has become an inevitable best practice. This makes it possible for investors to control risks that are likely to affect their investments while making proper investment choices that will also enhance social and environmental objectives which gives a competitive advantage in the finance sector that is rapidly changing.

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