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THE IMPACT OF ESG ON CORPORATE PERFORMANCE AND INVESTOR DECISION-MAKING: A COMPREHENSIVE ANALYSIS

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Introduction

In recent years, Environment, Social and Governance (ESG) considerations have emerged as a crucial aspect affecting the corporate environment and investment decisions at a global level. The incorporation of ESG principles into business strategies is increasingly becoming a popular topic of discussion among the corporate decision makers, policy makers, scholars as well as investors. This research paper aims to explore the impact of ESG on corporate performance on one hand and investor decision-making on the other, considering its influence on strategic decision-making processes of corporates and the effect it has on investment decisions.

The growing recognition of ESG factors comes as a result of the realisation that business operate within a broad socio-environment structure and their actions can create a huge impact not only on the financial metrics, but on various social and environment concerns. By incorporating ESG considerations into their policies and operations, companies acknowledge their responsibilities towards the society and align their interests with broader societal goals. ESG principles ensure the long-term sustainability of corporates and links to an enhanced financial performance by attracting investments.[2]

This research paper addresses the nature of relationship between ESG practices and corporate performance and determines how ESG considerations influence strategic decision-making processes within an organization. The paper reiterates the importance of ESG factors in shaping investors' perceptions and its influence on investment decisions. It also explores various regulatory frameworks which impact the integration of ESG into corporate strategies.

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[2] Zhan, Shuyuan "ESG and Corporate Performance: A Review." SHS Web of Conferences. 169. (2023)

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By addressing these concerns, the research paper aims to contribute to the existing literature on ESG by offering valuable insights and practical implications for corporate decision-makers, investors, policymakers and stakeholders. It sheds light on the potential of ESG in the development of long-term value for corporates, mitigating risks and making a positive impact on society.

Brief Overview of ESG

ESG, which stands for Environmental, Social and Governance incorporates a set of principles that analysts, investors and stakeholders use to assess the sustainability and societal impact of companies. These principles consist of a comprehensive range of criteria that assess how well an organization performs in terms of governance, social accountability and environmental preservation. Investors are placing importance on these aspects, as highlighted in the "Global Sustainable Investment Review 2022" by the Global Sustainable Investment Alliance (GSIA), when determining whether to invest in a company or maintain their investments in a company they have already invested in. This approach highlights the importance for companies to make decisions which are ethically sound and environmentally conscious.

In today's business landscape, the concept of ESG has become an important tenet that companies cannot undermine while determining their conduct and decision-making. ESG, at its core, acknowledges the connection between a company's actions and broader societal and environmental concerns. Companies embracing ESG values prioritize ethics and sustainability recognizing that sustained success hinges on more than just profits. It also relies on their ability to mitigate challenges, support community welfare and uphold governance practices.

ESG principles have interestingly become an important aspect of the corporate set-up as investors which fundamentally analyse the company and predict the aspects of their growth in future heavily rely on these principles. They view these principles as a basis for an organization's long-term growth and a basis for risk-mitigation. Moreover, government is imposing stricter rules and regulations for companies to disclose their ESG policies. Failure to disclose such policies may have legal consequences for companies.

Importance of ESG in Corporate World

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ESG framework is increasingly becoming important in the corporate world. It extends beyond just profits, considering the impact which a company has on the environment and people. It takes into consideration the overall practices of the company.

One of the primary reasons why ESG has become an increasingly important consideration is because of its role in driving sustainability. Environmental factors like waste management, carbon emissions and resource efficiency are important in mitigating climate change and for the preservation of natural ecosystems. Companies which work towards the sustainability of environment contribute to a healthier planet and help in preserving natural resources which ensures that resources are available for future generations. Studies like one by McKinsey & Company show that strong ESG practices can lead to improved operational efficiency and cost reduction.[3]

ESG encompasses a variety of social factors like labour practices, diversity, human rights, etc. By ensuring that labour practices are fair and transparent, promoting diversity in the workplace and engaging with local communities, companies accept their social responsibilities and work towards creating a positive impact in the society. This helps to improve the morale of their employees and their retention. It also enhances company's reputation and its relationship with its stakeholders.

A sound corporate governance is fundamental to the concept of ESG. It involves transparency, accountability and a behaviour which is ethical in taking decisions for the company. Strong governance practices can help to prevent fraud and corruption. It ensures that the company operates in such a way which maintains the trust of shareholders and also ensures compliance with laws and regulations.

Sustainability practices such as resource efficiency can help companies save a huge amount of money as ESG encourages efficient use of resources like water and raw materials. It can reduce the dependability of the company on depleting sources by finding alternatives. ESG policies which focus on sustainability practices such as the efficient use of resources offers cost-saving opportunities to companies.

Incorporating ESG strategies act as a long-term value creator for the companies. By focusing on ESG, companies can reduce their operational costs which in turn can enhance their efficiency. The Social aspect of ESG can help create a positive brand image which can help

[3] McKinsey & Company. "The Role of ESG and Purpose." McKinsey & Company, https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/the-role-of-esg-and-purpose.

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the company to retain customers. Ultimately, ESG policies align with shareholder interests, reduces risks and attracts investors which creates a long-term value for the company.

ESG drives innovation. Companies which prioritise ESG tend to develop innovative products and services which meets the evolving demands of customers. When companies pay more attention to ESG, they often find themselves thinking creatively and developing innovative solutions to address environmental and social challenges. This leads to market differentiation and helps companies to distinguish their products from their competitors.

Pillars of ESG – Environment, Social and Governance

The three pillars of ESG, namely, Environment, Social and Governance are the three categories which are used to assess any organisation's sustainability and the impact it creates on the society. These pillars basically provide investors with a framework to evaluate the performance of companies in areas other than their financial metrics. These three pillars are as follows:

Environment (E) – This pillar of ESG determines the impact of a company on the environment and the efforts which it puts in to mitigate environmental risks. Major components of this pillar include:

1. Usage of Resources: It determines how efficiently a company uses its resources such as water, energy and raw materials. A company which is potentially viable to invest in is one which uses resources in a way that prevents wastage.
2. Pollution and Waste: This component suggests a company policy which minimises pollution and has proper waste management practices in place. It also includes a company's adherence to regulations concerning the environment.[4]
3. Biodiversity: It covers preservation of ecosystems and protection of biodiversity in its ambit and suggests companies to put in efforts to minimise negative impacts on biodiversity.
4. Climate Change: The carbon footprint of the company and its greenhouse gas emission percentage determine the impact it has on climate change. Any sound company should have strategies in place which reduces its impact on climate change. [5]

[4] Global Reporting Initiative (GRI) Standards (2021)

[5] Task Force on Climate-Related Financial Disclosures (TCFD), Recommendations of the Task Force on Climate-Related Financial Disclosures. (2015)

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5. Renewable Energy: A company should invest in sources of renewable energy such as solar power, wind power and reduce its dependency on non-renewable sources of energy such as fossil fuels which ultimately have a negative impact on the environment.

Social (S) – This pillar of ESG evaluates the impact which a company has on society including the treatment of its employees, its relationships with communities and the social initiatives which it undertakes. Key components of this pillar are:

1. Labour Practices: It includes various policies and practices which a company incorporates like fair wages and safe working conditions for its workers, employee rights, etc. A company which treats its employees in a decent manner and has diversification and inclusion policies in place is considered fundamentally strong.[6]
2. Health and Safety: This aspect states that a company should ensure the health, well-being, and safety not only of its employees, but also of the customers it deals with and the communities which get affected by its operations.
3. Human Rights: A company should have respect for human rights and avoid violations of these rights including child labour and forced labour. It should have sound human right policies in place.[7]
4. Product Quality and Safety: By ensuring that the products and services that a company provides to its customers are safe, high in quality and keeping in mind the customer's best interests, the company can create a better overall impact on the society. The company can attract customers and enhance their brand loyalty by providing quality products and services.

Governance (G) – Governance pillar assesses the manner in which a company is directed, managed and controlled. The major focus of this pillar of ESG in on the structures and processes which have an influence on the decision-making in the company. Following are the main components of this pillar:

1. Board of Directors: This aspect of Governance places more emphasis on the main decision-making body of the company. It suggests that the directors should encompass a diverse array of skills, experiences and background and should be unbiased in taking administrative decisions for the company.

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[6] International Labour Organization (ILO), Core Labour Standards (2023)

[7] The United Nations Guiding Principles on Business and Human Rights (2011)

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2. Ethical Standards: It basically suggests that the company should establish a fair code of conduct which reflects the company's core values and principles. The behaviour of all the employees should be ethical which promises the long-term sustainability of the company.
3. Risk Management: The company's ability to identify, assess and mitigate potential risks which would have a negative impact on the company's performance, operations and reputation is demonstrated through this aspect of the Governance pillar.[8]
4. Compliance with Laws: Governance practices should ensure compliance with the rules and regulations of the country and the acceptable industry standards pertaining to the field in which the company operates. Failure to comply with the law would have negative consequences for the company.
5. Transparency: A company which provides accurate information in a timely manner to its shareholders as mandated by the regulations or otherwise is considered to have robust governance policies in place. Such a company is believed to be transparent and attracts potential investors.

ESG Regulations and Corporate Governance Laws across the World

European Union (EU)

EU has several laws and directives which makes it mandatory for certain companies to report their ESG performance. The Non-Financial Reporting Directive (NFRD) makes it mandatory for publicly listed entities with more than 500 employees to include a non-financial statement in their annual reports which describes its policies and risks related to ESG factors.[9]

Additionally, the European Commission has proposed the implementation of Corporate Sustainability Reporting Directive (CSRD) to replace the NFRD.[10] CSRD aims to extend the scope of reporting entities by including all companies which are publicly listed in the EU markets irrespective of their size.

From the perspective of investors, the Taxonomy Regulation of the EU makes it mandatory for all financial market participants to disclose how their investments are environmentally sustainable. The Shareholder Rights Directive II (SRD II) is yet another directive aimed at

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[8] Committee of Sponsoring Organizations of the Treadway Commission (COSO), Enterprise Risk Management – Integrated Framework (2013)

[9] European Commission. "*Non-Financial Reporting Directive (NFRD)" (2014)*

[10] European Commission. "*Corporate Sustainability Reporting Directive (CSRD)" (2023)*

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encouraging long-term shareholder engagement and transparency. It requires the investors and asset managers to disclose the manner in which their investment strategies include the shareholders' engagement in ESG factors.[11]

India

In India, there currently are no specific laws which makes ESG reporting mandatory for companies. However, the Securities and Exchange Board of India (SEBI) has mandated the Business Responsibility Report (BRR) as part of the annual report for certain listed entities under the SEBI (Listing Obligations and Disclosure Requirements).[12] BRR requires companies to disclose their initiatives towards ESG factors which promotes responsible business conduct and transparency related to ESG reporting. SEBI has also issued various circulars to encourage investors and mutual fund managers incorporate ESG factors in their investment strategies.

The Companies Act, 2013 makes it mandatory for certain companies which cross the threshold limits to form a committee to manage various Corporate Social Responsibility (CSR) activities and policies of the company.[13] The Ministry of Corporate Affairs (MCA) had also introduced the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities (NVGs) which provide a framework for companies to integrate ESG considerations in their operations.

United Kingdom

There are various rules and regulations related to mandatory ESG reporting for companies in UK. The Companies Act 2006 (Strategic Report and Director's Report) Regulations 2013 makes it compulsory for companies over 500 employees to disclose information on the impact caused by their operations on the environment, their employees, social and community affairs as well as the respect it fosters for human rights and matters related to anti-corruption and bribery. Certain companies crossing the threshold limits are also required

[11] European Commission. "*Shareholder Rights Directive (SRD II)*" (2017)
[12] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015
[13] The Companies Act, 2013. Act No. 18 of 2013.

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to publish a statement on annual slavery and human trafficking emphasizing the steps taken by them to ensure that social injustices are not prevalent in their operations. [14]

UK has also issued the UK Corporate Governance Code which provides guidance on corporate governance principles to companies.[15] It emphasizes the importance of sound governance policies including effective board of directors, accountability, remuneration policies and active engagement of stakeholders in decision making. Additionally, the Task Force on Climate-related Financial Disclosures (TCFD) Recommendations provides a framework for companies to disclose information related to its impact on climate. Moreover, the Streamlined Energy and Carbon Reporting (SECR) policy of UK requires certain companies to include their energy consumption as well as greenhouse gas emissions in their annual reports.

Unites States (US)

US doesn't have specific laws which mandate ESG reporting for all companies. However, there are various regulatory frameworks and guidelines that influence ESG reporting such as the Security and Exchange Commission (SEC) Regulations which requires publicly traded companies to disclose material information related to ESG which may affect their financial performance.[16] US emphasizes the importance of disclosing information which may be relevant to investors and companies themselves assess the materiality of any information which is likely to impact investors' decisions.

Frameworks such as Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD) are voluntarily adopted by many companies in the US to disclose ESG related information. Some states in the US are taking a more proactive approach to ESG disclosures. As an example, California has proposed various bills which mandate companies to report their greenhouse gas emissions and information about their board diversity.[17] Changes in the regulatory frameworks by SEC and initiatives taken by various states suggest a potential move towards a highly standardized approach towards ESG reporting in the future.

[14] The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022.
[15] Financial Reporting Council. "*UK Corporate Governance Code*." (2018).
[16] US Securities and Exchange Commission. *Conflict Minerals: Information and Disclosures Required, rule 13p-1* (2012)
[17] California Legislature. Senate. Senate Bill No. 253. (2023)

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Theoretical Frameworks linking ESG to Financial Performance

Several theoretical frameworks have been used to explain the relationship between ESG considerations and financial performance. These frameworks provide a basis through which researchers can understand the mechanism behind the impact of ESG on financial outcomes. The following theories are most widely used by researchers in order to analyse the financial performance of companies and its link with healthy ESG practices:

Stakeholder Theory – This theory suggests that organizations have a network of relationships with various stakeholders which include employees, customers, local communities, suppliers and other entities which get affected by its operations. The stakeholder theory provides a framework for understanding the manner in which companies manage their relationships with these stakeholders. It emphasizes the importance of considering the interests of all stakeholders in the decision-making process which involves balancing the interests of all stakeholders to achieve mutually beneficial outcomes.[18]

Resource-Based View (RBV) – The RBV theory relates to the company's possession of resources and capabilities which are unique, valuable and difficult to duplicate. These resources can include tangible assets like infrastructure as well as intangible assets such as intellectual property. One such resource is the company's ESG practices which can be categorised under the intangible resources that contribute to their financial performance and distinguishes them from their competitors. As an example, companies which includes waste reduction practices and efficient use of energy which has a positive impact on the environment can contribute to the long-term financial success of the company.

Legitimacy Theory – It is a sociological theory which suggests that companies aim to enhance their legitimacy and social acceptance by incorporating ESG practices that align their operations with societal expectations. Legitimacy is important for any business in order to be accepted and get support by various stakeholders including customers, employees, investors and the public in general. Compliance with ESG regulations help companies to meet the legal requirements and demonstrate commitment to ethical business practices. It helps companies to avoid legal implications, damage to its reputation and loss of legitimacy. The legitimacy

[18]Horisch, J., Freeman, R. E., &Schmidheiny, B. (2014). Applying stakeholder theory in sustainability management: Links, similarities, dissimilarities and a conceptual framework. Organizations and Environment, 27(4), 591-608.

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theory emphasizes the need for transparency and accountability in operations of the company and disclosure requirements.[19]

Agency Theory – This theory examines the relationship between shareholders who act as principals and the management which acts as agents within organizations. It focuses on the decision-making authority which has been delegated by shareholders to the management and recognises that there may be information gaps wherein agents possess more information about their actions and performance than the principals, which can lead to problems. The main goal of this theory it to ensure that agents act in the best interests of the principals which can be achieved through better executive compensation, incentive mechanisms, monitoring practices and enhanced governance structures.

Stewardship Theory – It is a theoretical framework which states the importance of responsible behaviour by corporate stewards including the board of directors and senior executives. It places an emphasis on the fiduciary duty of corporate stewards to act in the best interests of all the stakeholders by efficiently managing resources and making decisions which maximise the creation of value for the company. This theory advocates in favour of integrating disclosure practices which provide stakeholders with a comprehensive view of the company's performance.

These theoretical frameworks provide conceptual models for understanding ESG factors and their influence on businesses, society and environment. These theories play a major role in guiding research, understanding concepts, promoting ethical and responsible behaviour and developing sustainable practices. These frameworks help in fostering innovation and addressing existing challenges in ESG considerations, thereby increasing sustainability for corporations in future.

Evaluating the Relationship between ESG and Corporate Financial Performance

The relationship between ESG and corporate performance is a highly debated topic. There are multiple studies on the correlation between the two. While some studies suggest that a positive correlation exists, others show mixed results. Factors such as industry, size of the company and the manner in which ESG performance is measured can have a great influence

[19]Suchman, M. C. (1993). Legitimacy in the society of organizations: A historical and institutional perspective. Academy of management review, 18(2), 571-610.

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on the results. In 2015, a study by Friede et al., found a largely positive relationship between ESG and financial performance.[20] The study analyzed over 2200 individual studies and concluded that companies with strong ESG practices tend to outperform companies with weak ESG practices. However, there is a certain level of ambiguity whether strong ESG performance drives financial success or that companies with good financials have more readily available resources to invest in ESG initiatives.

The impact of ESG on financial performance may vary depending on the industry and the overall market conditions prevailing in the economy. Each industry faces different challenges related to ESG. Companies which address ESG issues which are most relevant to the industry in which it operates are likely to gain a financial advantage over their competitors. As an example, efficient use of energy may be a bigger priority for a manufacturing company than for a software company. Studies on healthcare companies by Asif et al. in 2023 show a positive correlation between high ESG scores and financial ratios such as Return on Assets (ROA) and Return on Equity (ROE).[21] This suggests that strong ESG practices can also benefit companies within specific sectors.However, the benefits of ESG practices are evidently seen in the long run. Assessing short-term financial metrics may result in missing-out on the long-term positive effects of ESG on company's financial performance as well as sustainability.

A study conducted by Mahmut Aydogmus et al. in 2022 suggests that while Social and Governance pillars of ESG have a positive relationship with financial performance of a company, the Environment Pillar doesn't have any effect on it.[22] The reason that the study didn't find any correlation between Environment and financial performance might be that environmental practices take a longer time to produce the same results as social and governance practices do. Moreover, the higher costs associated with Environmental practices as compared to the other two pillars of ESG could also be one of the reasons behind the results of the study.

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[20]Friede, G., Busch, T., & Bassen, A. (2015). ESG (environmental, social and governance) factors and corporate financial performance: The evidence and its implications for investors. Business & Society, 54(2), 189-228.
[21]Asif, M., Zhang, Y., Men, X., & Ji, Y. (2023). Examining impact of ESG score on financial performance of healthcare companies. Emerald Insight,doi: 10.1108/JGR-05-2022-0045
[22] Mahmut Aydoğmuş, Güzhan Gülay, Korkmaz Ergun, (2022). Impact of ESG performance on firm value and profitability, Borsa Istanbul Review, Volume 22, Supplement 2, Pages S119-S127, ISSN 2214-8450

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Overall, the relationship between ESG and financial performance of companies is dynamic in nature. While the evidence points to a positive correlation between strong ESG practices and financial performance, it is necessary to delve into specifics of each company and the industry in which it operates. The evidence points out that companies which integrate ESG considerations in their policies and strategies benefit through an improved financial performance, reduced risks, enhanced brand reputation and loyalty, access to capital, and results in the overall growth of a company in a sustainable manner while creating long-term value for the company.

Growing Interest of Investors in ESG Factors

Traditionally, investors made investment decisions by relying solely on the financial metrics of a company. The profitability of company and high short-term returns attracted majority of investors. However, a growing awareness among the people about environmental degradation, social inequalities and poor corporate governance led to a shift in investor's approach. Today, investors are increasingly relying on ESG factors in taking investment decisions.[23]

One of the major reasons why investors are taking the ESG metrics of companies into consideration is because of its potential to improve risk management. Beyond the traditional financial risks, companies also face many environmental, social and governance challenges which has the potential to impact their long-term sustainability and viability. Climate change is a serious threat to companies. Extreme weather, rising sea levels, resource scarcity among others can disrupt the operations of companies and damage their infrastructure and supply-chain which would ultimately lead to substantial financial losses. Integrating ESG considerations into their decision making helps investors to identify the risks associated with poor environmental practices and help mitigate these risks by investing in companies which have strong sustainability practices in place.

Investors are becoming more aware of the impact that companies' operations have on the society. They are beginning to recognize that companies which have a strong ESG performance tend to outperform financially over the long term. Companies with better ESG considerations act as a guarantee for investors that their investments are safe and would maximize their returns on investments (ROI) in the long run. It may not provide short term

[23] Zhan, Shuyuan. "ESG and Corporate Performance: A Review." SHS Web of Conferences. 169. (2023).

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gains, but in the long run, such companies are considered more resilient and have a better chance at succeeding than their peers who have poor ESG practices.

Companies which have poor labour practices, discriminatory habits or inadequate safety standards for their workplace tend to expose themselves to lawsuits, fines and suffer damage to their reputation. Companies which pay no heed to the social implications of its operations, management and policies make losses in the long run. Poor labour practices and employee dissatisfaction leads to low productivity and higher operation costs. If investors invest their money in companies with poor ESG policies, it can lead to short-term gains but would ultimately result in losses as these companies will not sustain in the long run. By considering social aspects like diversity, inclusion, fair labour practices, investors can save their investments in companies with high social risks.

Strong corporate governance policies go hand in hand with sustainability and profitability of the company. Companies which have weak corporate governance like lack of transparency in financial reporting, lack of board accountability and poor management policies can diminish the confidence of investors and lead to financial losses. Assessing a company's governance structure which includes evaluating risk management practices, ethical leadership, auditing and reporting standards and moral business ethics allows investors to minimise the risks associated with poor corporate governance. Hence, ESG principles serve as a valuable risk management tool which enables investors to build more viable portfolios by including companies with sound ESG policies.

Institutional Investors as well as brokers and asset managers are integrating ESG considerations into their investment strategies. Investment through this strategy involves screening companies based on ESG criteria available on various indices. There are various ESG indices and ratings available for investors to identify companies with strong ESG performance. As an example, the S&P ESG India Index is widely used by Indian investors to assess the ESG performance of the top 500 Indian companies listed on the National Stock Exchange (NSE) on the basis of total market capitalization.[24]

Influence of ESG Factors on Investment Decisions

ESG factors influence investment decisions in several ways as investors are increasingly recognising the importance of considering non-financial metrics along with the financial

[24] S&P ESG India Index Methodology. S&P Dow Jones Indices. (2024).

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metrics. ESG factors provide valuable information about a company's exposure to various environmental, social and governance risks. Investors rely on these ESG metrics to assess the potential risks involved in their investment which can create an impact on the returns generated on their investments. Companies with proper risk identification and mitigation systems are identified to be sustainable over the long term and hence attracts a wide pool of investors.

Evidently, many researchers have found out a positive correlation between strong ESG performance vis-à-vis the financial performance of companies. Efficient ESG practices have linked to lower costs of capital, enhanced efficiency in operations, improved brand reputation and reduced legal risks, all of which contributes to enhanced financial performance. Investors are increasingly relying on the ESG performance of companies to generate sustainable returns on their investments. Enterprises with outstanding ESG performance can be seen as more resilient and better fit to deal with risks, hence more appealing to investors.[25]

As people are getting more aware about ESG concerns, there is an increasing pressure on companies to adopt best ESG practices along with their necessary disclosures. Companies which fail to address ESG issues face damage to their reputation, regulatory scrutiny and downward performance making them less attractive options for investment. Regulatory changes related to ESG disclosures also have an influence on investment decisions. In order to promote transparency in the corporate environment, governments and regulatory bodies are making it compulsory for companies to report their ESG performance which is readily available on companies' official website as well as various indices for investors to make informed decisions. Compliance with these regulations and standards is becoming a major consideration for investors to mitigate long term financial losses due to companies' non-compliance with these regulations.

Investors are day by day realising the importance of long-term sustainability while making investment decisions. They are beginning to recognise that the stability of their investments relies not only on the short-term financial performance of the company but also on the company's ability to face challenges and adapt to changing circumstances. Companies with better ESG practices tend to adapt better to the changing market conditions which increases

[25] ESG: A Guide for Investors, Aviva Investors. (2021).

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their long-term viability. Investors who seek to build sustainable portfolios are incorporating ESG factors in their investment strategies which align with their own values and objectives. Stakeholders' activism and engagement in influencing corporate behaviour also plays a crucial role in investment decision making. Investors as well as many social organizations engage with companies on a daily basis to address ESG issues and advocating for ESG related changes in corporate policies. Investors choose to support the companies with a positive response to address these issues through increased stakeholders' engagement and show a positive commitment to support these concerns, and divest from companies which fail to meet ESG expectations.

Ways to Incorporate ESG in Investment Decisions

There is a growing concern about environmental and social aspects of company operations persisting among investors due to which they use various methods to avoid companies which have poor ESG considerations. These are:

Exclusionary Screening Method – Investors are increasingly using the screening method to exclude certain companies as well as industries from their investment portfolio based upon ESG criteria. As an example, keeping in mind the negative impact on environment, investors may avoid companies producing tobacco or related products, fossil fuels, or firearms.[26] On the contrary, they are seeking out companies which adhere to the ethical standards and include these companies in their portfolios for a sustainable growth. Some investors also practice the method of setting a minimum threshold for ESG performance below which they cease to invest in companies.

ESG Integration Strategies – This is the most common approach. Investors rely on ESG integration strategies which incorporate ESG factors into their decision-making processes. ESG integration method involves analysing companies based on ESG criteria and assessing risks and opportunities to identify investments which have a potential of long-term growth along with assessing the traditional financial metrics like growth and profitability. There are various ways of analysing a company's ESG performance such as:

[26] MSCI ESG Research. "ESG Screens: A Primer." (2020)

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1. *ESG Ratings* – Agencies which rate companies evaluate their ESG performance and assign scores or rankings which are used by investors as a starting point for further analysing the fundamentals of the company.[27]
2. *Company Reports* – Companies disclose their annual report and sustainability reports on their official website as a part of mandatory disclosures, which are examined by investors to understand the company's ESG policies, initiatives and performance.
3. *News and Industry Research* – Investors stay updated on ESG-related news and regulations promulgated in regard of ESG as well as industry trends to understand the risks and opportunities involved in making investment decisions.[28]

Thematic Investing – This is a strategy which focuses on investing in specific themes related to ESG issues like climate change, resource efficiency, water scarcity and clean energy. Thematic investing allows investors to align their portfolios with their own values and beliefs. Thematic Exchange-Traded Funds (ETFs) and several mutual funds exposes investors to companies which have aligned themselves with a particular ESG theme. By investing in companies through the method of thematic investing, investors get the opportunity to generate profits while making a positive impact on the society and environment.[29]

Engagement and Stewardship – Some investors engage themselves directly with the companies which they invest in and encourage them to improve their ESG practices. This practice may involve filing of shareholder proposals or participating in shareholder meetings and advocating for better ESG policies. Engaging directly with companies allows investors to influence the decisions of management, mould the corporate behaviour and improve the overall ESG performance of the company. This can help the company to unlock its long-term value and in turn create growth opportunities for the investors.

Impact Investing – This strategy focuses on investing in companies which actively contribute to social and environmental concerns. It allows investors to generate positive social and environmental outcomes along with financial returns. Impact investing also involves directly investing in social enterprises, community development projects or sustainable initiatives which aim to benefit the society and environment. Conversely, investors can also invest in

[27] Morningstar. "Morningstar Sustainability Ratings Methodology." (2020)
[28] Sustainability Accounting Standards Board (SASB). "SASB Standards Navigator." (2021)
[29]RobecoSAM. "Thematic Investing: A Sustainable Future." (2017)

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companies that belong to specific ESG-focused sectors like renewable energy, healthcare, sustainable agriculture, etc.[30]

By incorporating ESG factors in decision-making, investors aim to build a strong portfolio by mitigating potential risks and seize opportunities arising as the economy is transitioning to a more sustainable future. However, the integration of ESG factors varies from investor to investor. Long-term investors may give a higher weightage to ESG as compared to short-term investors. The specific methods used by investors depends upon their individual risk tolerance, investment goals and ESG priorities.

Conclusion

In conclusion, this research paper highlights the significant impact of ESG factors on both, the financial performance of companies and the investors' decision-making processes. The integration of ESG considerations in corporate strategies has emerged as a crucial aspect which has the potential to improve the long-term sustainability and value creation for companies.

Various studies have demonstrated a positive correlation between strong ESG performance and improved financial performance including higher profitability, stock market performance, and lower cost of capital. Companies that prioritize ESG principles are better resilient to risks, improved operational efficiency and enhanced reputation among stakeholders. However, despite the growing number of studies supporting a positive relationship between ESG and financial performance, there are still some challenges such as standardization and measurement of ESG data. Issues like greenwashing, incorrect disclosure practices and lack of uniformity in ESG ratings still remain unresolved.

Moreover, investors' interest in ESG factors has increased in recent years with growing recognition of the importance of considering non-financial metrics in investment decision making along with the financial performance and growth of companies. Investors are increasingly incorporating companies with better ESG practices in their portfolios viewing ESG integration as a means to mitigate risks and identify opportunities.

[30] Global Impact Investing Network. "Impact Investing 101." (2019)

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Moving forward, there is a need for further research and collaboration to address the challenges related to ESG reporting and disclosures as well as the standardization in measurement of ESG performance in order to get a better understanding of the complex relationship between ESG factors and corporate performance. By addressing these challenges, companies and investors can harness the potential of ESG to create a positive societal impact along with the creation of value for the companies.

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