

Global ESG Investment: Recent Trends and Major Discussions

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Recently, there has been growing interest in ESG investing that incorporates non-financial factors such as environmental, social, and governance aspects into investment decisions. ESG investing has picked up particularly among institutional investors and large-scale pension funds who prioritize sustainability and long-term performance over short-term returns. Backed by the trend, ESG assets under management have ballooned rapidly. On another front, however, ESG investing has been the subject of concern over its financial performance, rating consistency, and a proper disclosure scheme. As ESG investing is expected to grow its importance in Korea with the National Pension Fund's move towards more socially-responsible investing, it's desirable to channel more efforts into assessing ESG investment performance on an on-going basis, building more track records, standardizing the ESG rating scheme, and making improvements on disclosure.

Recently, there has been increasing global attention to environmental, social, and governance (ESG) investing¹⁾ that incorporates non-financial factors into investment decisions. Large-scale asset management companies such as BlackRock, Vanguard, State Street, and Fidelity have underscored the importance of ESG investing, making aggressive strides in developing and

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1) ESG investing was first derived from a religious and ethical motive that tries not to invest in specific industries such as liquor, tobacco, weapons, etc. The concept and meaning have evolved amid the growing social interest in global warming, corporate corruption, human rights, etc. Today, ESG investing is labeled as various terms such as socially responsible investment, responsible investment, sustainable investment, and ethical investment (Kim, S.C., 2014, Korea's regulatory framework on SRI: Trends and challenges, CGS Review 73).

launching relevant investment products. In addition, major pension funds including CalPERS in the US and public pension funds in Japan and Netherlands have expanded their sustainable and responsible investing with the aim to achieve transparency in managing investment and to enhance long-term returns. Korea's National Pension Service (NPS) revised its investment principles to unveil its plan to expand its ESG investing to all asset classes. Accordingly, there has been growing interest among domestic investors in ESG investing.

The expansion of ESG investing was triggered largely by the UN Principles for Responsible Investment (UN PRI).²⁾ The number of UN PRI signatories has persistently risen from 63 at the 2006 inception to 2,372 (AUM at \$86.3 trillion) as of the first half of 2019. Given the international community's subsequent cooperative efforts such as the UN Sustainable Development Goals (SDG), and the Paris Agreement in ESG areas, ESG investing is expected to draw growing attention going forward. Under the context, this article explores the recent trends in and key issues around ESG investing, from which to draw implications for Korea's ESG market participants.

Recent trends in global ESG investing

According to the Global Sustainable Investment Alliance (GSIA), global ESG investing stood at around \$30.7 trillion as of 2018, a 34% increase from \$22.8 trillion as of 2016. By region, Europe and the US are a clear leader taking up over 85% of global ESG investing. In Canada, Australia, and New Zealand, ESG investing accounts for over 50% of AUM. The proportion of ESG investing is not quite high in the Asian region, except for Japan recently showing a rapid growth trend. Japan's ESG investing has shot up steeply since it first introduced the Stewardship Code in 2014 and Japan's Government Pension Investment Fund became a signatory to the UN PRI in 2015. Japan's compound annual growth rate of ESG investing recorded 307%, from JPY 57,000 in 2016 to JPY 232,000 in 2018.

In line with the increase in ESG investing as shown above, there has been a trend shifting away from the negative screening-centered conventional strategy towards diversification in ESG investing strategies, such as ESG integration, shareholder engagement, impact/community investing, sustainability-themed investing, positive screening, etc. Negative screening is an early-

2) The UN PRI consists of a set of investment principles on ESG core values that institutional investors should consider in their investment decisions. This includes six principles (incorporating ESG issues into investment analysis and decision-making processes; incorporating ESG issues into ownership policies and practices; seeking disclosure on ESG issues by investment target firms; promoting acceptance and implementation of the Principles within the investment industry; working together to enhance the effectiveness in implementing the Principles; and reporting on activities and progress towards implementing the Principles) and 33 action plans.



stage ESG strategy excluding investment assets related to tobacco, liquor, and gambling that are deemed unfit for ethical standards. More recently, there's an increase in ESG integration and active ownership strategies.³⁾ Other less-used strategies include positive screening that selects and invests in firms with a high ESG score, and sustainability-themed investing that invests in firms related to specific themes such as new and renewable energy, climate change, green technologies, etc.⁴⁾

Under the circumstances, Korea also sees rising interest in ESG investing, largely led by institutional investors such as the NPS. In 2019, the NPS voted on “Plans to Facilitate Responsible Investing”, making a bold move towards ESG investing. By more engaging in ESG investing, the NPS plans to minimize adverse external effects arising from environmental, social, and governance issues, with the aim to improve the National Pension Fund's long-term returns and sustainability.⁵⁾ Compared to advanced economies, however, Korea's ESG investing is still at a nascent stage. As of 2018, the size of ESG investing by Europe, the US, Canada, Australia, and New Zealand combined stood at \$30 trillion approximately, which takes up 25% to 60% of each nation's AUM. This largely dwarfs Korea's ESG investing worth of KRW 28 trillion, or 4.18% of AUM. And the NPS accounts for over 96% of Korea's ESG investing.⁶⁾

Issue 1: Financial performance of ESG investing

As ESG investing is drawing renewed attention as one of the new investment strategies particularly in Europe and the US, its ability to achieve the dual goals of financial returns as well as social and environmental value has been constantly challenged. Recently, a Morgan Stanley survey of US asset management companies⁷⁾ reveals that although financial returns are an element as important as non-financial value in an investment decision, it's still not clear whether ESG investing has a positive impact on financial performance. In theory, ESG investing can possibly have both a positive (+) or negative (-) correlation with financial performance.⁸⁾

3) ESG integration means taking into account ESG issues in corporate valuation and risk assessment, whereas active ownership refers to a shareholder's full engagement in ESG issues via dialogue with the management or voting rights.

4) IMF, 2019, Global Financial Stability Report.

5) National Pension Fund Management Committee, Ministry of Health and Welfare, November 29, 2019, Follow-up measures on the principles of fiduciary responsibilities for higher predictability and better long-term performance, and plans to facilitate responsible investing, Press Release.

6) GSIA, 2019, 2018 Global Sustainable Investment Review.

7) A recent survey by Morgan Stanley on US asset managers found that about 79% of respondents value financial returns as much as (or over) social and environmental impacts in their decision making for ESG investing (Morgan Stanley, 2019, Sustainable Signals).

8) Renneboog, L., Ter Horst, J., Zhang, C., 2008, The price of ethics and stakeholder governance: The performance of socially responsible

If an investment evaluation process can effectively select firms with good ESG scores, that could reduce the risk of exposure to a downside risk, e.g., an ESG-related accident eroding a firm's reputation and financial performance. This is expected to be positive to ESG investing's investment returns.⁹⁾ However, it's possible for ESG investing to have a negative impact on returns because adding an ESG criterion to the investment evaluation process leads to extra costs for selection, and an inclusion or exclusion of a certain asset during the process could narrow the scope of investments.¹⁰⁾

With regard to this issue, there has been abundant literature on testing the financial performance of ESG investing. Based on research results thus far, positive results seem to have slightly the upper hand. According to a meta analysis by Friede et al. (2015) on 2,200 empirical studies that analyzed the relationship between ESG and financial performance since 1970, about 90% of the studies analyzed show a positive or neutral relation, from which the authors conclude that ESG investing overall leads to positive investment performance.¹¹⁾

On another front, there're a number of empirical results indicating a negative or neutral result on ESG investment performance. An IMF report released in 2019 argues that there's no clear evidence that a sustainable fund continues to outperform a global equity fund, and that a limit in investment targets could bring down the performance further.¹²⁾ Auer & Schuhmacher (2016) confirm that ESG factors have no impact on investment returns in the Asian and US markets, whereas investment returns—if ESG factors are taken into account—tend to fall in Europe.¹³⁾

To sum up, great caution is necessary not to fall for biases—either unconditionally prefer or disbelieve ESG investing—without any consistent evidence of ESG investment performance. Furthermore, Korea's ESG investing is still taking baby steps, and thus lacks relevant literature. Going forward, Korea needs to carry out more tests and accumulate empirical evidence on ESG investment performance.

mutual funds, *Journal of corporate finance* 14(3), 302-322; Friede, G., Busch, T., Bassen, A., 2015, ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment* 5(4), 210-233.

9) Krüger, P., 2015, Corporate goodness and shareholder wealth, *Journal of financial economics* 115(2), 304-329; Diemont, D., Moore, K., Soppe, A., 2016, The downside of being responsible: Corporate social responsibility and tail risk, *Journal of business ethics* 137(2), 213-229.

10) In the midst of deteriorating investment performance, CalPERS was reported to mull over a potential overhaul on its current disinvestment policies that exclude coal-mining firms, gun manufacturers, emerging firms violating human rights and environmental principle, and others (The Wall Street Journal, June 16, 2019. Calpers' Dilemma: Save the World or Make Money?).

11) Friede, G., Busch, T., Bassen, A., 2015, ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment* 5(4), 210-233.

12) IMF, 2019, 『Global Financial Stability Report』.

13) Auer, B. R., Schuhmacher, F., 2016, Do socially (ir) responsible investments pay? New evidence from international ESG data, *The Quarterly Review of Economics and Finance* 59, 51-62.



Issue 2: Consistency across different ESG rating frameworks

Also pointed as difficulties in carrying out ESG investment are the intransparency and inconsistency across ESG scores provided by multiple ESG research firms. The Global Initiative for Sustainability Ratings (GISR) estimates that there are roughly over 126 ESG research firms across the globe as of 2016. Among them are general ESG rating firms including Bloomberg, FTSE Russell, MSCI (former KLD), Sustainalytics, Vigeo-Eiris, and RobecoSAM, and those focusing on more specific ESG areas such as S&P's Trucost and GRESB.

The problem is that ESG research firms have developed and adopted a wide range of different approaches to collecting, analyzing, and assessing information, under which they often offer different ESG ratings for one institution. For instance, FTSE gave a low environment rating to Tesla, citing the carbon emission during the car manufacturing process, whereas MSCI positively assessed Tesla's clean technology and low carbon emission from the completed cars, assigning Tesla an almost-perfect score on environment.¹⁴⁾ According to State Street Global Advisors, a low correlation at 0.53 was found between ESG scores of the MSCI World Index stocks by MSCI and Sustainalytics as of end-June 2017.¹⁵⁾

Overall, Korea's ESG rating framework—excessively slanting towards corporate governance—is viewed as lagging behind that of developed countries especially in the aspect of social responsibility and environment-friendly management. Although it's hard to estimate the correlation between ratings by multiple agencies due to the unavailability of ESG rating data, such rating inconsistency is likely to exist in Korea given the unstructured nature of ESG data.

As pointed out by Berg et al. (2019),¹⁶⁾ causes behind the problem could stem from the divergence in the scope, weight, and measurement for ESG ratings. In the case of Korea with a short history of ESG investing, however, the problem could be the lack of data and individual

14) The Wall Street Journal, 2018. 9. 17, Is Tesla or Exxon More Sustainable? It Depends Whom You Ask.

15) State Street Global Advisors, 2019, 『The ESG Data Challenge』

16) Berg et al. (2019) point to the following three factors as the primary causes behind divergence in ESG ratings across agencies. First, scope divergence means a situation where each agency has a different set of features that are used as a basis for ESG scoring. Second, weight divergence means that the weights given to each ESG factor are different across agencies. Third, measurement divergence refers to when each agency uses a different method to measure the same ESG factor. For example, one agency would use the employees' job shift to measure a firm's labor environment, whereas another agency would adopt the number of labor disputes, which could result in widely different scores on the labor environment. Furthermore, the most influential factor in ESG score differences across agencies is measurement divergence, which explains about 50.1% of ESG score differences. The divergence of scope and weight has explanatory power of 36.7%, and 13.2%, respectively (Berg, F., Koelbel, J.F., Rigobon, R., 2019, Aggregate Confusion: The Divergence of ESG Ratings).

firms that are needed for thoroughly quantifying ESG data. Because this requires a long-term approach, it's desirable to accumulate more data while closely watching the development of rating models and techniques.

Issue 3: Disclosure of ESG-related information

Another area of heated discussion is whether to mandate the disclosure of ESG-related information, or to allow for discretion. The proponents of mandated disclosure argue that mandated ESG disclosure could address information asymmetry between firms and the investors, which could raise investor confidence in their investments and ultimately impose a positive impact on corporate value. However, the opponents favoring autonomy over mandated disclosure argue that the possibility of tougher ESG disclosure and the resultant cost burden would undermine firm profitability, and that the absence of accurate ESG rating criteria would hinder disclosure from properly reflecting the reality.¹⁷⁾

Although a shift towards tougher ESG-related disclosure is a global trend, the details—such as the scope, method, and level of obligation—vary widely across countries. EU countries, the UK, Singapore, the republic of South Africa, and Taiwan chose to mandate all or part of listed firms to disclose ESG information, whereas the US requires firms to disclose only matters related to corporate governance and environment.¹⁸⁾ More recently, the EU and the UK have recently endorsed the Task Force Climate-Related Financial Disclosure (TCFD) recommendations by obligating firms to disclose in their business reports financial information related to climate change. By contrast, a similar bill was rejected by the US Congress in July 2019.¹⁹⁾

In Korea, some firms voluntarily publish sustainability reports based on the Global Reporting Initiative (GRI) standards, a global reporting guideline.²⁰⁾ Although the GRI standards recommend companies worldwide to publish general issues, their lack of precision makes it unfit to be used for assessing firm-level performance or comparison across firms.²¹⁾ Furthermore,

17) Korea Economic Research Institute, December 11, 2019. More autonomy for ESG disclosure instead of mandated disclosure.

18) Oh, D.G., 2017, Recommendations on tougher ESG disclosure, CGS Report.

19) Financial Times, 2019.7.12, US Congress rejects European-style ESG reporting standards.

20) The GRI is an NGO founded by the United Nation Environmental Program (UNEP) and US environmental activist group CERES. It has developed and distributed guidelines on how to draft and publish sustainability reports for companies across the globe. After releasing the first guideline (G1) in 2000, it continuously revised the guidelines (G2, G3, G4, and GRI standards).

21) According to the Korean Standard Association, the number of sustainability reports published by private sector firms, municipalities, public institutions stood at 133, among which only 98 were from listed companies as of 2018.



access to relevant information is not easy for stakeholders because information is scattered across multiple locations: governance information in annual reports or sustainability reports; social responsibility and environment-related matters in sustainability reports, the environmental information disclosure system, or corporate websites. As the Korean government unveiled its regulatory improvement plan with the aim to clarify and standardize ESG disclosure, disclosure quality is expected to improve going forward.²²⁾ For higher policy effectiveness, more detailed measures are needed to specifically enumerate the scope, content, and method of disclosure.

Devising a uniform disclosure framework on ESG information is a daunting task given the intricate mix of interests of firms, investors, governments, NGOs and other entities, on top of many characteristics specific to firm size or each industry. A wider scope of disclosure would surely benefit investors, but at the same time increase disclosure burden. Also problematic is the difficulty to apply a uniform disclosure standard to industry-specific risk type and range related to ESG. Hence, what's more realistic is a phased approach starting with setting priorities depending on information materiality, and then extending the range of disclosure further. This is more desirable than a uniform disclosure rule.²³⁾ Another idea is selecting and providing a set of standardized indicators on core issues that reflect industry-specific aspects faced by individual firms. This will help firms to reduce disclosure burden, and investors to more clearly assess firm performance.

Conclusion

As discussed in this article, global market trends and key issues related to ESG investing evidence that the size of ESG investing has grown rapidly every year despite many controversies such as financial impacts of ESG investing, consistency across different rating schemes, standardized disclosure, etc. Given ESG investing's short history, it's a bit too early to judge the impact at this point. However, what seems obvious is that ESG investing will become a critical issue in the capital markets in the upcoming future. As ESG investing is attracting growing interest amid the rise of the NPS's responsible investing, it is hoped that ESG investing will see further discussions and progress going forward.

22) Financial Services Commission, February, 20, 2020 Work Plan, Press Release.

23) For example, another idea is to use the Sustainability Accounting Standard Board (SASB) standards, instead of GRI standards. The SASB standards classify ESB issues based on the SASB Materiality Map[®] process that consists of three criteria; 'evidence of interest', 'evidence of financial impact', and 'forward-looking adjustment'. Among those the standards select critical issues specific to each sector and industry, and make standardized indicators and provide them (Park, 2013, A move for sustainability accounting standards in the US, and a comparison with the ESG disclosure standards, CGS Report).