Leibniz Institute for Financial Research SAFE

SAFE Finance Blog

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100 trillion dollars of ESG investments in the world must not be wasted

Different measuring methods and a lack of consensus of sustainability, social, and governance criteria could misallocate a huge amount of savings. Thus, it is necessary to train tomorrow's managers to deal with the risks and opportunities associated with ESG issues

The term ESG was officially coined in 2004 with the publication of the "Who Cares Wins" report by the UN Global Compact Initiative. This term is intended to set the ambitious goal of bringing together three of the main pillars of ethical finance: namely the environmental (E), social (S), and good governance (G) pillars.

However, this is not the first time that investors have become interested not only in profit but also in the social impact of their savings. The first socially responsible investing (SRI) dates back to 1920 when a group of church investors decided to fund only projects with high social impact. Over the years, this practice has become increasingly popular, especially in light of environmental disasters as of Santa Barbara in 1969, Bhopal in 1984, and Exxon Valdez in 1989.

Sustainable investments are no longer niche investments

In recent years, growing and objective concerns about global warming and the implications of the 2008 global financial crisis have led to sustainable investing seeing a significant increase in interest and it has now become a concern of general interest and not just a niche investment practice. The impact is even more relevant if one considers the impact that the EU Sustainable Finance agenda of the European Commission and the Next Generation EU plan may have on financial investments.

Today, most the world's asset managers are signatories to the United Nations Principles for Responsible Investment (PRI), representing around 100 trillion dollars in assets under management.

However, in this new and rapidly expanding industry, but not yet sufficiently and properly regulated, investors, business managers, and policymakers need a deeper understanding of its inherent peculiarities and a broader knowledge of the potential impacts of ESG dimensions.

The role of ESG rating agencies

Simultaneously, due to investors' interest, the market for ESG data and ratings has significantly developed. In SAFE Working Paper No. 284 "Inside the ESG Ratings: (Dis)agreement and Performance" we investigated the calculation methodology, the metrics used, and the main key differences among the many ESG rating agencies operating in the market today. What emerges from our research is that the lack of a shared definition of what correctly represents ESG dimensions - and what does not - has led agencies to use different measures of analysis and for ranking.

As a result, the same company can have highly discordant ESG ratings depending on the agency that rated it. This has strong implications both on the operational side, hence in identifying reliable benchmarks, and in terms of returns. Indeed, disagreement over the scores provided by rating agencies dissipates the effect of ESG investors' preferences on financial asset prices to the point that even when there is general agreement it has no impact on financial performance.

Contributing to this confusion are the rating agencies themselves that, following market demands, find themselves forced to frequently change the methodology for calculating their ratings. The effects of these changes have been highlighted in another SAFE Working Paper No. 310 "The Salience of ESG Ratings for Stock Pricing" where it is demonstrated how "pseudo" changes in ESG ratings induced by the change in methodology (and not related to potential fundamental changes in the sustainability of the company) exert a transitory pressure on prices. The study shows that retail investors are particularly sensitive to changes in ESG ratings and divest in stocks they believe to be downgraded in terms of ESG ratings, investing instead in those they see increased in ratings. However, with these ESG rating changes having no tangible economic basis, short sellers act as arbitrageurs or informed investors, and by acting as counterparties to retail investors literally gain on the "confusion" that ESG rating agencies create.

The managers of tomorrow

It seems clear that navigating in this kind of heterogeneous and opaque environment has significant risks. Primarily, by leading investors to an inefficient allocation of their resources. In this context, university education has an important role to play. Starting from courses in economics and finance, but not only, these issues must be addressed with a scientific rigor. Workplace demand is very high in this regard with a clear need of professionals able to integrate ESG criteria in the assessment of creditworthiness and thus to evaluate the risks and opportunities related to climate change. Only in this way, it is possible to increase the awareness of sustainable finance issues among tomorrow's managers.

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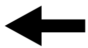

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