


Chapter 4

Green Investing: Decoding Investor Psyche Towards High-Scored ESG Companies

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ABSTRACT

In the awakening of persistent environmental issues and upsurged societal pressures constantly seeking attention from corporate stakeholders, the integration of investment decisions with the spectrum of environmental, social, and governance has gained significant momentum. This chapter aims to unfold the intricacies of the relationship between the mindset of an investor while investing in the companies that are on the upper end of ESG scores. In the beginning, the fundamentals of ESG and ESG investing have been explored. Investors' preferences and risks associated with a particular investment are the major twin aspects affecting the expected returns for corporates carrying robust ESG ratings. Lower cost of capital is one benefit enjoyed by these companies. Further, future trends and challenges have also been discussed. The chapter aims to provide the readers with a comprehensive understanding of an investor's behavior thus paving the way for responsible decision-making and fostering a transition to a green economy.

INTRODUCTION

In the last two decades, the concept of conscious decision-making within a business concerning environmental, social, and governance (ESG) factors has gained a significant impetus (Alkaraan et al., 2023). As the world grapples with global challenges such as carbon emission, corporate misconduct, and climate change is garnering attention from the stakeholders across various verticals. Governments,

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regulatory bodies, and investors are keen to know about how businesses are addressing these issues and aligning their values by integrating ESG considerations into their business processes and strategies.

Investments that have been made considering the various environmental, social, and governance concerns are known as ESG investments. Various other forms of investing revolving around ESG investment are green investing, socially responsible investing, and impact investing. However, all these forms of investments are slightly different from each other. Major fund flow has been observed in investing in environmental, social, and governance which have been primarily driven by the two major factors—risk and return associated with those investments (Kapil, & Rawal, 2023). The major theory of Finance demonstrated that the rate of return excluding risks is resultant of the following major causes—Market hurdles, such as (1) liquidity, (2) behavioral predispositions (3) Risk bearing reward for handling risk. As this is primarily focused on studying the relationships between return, risk, and ESG involvement, it is implicit that securities are traded in the active developed market so market inhibitions shouldn't be a priority. Furthermore, behavioral predispositions are considered only regarding investment preferences that are somehow related to ESG, therefore, the term predisposition should not be belittled. For instance, Investors might prefer equity issued by the company which is backed by high ratings given the fact that they value the cruciality of protecting the environment, such as reduced carbon emissions, alongside lucrative returns associated with such stocks (Pederson et al., 2021).

A hint of obscurity underlies ESG ratings which is one of the issues that affect the study of the connection between return, risk, and ESG (Pango et al., 2018). This obscurity arises out of the fact that ESG ratings provided by organizations are large in number. It should be noted that government organizations, investment banks, and research organizations involved in ESG-related research which provides customized ratings, have been kept outside the purview of this research. In 2022, over 600 ESG ratings were produced making it complex to identify which firms are considerably high in ESG scores. Consider whether Tesla's manufacturing operations in China vindicate high ESG ratings. A China-based company—Tesla owned by US Business tycoon Elon Musk emits zero emissions, making batteries take a lot of energy and a lot of electricity to charge e-cars. (Tendon et al., 2020) In China, energy is majorly acquired from coal plants or we can say that a Tesla which has been driven in China would have carbon emissions as compared to any other standard gas-powered car (Sacchi et al., 2022). Coal Plants are the major source to generate energy in China, as of now, a standard gas-powered car is less perpetrator than a Tesla when it comes to fuming carbon-related emissions (Gao et al., 2019). Does this indicate that Tesla's business affairs in China merit a lower ESG score? Coal plants are a major power generator in China, accounting for more than 60% of the power. These uncertainties and the brief period in which we get the ESG rating kind of make it challenging to understand the complexities vis a vis ESG, risk, and yield.

Notwithstanding the challenges, there is a significant surge in the literature about How ESG-based investments have performed and what were the strategies behind them (Zehir & Aybars, 2020). The focus of this paper is not to stand in the queue and add one more to the already exhaustive list, but rather to address the issues arising to gauge the conundrum of the relationship between yield, risk, and ESG. Considering the above-stated situation, the expected yield for ESG stocks affected by investor preference will be analyzed in the next section. The association between risk in investment and ESG factors is the focus of the following section. In this regard, a crucial question is whether or not environmental, social, and governance (ESG) factors can be deemed risk factors and, if so, what effects this has on expected yield (Cornell, 2021).

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