


Chapter 6

Optimization of Sustainable Portfolios Considering Behavioral Biases: ESG Risk Management

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ABSTRACT

As the role of sustainability is gaining importance among investors, they are more focused on adopting ESG principles into their portfolios. Despite this, bringing a balance between financial returns and sustainability objectives is frequently challenged by the behavioral biases affecting investor's decision-making. Biases like herd behavior, overconfidence, and loss aversion disrupt the investor's investment decisions, weakening the effectiveness of ESG strategies and negatively affecting portfolio returns. Therefore, it is essential to embed behavioral finance concepts into optimizing sustainable portfolios. This research explores the optimization of sustainable portfolios by addressing behavioral biases and the application of effective risk management techniques. The research identifies the significant cognitive biases that shape investor's behavior in the context of ESG investing. The research then investigates how these biases influence financial returns and ESG goals.

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INTRODUCTION

Sustainable investment has emerged as a revolutionary approach in the modern world, where people are impacted by distinctive growing environmental, social, and economic concerns. Sustainable investment is an approach that integrates financial decision-making with environmental, social, and governance criteria in order to fulfill both financial goals and societal well-being (Kölbel et al., 2020). With the growing awareness among investors about the relationship between financial performance and social well-being, there is a clear transition toward incorporating ESG considerations in portfolio construction (Avramov et al., 2022). With the rising challenges of regulatory changes, data quality and availability, and market uncertainty, organizations and investors work to align their portfolios with an advanced sustainability framework (Chen et al., 2022). Evidence-based research additionally suggests that negative environmental disclosures can harm a company's value and reduce investor confidence (Wei et al., 2020).

The ESG (Environmental, Social, and Governance) framework is a collection of standards that are employed to assess the ethical behavior and sustainability dedication of a company. It was first founded on the idea of responsible investment and has expanded to offer a comprehensive evaluation of both financial performance and long-term sustainability (*What Is Responsible Investment?*, n.d.). The framework of Environmental, Social, and Governance (ESG) was highlighted in the early 2000s by the United Nations in its report "Who Cares Wins", which emphasizes the importance of incorporating ESG factors within investment evaluation and selection (Atkins, n.d.). The United Nations provided official legitimacy to ESG investment in 2006 through its principles for responsible investment (UNPRI) report (Avramov et al., 2022). Since then, individual and institutional investors have increasingly used ESG tools and models to align financial performance and ethical issues (Kim & Li, 2021). Policymakers now recognize the role of ESG transparency in protecting investors and driving sustainable economic growth (Iazzolino et al., 2023). To promote better ESG assessment and disclosure, a wide range of stakeholders, which includes investors and financial institutions, have collaborated (Iazzolino et al., 2023). As a result, governments across the globe have begun passing legislation to strengthen and streamline ESG disclosure practices.

Behavioral finance explores how psychological factors influence investment decisions. This is a successful field that gives a deeper understanding of investor behaviour and points out market anomalies that traditional finance struggles to explain (Nofsinger, 2017). While researchers have widely studied how behavioral biases affect decision-making, many still ignore their deeper impact, particularly how these biases influence an investor's ability to recognize opportunities and determine the likelihood of their success (Zacharakis & Shepherd, 2001). Rather than assuming

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