Seeking Chinese Opportunities from International ESG Investing Research

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Abstract. In recent years, the concept of sustainable development and green development has gradually taken root in the hearts of the people, and the performance of enterprises in environmental, social and corporate governance (ESG) has received extensive attention from all walks of life. ESG investment has shown exponential growth in recent years and is one of the key investment concepts being studied today. Researchers have found that while Chinese companies are responding positively to the ESG concept, there is still a lack of uniform understanding of the value and influencing factors of ESG. Therefore, the research theme of this paper is to identify opportunities in China from global ESG research. This paper compares some ESG-related research results and analyses them in the context of the actual situation in the Chinese capital market. The results show that ESG has great potential for development in the Chinese market, but there are many difficulties to overcome. This paper has important theoretical reference value for ESG investment in China.

Keywords: ESG · Investment · Firm value · China

1 Introduction

1.1 Research Background

The environment and society concern all of humanity, and companies, as the most dominant economic organizations in the marketplace, influence all types of entities on the planet through the invisible hand. ESG (Environmental, Social Responsibility and Corporate Governance) is an approach to investing in targets and evaluating companies based on their environmental, social and governance performance. In this evaluation system, the sustainability, environmental and social impact of a company overtake financial performance as the three core factors that investors are most concerned in their investment process. ESG is the market's corrective and complementary approach to the dysfunctions that have been building up in the global economy over the past years. The concept seeks to encourage and guide companies to take greater social responsibility to combat common challenges facing all of humanity, such as global warming, the wealth gap and financial risk, and to work to prevent and mitigate the ethical conflicts and social risks that

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can arise from rapid technological change. ESG is now becoming a major criterion for assessing the investment value of a listed company globally and has been incorporated into the evaluation system of many investment institutions around the world. It is no coincidence that the high-quality growth advocated by the Chinese capital market in recent years is consistent with the ESG concept, indicating that the focus of China's economic development is no longer only on economic growth, but also on social and environmental aspects, with more attention paid to the problem of imbalance and inadequacy and to common growth. Different from the traditional evaluation system for corporate financial performance, the ESG concept places more emphasis on being systematic, comprehensive and quantitatively comparable, a method that is more conducive to capital market practice through a combination of qualitative and quantitative approaches.

Led by the "double carbon" strategy, China's ESG investment has seen a very bright growth trend in recent years. According to the White Paper on ESG Development in China (2021) published by the Securities Times, by the end of 2021, there are 200 ESG-themed funds that had been established in China, with a total size of over RMB 257.84 billion. This is nearly double the growth from the end of the previous year, with the number of newly launched products close to the sum of the past five years. At the same time, driven by the Chinese regulator's demand for high-quality development of the capital market, support for the real economy and further opening of the financial sector, some asset management institutions have started to experiment with new ESG strategies to promote high-quality development of listed companies through active due diligence management, improve ESG performance of listed companies and create long-term benefits for investors. In recent years, the number of companies actively disclosing ESG information in China's A-share market has increased year on year.

1.2 Research Significance

However, ESG topics are in a developmental stage, so there are still many topics that require ongoing attention. For example, the stage of market development is such that the early stages of economic development require rapid growth, and indicators such as size and speed are of greater concern. Mature markets, on the other hand, are more concerned with environmental issues, social issues and the protection of investor rights, in addition to financial indicators. The Chinese capital market is still improving, so how can we study and learn from mature experience to promote ESG in the context of China's actual situation, and the lack of maturity in the way ESG is assessed makes it very difficult to accurately assess the effectiveness of companies in terms of ESG. Instead of researching companies themselves, many investors and fund managers simply use the ESG ratings of rating agencies. This approach simply avoids companies with significant ESG concerns but does not meticulously screen out the more valuable and promising companies. How can we find a more appropriate measurement method for the Chinese market with multiple criteria? What is the reaction of the market and companies when ESG indicators are used?

Based on this, this paper has made the analysis of the international ESG developed experience with the inductive approach, trying to find strategy which is more adapted to the current situation in China. Therefore, this paper wants to summarize the current research results, compare and analyse the current research status of ESG investment

Table 1. The number of papers published on the keyword "ESG" from 2011 to 2021

2021	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
22700	17200	13200	11500	9950	9340	8570	7900	7630	7000	6010

system, and point out the possible development direction of Chinese ESG investment in the future.

1.3 Paper Organization

This paper attempts to contribute to the development of ESG investment systems in the Chinese capital market by analyzing ESG from different perspectives and considering the actual situation in the Chinese capital market. The rest of the paper is presented as follows: the next section reviews previous research and uses an inductive approach to divide the research into three categories, namely the influencing factors of ESG, the role of ESG, and the embodiment of ESG in specific markets, helping the reader to understand ESG from multiple perspectives and discussing it in the context of the actual situation of the Chinese capital market. The final section is the concluding remarks, which obtains the main conclusions of the article and points out the limitations of this study.

2 Literature Review

With the rise of ESG investment in the last decade, the Google Scholar database shows that the number of papers published under the keyword "ESG" is increasing year on year (Table 1).

2.1 The Role of ESG Scores

The popularity of ESG investment concepts in capital markets around the world is linked to the practical economic benefits, in addition to the strong advocacy of international social organizations. Many scholars have done a wealth of research around the role of ESG. Aouadi and Marsat suggest that ESG controversies do not add to company value, but they do prompt investors to focus on a company's corporate social performance score, especially for the well-known companies, which in turn adds to the value of the company [1]. Kumar presents those investors actively engaging with companies on ESG issues can create shareholder value. The hypothesis that ESG factors are a good representation of the company's financial position is indirectly supported by studies that suggest that companies rated highly on ESG scores have higher returns and lower risk volatility [2]. However, Torre et al. combine ratings and scores using quantitative analysis with opinion evaluations using qualitative analysis with the aim of examining the form and extent to which ESG components affect stock returns. The results show that, for the sample Eurostoxx50 companies, their performance and ESG commitments are unrelated. Furthermore, the result shows that ESG strategies only have a positive impact on market returns in some specific sectors, such as energy and utilities companies [3].

Looking at over 1,000 studies, Giese et al. find that the correlation between ESG performance and the returns a company receives in the market is uncertain. There are many factors that influence financial value and the impact of ESG affects corporate financial performance through a variety of channels [4]. The research of Zadeh and Serafeim also shows some important views. They had intensive conversations with many of the mainstream institutional investors. In interviews with investors, most claimed that their reasons for using ESG data came from better financial performance rather than social responsibility. Most interviewees acknowledge that ESG information contributes significantly to investment returns, but judgements about the importance of this information vary by country, by industry and even by company strategy. Many investors only use ESG information because their clients need it [5].

Several academics have studied the impact of ESG on investment. Pedersen et al. propose a theory in which the ESG score of each stock plays two roles, they are providing fundamental information of a corporate and influencing investor preferences. Many investors want to enter ethical companies to promote good corporate behaviour with guaranteed returns [6]. In addition to stocks, when investors select funds that have high ESG scores, these funds have remarkable factor exposures in most cases. If these factor exposures are desirable, in the long run they may provide higher returns related to these factor premiums. On the contrary, it is necessary to adjust the portfolio and try to hold up their ESG scores [7]. Dai finds that the use of ESG equity indices in investments can increase portfolio returns relative to market benchmark indices. And good ESG integration can enrich portfolio diversification, which facilitates diversification of investment risk [8]. Ruf et al. focus on ESG-rated mutual funds and their analysis shows that funds with high ESG ratings have significantly higher returns than funds with low or medium ESG ratings during market booms and in the early stages of economic downturns. This suggests that more responsibly managed companies are less risky and more resilient to financial crises [9].

There appears to be a difference in the degree of positive and negative impact of ESG scores. A study of ESG news for 100 listed companies showed that the market value of a company was reduced by approximately 0.1% when a negative event occurred, while no gains were made from it when a positive event occurred [10]. In addition, each pillar of ESG receives different levels of attention. According to a report commissioned by Aviva, many of FTSE's clients are increasingly interested in ESG-based information: some are more concerned with environmental factors, others with social or governance issues. Active managers often just want the basic data, while their product issuers may require bespoke indices based on specific ESG areas or approaches. ESG investors focus more on the analysis of specific companies than on the sector level, paying most attention to the dimension of corporate governance, which is closely linked to the quality of management. Although ESG investment is not strategic planning, the implementation of ESG policies requires many specific strategies to complement them. ESG affects the long-term development of companies [11].

In terms of the direction and extent of research in the literature, the ESG concept is currently being rapidly accepted by the market, but overall, the concept is still at an early stage of application. The theoretical community has basically reached a consensus on the meaning of ESG, but the relationship between ESG and a company's financial performance and its specific role in the realization of company value are still relatively vague. As the Chinese capital market has always been keen to chase hot topics, the ESG concept has been sought after by listed companies and funds. Driven by the national "double carbon" policy, the ESG concept becomes a hot topic for Chinese capital market.

2.2 Influencing Factors of ESG Assessment

Financial practitioners have always wanted to build models to accurately analyse every influencing factor in the investment process, but ESG, which is still in the process of being refined, has previously been analysed qualitatively. Evaluations of ESG scores, studies and surveys have also been relatively neglected in the literature, making it difficult to study and evaluate the influences of ESG. But there is always something to think about, for example, what rating agencies use ESG scores to evaluate and whether the financial community can use this measurement to achieve their self-imposed goals. ESG integration is a luxury for some companies and can add to the burden of investment [12]. Capital prefers companies with high quality ESG characteristics, and the data proves that corporate governance is the most market focused aspect of the three core dimensions of ESG consideration [11]. The ESG score depends on the resources used to acquire ESG data and the availability of the ESG data being acquired. This scoring mechanism favours larger companies. This view coincides with the fact that ESG scores show a bias towards large-cap stocks [13]. Larger companies are under more pressure from society and the public to disclose more corporate information. In addition, due to their larger scale, large companies have relatively complete management systems and better resources to provide ESG data [12]. This observation is in line with reality. First, people pay more attention to large companies than to small companies. In order to meet the requirements of regulators and to avoid the impact of negative information on the company's image, large companies will be more proactive in disclosing information. Second, large companies are more mature in development than small companies and will be more comprehensive in the direction involving the development of the company. For example, small companies only have the energy to focus on performance in order to survive, while large companies will allocate more energy to focus on the relationship between the company and the society for better development. In terms of the performance that corresponds to the energy spent, large companies have more data than small companies. Moreover, large companies have mature development and sound management standards, and have more accurate standards to describe ESG work, but small companies are not developed enough to easily compile ESG data. Finally, large companies have well-established management teams and departments with dedicated personnel to count and disclose ESG work performance and related data, but small companies have a simple structure and no dedicated personnel for such work.

In many ways, ESG investing is like fundamental investing, which also requires, for example, company annual reports and materiality disclosures. However, in order to get quick results, investors often refer directly to ESG ratings. Rating agencies collect information from public sources as well as company disclosures and assign ratings, and investment institutions select investment targets based directly on the ratings of the rating agencies. This directs market attention to the motivation of companies to disclose internal information on their own initiative and pushes companies to converge on sustainable financial market rules. However, it also in fact creates a relative inequity, as the resources available to companies to provide ESG data are not the same depending on the size of the company. Large companies have more resources to showcase their ESG results, while some high-growth start-ups may be ignored by the capital markets due to a lack of ESG data. Furthermore, some scholars mention research from human Resources aspect. Research has shown that when employees are on the board as board members, the contribution to ESG scores is not recognized by the market, as evidenced by the financial performance of the company. After employees become board members, good ESG performance may indicate a possible alliance between managers and employees, offsetting the dominance of shareholders on the board [14]. So, within companies, different people may have different attitudes towards the three pillars of ESG.

Some scholars study the relationship between the social responsibility and financial performance of companies, guided by the ESG concept. They find that different rating methods determined the direction and magnitude of performance differences and, in addition, that the direction and magnitude of performance differences depended on the underlying sample of companies. For each perspective, companies with high scores are less affected by size risk. However, different rating concepts can have a significant impact on the results. When rating sub-criteria are aggregated, some of them will overlap and even some scores will cancel each other out [15]. The selection of the base sample and rating concept is therefore very important. It is even necessary to use more than one ESG dataset to solve the problem of ESG rating concepts. ESG stocks differ from non-ESG stocks in their ESG dimensions and returns are different [16]. Fund managers in different regions have different attitudes towards ESG. The location or cultural attributes of fund managers influence their judgement of ESG, with US fund managers remaining sceptical about the benefits of ESG, while European fund managers are optimistic [11]. Therefore, this article is analyzed in the context of the Chinese market.

ESG is not suitable for all companies in the market as far as the current theoretical findings are concerned, and the measurement and calculation of ESG is still at a very vague stage. Without complete and unified criteria, ESG is still at the stage of subjective evaluation. Without objective scoring criteria, it is more difficult to apply them on a large scale and in depth. The Chinese capital market still needs further improvement in terms of improving legislation to protect the interests of small and medium-sized investors as well as regulating the capital market system. For listed companies in China, the perspective and extent of ESG information disclosure by companies is not clear enough. Under such circumstances, it cannot be ruled out that some companies use ESG hotspots to exaggerate corporate values.

2.3 ESG in Specific Markets

Many academics have made observations and statistics on specific markets. Some scholars study the Latin American business context. The results show that financial slack and geographical international diversification moderate the relationship between environmental, social responsibility and corporate governance aspects and the financial performance of companies [17]. Iamandi et al. summary their findings by arguing that companies should adopt a specific ESG approach to consider specific organizational objectives and areas of activity under the same market. Although there is no universal recipe for ESG to be applied and not all aspects involved in ESG evaluation can be equally supported, the ESG engagement of companies still needs to be continuously looked at and analysed [18]. For Italian companies, the attitude of the company depends on the confidence of the managers to obtain a leading ESG rating score and on the alignment of the ESG philosophy with the company's strategy [19]. Buallay provides an example for banks that the relationship between ESG disclosures is different. Environmental disclosures have a positive impact on return on investment and total asset quality. Social responsibility disclosures, on the other hand, can have a negative impact [20]. Weber summarizes that the quality and frequency of ESG reporting in China is catching up [21]. The international market does not have very mature experience in ESG investment, and the literature also shows that investors in different geographies have different attitudes towards ESG. Therefore, the right approach to applying ESG concepts in the Chinese capital market is to assimilate the sustainable development concept of ESG investment and combine it with the actual situation and analyse specific issues.

3 Conclusion

The ESG investment concept has a promising future in the Chinese market and is in line with China's "double carbon" policy and the promotion of a sustainable economy, but there are still many challenges to overcome. Firstly, Chinese companies invest differently in ESG, with larger companies having more resources to implement and disclose ESG than smaller companies, and it is more difficult for companies to improve their ESG indicators due to ambiguous evaluation criteria. Companies still have a long way to go from chasing market hotspots to truly practising ESG concepts. Secondly, the lack of clarity in the specific measurement dimensions and calculation indicators of ESG has made it difficult for investors to make investment decisions; ESG is beneficial for long-term investors to avoid corporate risks, but for the developing Chinese capital market, specific financial indicators are more beneficial for investors to make judgments. Finally, the construction of ESG-related organizations and talent teams should be strengthened. The CSRC and the China Economic and Trade Commission jointly issued the Code on Governance of Listed Companies in January 2002, which clearly stipulates the scope of disclosure of governance information of listed companies. This policy is considered to be the beginning of the clarification of corporate social responsibility by Chinese capital market regulators. Over the past two decades, ESG-related organizations and talent building in China have not received much attention. With the number and scale of ESG-themed funds in the Chinese market steadily growing and the number of companies actively disclosing ESG information increasing year by year, it is important to establish and build relevant authorities, executive agencies, regulators and research institutions as soon as possible, and to guide companies to cultivate relevant talent teams internally to promote the steady development of ESG in the Chinese market.

The limited amount of literature selected for this paper does not provide a comprehensive view of the theoretical community, and there is a need for continued attention to practical developments in ESG and richer perspectives contributed by the literature in the future.

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