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ESG Investing: Is it the Right Time for Indian Investors to Consider ESG?

Indransh Bhadauria

1. INTRODUCTION

In the past few years, Environmental, Social, and Governance (ESG) investing has seen colossal growth across the world, and more and more investors are beginning to either invest in ESG funds or incorporate ESG factors in their investment decisions. With such fast-track growth in the world, hurdles are guaranteed sooner or later. ESG investing suffers from a dearth of reliable data and performance issues that are not been thoroughly analyzed yet. With India beginning to take on ESG, there is a need for further study of ESG investing.

2. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG)

We know that non-financial factors can also be the drivers of return and financial performance of an investment (Boffo and Patalano 2020, 10-20). Financial analysts are aware of the risks associated with financial factors, but quantifying non-financial factors is complex. These issues, in general, are referred to as Environmental, Social, and Governance (ESG) issues.

While pure financial investing aims to maximize shareholder and debtholder value considering financial risks only, social impact investing considers both social and financial returns. ESG investing fits somewhere in the middle where investors consider ESG issues to maximize the long-term value of their investments by incorporating long-term environmental, social, and governance issues of investments. ESG investing is a good tool for risk management and helps investors align their investments with their values and ethics (Boffo and Patalano 2020, 14-15). All Social impact investing, Impact Investing, and ESG Investing utilize ESG metrics and methodologies, but they differ in their focus on the types of returns they pursue. While the former two are focused more on social return, ESG investing is focused more on financial returns that provide long-term value. The former two tend toward philanthropy in some respects, while ESG investing tends towards pure financial investing.

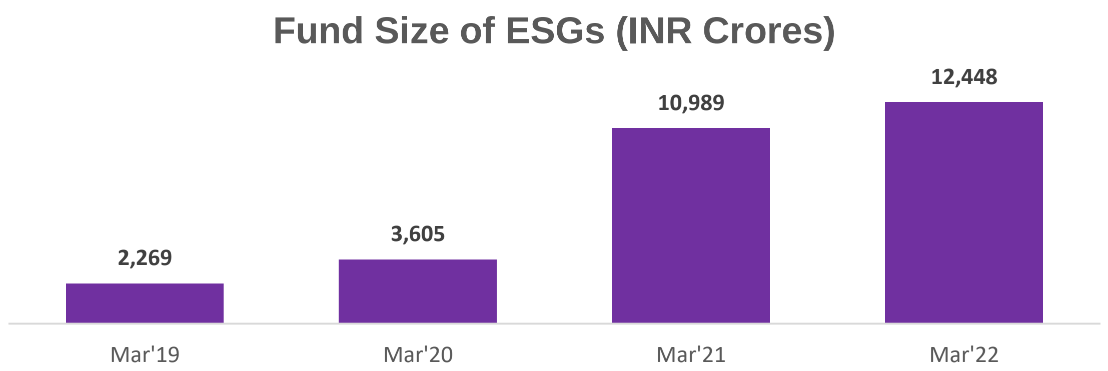
3. TRENDS

ESG investing has been growing around the world. ESG-focused exchange-traded funds and sustainable mutual funds grew by 53% globally to $2.7 trillion as per Bloomberg. In November 2021, ESG-focused funds saw money flow at a record of $649 billion, a growth of more than 18% over the previous year (Kishan 2022).

As per reports from Morningstar Inc., the estimated net flow in sustainable funds across the globe is around $600 billion, showcasing a consistent growth from the previous values of $200 billion and $400 billion in 2019 and 2020, respectively. Year-end total net assets in sustainable funds are estimated at around $2.7 trillion, considerably higher than those in the previous two years, $1.0 trillion in 2019, and $1.8 trillion in 2020 (Kishan 2022).

India's story is no different when looking from a bird's eye view of the sector. ESG funds in India grew to Rs. 12,448 crore by March 2022, a jump of more than 13% over 2021 (Madia 2022). The fiscal year 2021 was an exceptional year for ESG funds, which recorded a growth of more than 200% over 2020 as there were several fund launches in FY21. In India, investors tend to focus on ESG funds more during New Fund Offerings (NFOs), and the traction seems to reduce afterward. ESG funds showcased a net outflow of INR 315 Crores in FY22 against an inflow of INR 4,844 Crores in FY21. Despite their growing interest in ESG funds, Indian investors are yet to accept them like the rest of the world. Most inflows occurred during new fund offerings. India's story is still in the early stages of adopting ESG, but investors have found options due to past fund launches.

Figure 1:



Source: Morningstar India

4. DRIVING FACTORS

As per an OECD report, global drivers of ESG are primarily social/moral considerations (77%), risk mitigation (14%), and desire for alpha (6%). Another survey by BNP reveals various other factors pushing investors toward ESG, such as improved long-term returns, higher brand recognition, decreased investment risk, reduced regulatory demands, lower external stakeholder requirements, etc. (Boffo and Patalano 2020, 16-17).

Table 1:

Drivers of ESG Investing	2017	2020
Managing investment risks	65%	64%
Clients/investors demand	45%	59%
Fiduciary Duty	36%	43%
Reputational benefits	32%	41%
Better financial returns	N/A*	35%

Source: Advisor Channel – Visual Capitalist; based on a survey done by CFA Institute where 2800 members were asked members who were asked: 'Why do you or your organization take ESG issues into consideration in your investment analysis/decision?

India's story is no different, and the Securities and Exchange Board of India (SEBI) is focusing on standardizing the regulatory requirements. The SEBI introduced a new ESG reporting structure named the Business Responsibility and Sustainability Report (BRSR). Top 1,000 listed companies are required to submit BRSR, where they assess their material ESG risks and opportunities, provide strategies for mitigating or adapting to those risks, and specify the financial implications of such risks.

BRSR is a standard framework that has been developed keeping in mind the dynamic global sustainability reporting scenario. The Indian reporting scenario is evolving rapidly in line with international norms and regulations, and corporates are expected to run business conscientiously and maintain transparency in reporting. BRSR is supposed to become a single source for sustainability-related disclosures in India. The SEBI has made BRSR based reporting voluntary for FY 2021-22 and mandatory from FY 2022-23 onwards. BRSR questionnaire has three sections, namely general disclosures, management & process disclosures, and principal-wise performance disclosure.

The first section, General disclosures under BRSR deal with details of the listed entity, products/services including details of business activity, operations, holdings, subsidiary & associate companies (including joint ventures), CSR, transparency, and disclosure compliances. The second section, Management & Process disclosures deal with policy, governance, leadership, and oversight. The third section, Principle-wise performance disclosures further classify KPIs which are to be reported into two subcategories, namely essential indicators and leadership indicators. Essential indicators are mandatory and include data on training programs, environmental data on energy, emissions, waste, water, social impact generated by the company, etc. Leadership indicators are voluntary, and companies might report for better accountability and responsibility. Disclosures here include data on life cycle assessments, conflict management policy, supply chain disclosures, etc. The questions under the leadership category are likely to be shifted towards the essential category to bring in more comprehensiveness and standardize the reporting process (PwC 2021).

5. PERFORMANCE OF ESG FUNDS IN INDIA

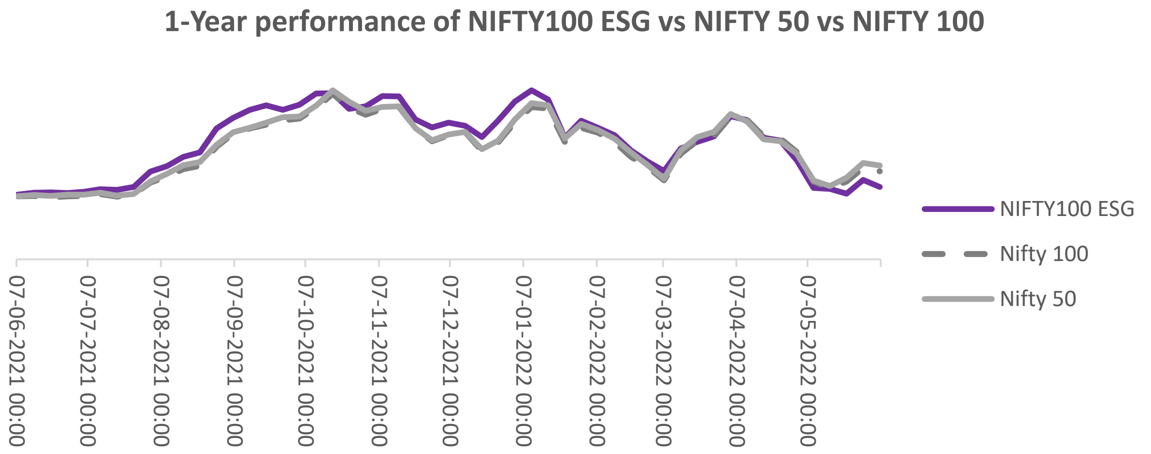
Analysis of the performance of ESG funds in India is slightly challenging as these funds are relatively new and many were launched in the past year itself. One way to estimate the performance from a bird's eye view is an analysis of the NIFTY100 ESG, a benchmark index. The NIFTY100 ESG tracks the performance of companies contingent on their Environment, Social & Governance (ESG) score within the NIFTY100 Index. Each index constituent's weight is determined by its free-float market capitalization and modified ESG risk score, which is modified based on the ESG score given to the firm. Table 2 provides the top five sectors and companies included in the index.

Table 2:

Sector	Weights	Companies	Weights
Financial Services	28.64	Infosys Ltd.	6.68
Information Technology	22.66	TCS Ltd.	5.58
Automobile and Auto Components	8.57	HDFC	4.72
FMCG	7.15	HCL Technologies Ltd	3.21
Healthcare	5.70	Bajaj Finance	2.77

Source: NSE https://www1.nseindia.com/content/indices/Factsheet_NIFTY100_ESG_Index.pdf

Figure 2:



Source: NSE

One year return of the NIFTY100 ESG index is 2% compared to 5.7% return of the NIFTY 50 and the 4.7% return of NIFTY 100. Such a low performance presents a problematic picture at first, as ESG funds are supposed to theoretically beat the market considering that they consist of the best-performing companies on parameters that are increasingly becoming important. But again, this doesn't seem right as we need to consider the overlap between indices and funds to gauge what is the accurate picture. Also, ESG reporting has a lot of issues that we will delve into later. But, for now, it seems we might need to look at individual fund performance to find out the performance differences and presence of alpha if any.

Most funds have of ESG stocks, equities, debt, money market securities, and cash. ESG stocks are the stocks of companies having high standards of corporate governance, having a primary focus on environmental issues, and addressing employee issues and social issues at large. The ratings are provided by ESG rating providers, such as MSCI, Morningstar, and Bloomberg, based on ESG parameters. Companies having a higher rating can be identified as ESG stocks. Each rating provider has its own criteria, which are a point of contention for the regulators as there is not a standardized process as such. The SEBI plans to standardize this through a regulatory framework where all rating providers would have to be accredited. The SEBI has further said that only credit rating agencies and research analysts would be eligible to be registered as ESG rating providers with the SEBI. These rating agencies rely on ESG scores to finally assign ESG ratings. MSCI provides ESG ratings on a seven-point scale consisting of AAA, AA, A, BBB, BB, B, and CCC where the first two are considered leaders, the second three are considered average, while the last two ratings are considered laggards.[15]

Factors that are used to calculate ESG ratings are grouped under three categories namely environmental, social, and governance factors. Environmental factors include factors such as carbon emissions, product carbon footprint, financing environmental impact, climate change vulnerability, water sourcing, biodiversity, land use, raw material sourcing, etc. Social factors refer to health and safety practices and protocols, worker training, supply chain labor standards, chemical safety, consumer financial protection, privacy, and data security, etc. Governance factors on the other hand include factors such as the composition of the board in terms of diversity and independence, executive compensation, ownership, and accounting practices (Brock 2022).

I have considered the top four ESG funds by assets under management (AUM), namely SBI Magnum Equity ESG Fund (AUM 4,246 INR crore), Kotak ESG Opportunities Fund (AUM 1,336 INR crore), Axis ESG Equity Fund (AUM 1,769 INR crore), and ICICI Prudential ESG Fund (AUM 1,396 INR crore). SBI Magnum Equity Fund invests 80% in ESG stocks and 20% in equities, debt, and money market instruments. Kotak ESG fund designs a portfolio based on ESG ratings and a business, management, and valuation framework. Other

[15] https://www.msci.com/our-solutions/esg-investing/esg-ratings

funds also follow the same lines. Each of these funds focuses on picking the best available stocks fulfilling ESG criteria.

Most of these funds were launched recently, so a 1-year performance comparison between them and the NIFTY 50 index seems appropriate. And direct plans are considered due to lower expense ratios and ultimately better returns. The analysis revealed that only SBI Magnum could generate some alpha and beat the NSE NIFTY50 index over a 1-year time frame. But, since SBI Magnum is an old fund when we look at its 5-year performance, it becomes clear that it performed poorly (11.87% returns) compared to the NSE NIFTY 50 index (14.15%).

Table 3: Comparison of returns of various ESG Funds with the NSE Nifty 50 index returns

Fund/Index	**Returns (1Y)**	**Returns (5Y)**
NSE NIFTY50 index	2.80%	14.15%
SBI Magnum Equity ESG Fund	4.26%	11.87%
Kotak ESG Opportunities Fund	-2.87%	
Axis ESG Equity Fund	-0.95%	
ICICI Prudential ESG Fund	0.71%	

Source: Moneycontrol

The 3-year Jenson's alpha of the SBI Magnum ESG fund is -2.43%.[16] ESG funds are not as significant as they seem initially, not at least in India yet considering their returns do not match up to the expected levels. SBI Magnum Equity ESG fund is the biggest ESG Fund and it is not able to generate a positive alpha over a 5-year five period. The other primary ESG funds have generated negative returns over a time frame of one year. ESG funds are not able to compete with major benchmark indices such as NIFTY 50 despite having considerable overlap with NIFTY50.

Most ESG funds have considerable overlap with the NIFTY50 index. SBI Magnum has the highest overlap with NIFTY50 with the intersection portfolio being 71.14%, followed by Kotak ESG fund at 66.44%.[17] Axis and ICICI lag at 46.64%. [18] [19]

[16] Source https://www.moneycontrol.com/mutual-funds/nav/sbi-magnum-equity-esg-fund/MSB085
[17] https://www.moneycontrol.com/mutual-funds/nav/kotak-esg-opportunities-fund-direct-plan/MKM1356
[18] https://www.moneycontrol.com/mutual-funds/nav/axis-esg-equity-fund-direct-plan/MAA901
[19] https://www.moneycontrol.com/mutual-funds/nav/icici-prudential-esg-fund-direct-plan/MPI4488

Table 4: The overlap between the Portfolios of Top 4 ESG Funds with the NSE Nifty50 index

Fund/Index	Portfolio overlap with the NIFTY50
SBI Magnum	71.14%
Kotak ESG Opportunities Fund	66.44%
Axis ESG	46.64%
ICICI Prudential ESG Fund	46.60%

Source: Coin-Zerodha, Groww, and NSE

The fund portfolio overlap is dynamic and changes continuously, the above table represents data as of June 2022. Even if someone invests in index funds, along with some other good funds, they won't even need to think about ESG investing as there is a considerable overlap unless moral grounds are the primary reason like that for sustainable impact investors. Even in that case, simple index funds have companies that are anyway performing well on various ESG metrics. Despite a considerable overlap with NIFTY50, ESG funds are not able to generate good alpha, and the nascent firms are already underperforming.

6. CHALLENGES

6.1 Track record: ESG funds in India are quite a recent phenomenon with three out of four top funds launched in the past two years. There is not just enough historical data and track record yet to rely on. However, growing with time, this challenge might not be any hurdle, and if the funds perform well, it might also act as a driver for intelligent investors.

6.2 Data reliability: ESG reporting is not of the highest order in India. The SEBI is trying to standardize it with the new BRSR ESG reporting structure and has raised the ESG reporting requirements for the top 1,000 listed companies. However, companies may greenwash the results to secure higher ESG ratings and mislead an investor into believing that they follow environmentally conscious business practices. If this issue can be resolved, ESG investing will have cleared away one of the biggest hurdles in its path.

6.3 Market scenario: Despite the SEBI mandating that 80% of the companies in any ESG fund need to be ESG compliant, or to be precise meet the schemes' objectives. It is not always possible for fund managers to build an efficient portfolio. As many Indian companies such as ITC, Reliance, etc. have both ESG and Non-ESG components. ESG market in India has a dearth of sustainable and green companies. It comprises of rather those who are performing well for now and are transitioning towards sustainability.

7. CONCLUSION

ESG funds in India are a recent phenomenon, the world is accepting them with open hands, but that is yet to be seen in India at that scale. India has its own share of problems from data reliability and reporting regulations to market scenarios. As such ESG funds haven't been able to perform as well as expected. Many investors subscribe during new fund offerings and leave later on account of poor performance. There is considerable overlap with simple index funds and it can be assumed that as more sustainable businesses come up in India and data reporting infrastructure becomes better, ESG investing will become an attractive option, which doesn't seem to be the case now.

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