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SFI Public Discussion Note

The Value of ESG: Where and Why It Matters

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Executive Summary

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Investment strategies that incorporate environmental, social, and governance (ESG) criteria have recently been questioned, especially in the United States, and cynically termed "woke capitalism." Some of this skepticism is spreading to Europe. Here we argue that this criticism largely stems from a misunderstanding of what ESG investing is and how it creates financial value for investors, for example, by increasing firm valuation or reducing risk. We illustrate this point by focusing on two major ESG risks: climate and biodiversity. Both constitute financially material investment risks that institutional investors, whether banks, asset managers, mutual funds, pension funds, sovereign wealth funds, endowments, or hedge funds, must address in the investment process. By actively managing these risks for the firms in their investment portfolios, institutional investors can not only create financial value, but also contribute to society by helping to meet the grand challenges of our times. This role is distinct from any moral or values-based judgment of ESG investing. To counter the rising ESG backlash, we stress the importance of highlighting institutional investors' role in financing the green transformation, thus preventing their vital risk management activities from being undermined by political attitudes, social values, or moral principles.

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1. Motivation

"ESG is a scam. It has been weaponized by phony social justice warriors" (Musk, 2022).

This tweet by billionaire Elon Musk reflects an increasingly common view of investment strategies that incorporate ESG criteria into decision-making. In the United States, some states, such as Texas and Florida, have even passed "anti-ESG" laws that ban municipalities or state pension funds from doing business with institutional investors who incorporate ESG issues into their products. This backlash is based on a grave misunderstanding. The idea that ESG investing is a form of woke capitalism, through which political attitudes or moral principles are transferred into investment decisions at the expense of financial value, is at odds with recent academic research.

Fundamentally, ESG investing should be understood as rational decision-making that structurally addresses new risks in the investment process. These new risks include, for example, climate transition risks at portfolio firms that generate large carbon emissions, or biodiversity risks at portfolio firms that negatively affect biodiversity. In both cases, the risk derives from future regulation to protect the climate or to combat biodiversity loss; such regulation may generate large declines in the valuations of some firms.

Put simply, ESG risks are investment risks that every investor needs to address for financial reasons. Financial markets have started to incorporate this idea, with ESG risks, especially those related to climate change and biodiversity loss, being priced in stock returns. Even for ESG-sceptics, the risks related to ESG factors and their pricing are a reality in today's financial markets. They require proper risk management.

2. ESG-Related Investment Motives

Value or Values?
Much of the confusion about ESG investing originates from an unclear understanding of what it should (and should not) concern: Is ESG investing about *value* or *values?* That is, are ESG aspects incorporated into investments primarily for reasons of *(financial) value* or of *(moral) values* (Starks, 2023)? This (financial) value versus (moral) values distinction is important to avoid confusion about why ESG risks should be incorporated into the investment process (see Table 1).

Table 1
(Financial) Value and (Moral) Values Investing in Terms of ESG Drivers, Risks, and Returns

(Financial) Value	(Moral) Values
Risk and return considerations primarily drive ESG investing	Political, social, or moral considerations primarily drive ESG investing
Expectation of lowering risks or achieving higher risk-adjusted returns	Expectation to give up returns to achieve a values-based impact
Example: Engage portfolio firms with large carbon emissions to reduce risks	**Example:** Invest in social projects that generate positive externalities in a neighborhood

Source: Starks, 2023.

In the context of climate change, the (moral) values interpretation assumes climate risks are incorporated into investments primarily for political, social, or moral reasons. In other words, the investment process is being used to reduce the impact of portfolio firms on societal problems, even if there is no direct financial benefit to investors.

The (financial) value argument, by contrast, assumes a targeted beneficial financial outcome from incorporating climate risks. For example, through shareholder engagement an investor can reduce the carbon emissions of a portfolio firm. Such an outcome creates (financial) value for the investor, as the firm's valuation should increase with the lowering of the climate transition risk that is associated with high carbon emissions. Another example is obtaining higher stock returns by identifying, through the investment process, the qualities of firms that manage climate risks well. Assuming that these qualities are not yet priced, but will gradually be incorporated into market valuations, ESG investing can result in higher returns.

Importantly, even when ESG risks are addressed purely for (financial) value, the outcome can be beneficial to society. The shareholder engagement of the portfolio firm mentioned above, while aimed at reducing its climate transition risk, results in lower emissions (if successful) and, in turn, a reduction in the firm's impact on climate change.

Impact-Aligned or Impact-Generating?
Another important distinction is whether ESG-related investment strategies are *impact-aligned* or *impact-generating* (Busch et al., 2021; Swiss Sustainable Finance, 2023).

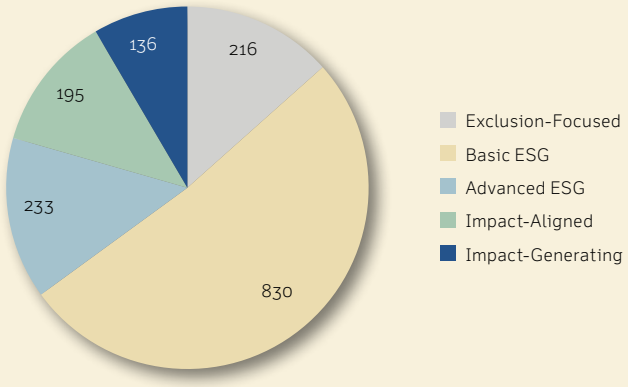
Impact alignment typically originates from positive screenings. This investment approach implies investing in firms that *already* have a positive impact on an ESG objective through their products, services, or operations. An example of such a strategy is an investment fund that only invests in firms whose projected carbon emissions are aligned with the 1.5°C target of the Paris Agreement.

Conversely, impact generation refers to investing in firms that are not *yet* aligned with a specific ESG objective but could be, if they were convinced to change their corporate policies.[1)] Active stewardship and engagement typically drive investment strategies related to impact generation. The goal is to actively encourage (and document) a shift at portfolio firms toward, for example, more pro-climate practices.

1) Impact generation is often also the explicit goal in private market strategies. ESG investment strategies in listed equities can be impact generating if the financing leads to real economic changes.

Swiss Sustainable Finance (2023) has started classifying ESG investments in the Swiss market according to whether they are impact-aligned or impact-generating. As shown in Figure 1, out of the CHF 1.6 trillion ESG ("sustainability-related") investments in the Swiss market, CHF 136 billion are classified as impact-generating and CHF 195 billion as impact-aligned. These figures highlight that currently, about 20% of investments have a direct link to firm or investor impact. The remaining 80% incorporate ESG issues to some extent, but without a clear link to impact. Interestingly, 60% of the investments classified as basic ESG could be reclassified as advanced ESG if they were to apply and report ESG performance measurements. These numbers reveal some need for more impact-driven investment strategies and better application and reporting of ESG achievements.

Figure 1: Breakdown in the Classification of Sustainability-Related Investments in Switzerland



Note: This figure reports ESG-related investment strategies in the Swiss investment market in 2022 (amounts in CHF billion).

Source: Swiss Sustainable Finance (2023).

3. Pricing of ESG Risks in Financial Markets

Why ESG Risks Should be Priced

A fundamental principle in finance is that material risks should be priced in financial markets. This is also the case for ESG risks. Stocks of firms that will be more negatively affected by future ESG events are riskier and, therefore, they need to deliver higher expected returns to investors; these higher returns constitute a risk premium.[2] In what follows, we discuss recent research demonstrating the pricing of ESG risks related to climate and biodiversity transition risks in equity markets.

Pricing of Climate Transition Risks

Climate change poses a major risk to the assets managed by institutional investors. As the world transitions to a low-carbon economy, some institutional investors' portfolio firms will experience declines in their asset values.[3] One type of climate transition risk is regulatory risk, which arises because some firms will be more negatively affected than others by the policies and regulations implemented to combat climate change. Another type of climate transition risk is technological risk, originating, for example, from the replacement of thermal engines by electric ones and the impact thereof on some car manufacturers. Hence, technological risks emerge from innovations and technological advances designed to combat global warming, which may threaten firms' business models in traditional industries. Finally, the transition to a greener economy may be accompanied by legal action from those adversely affected by climate change. When litigation is aimed at portfolio firms that are viewed (partially) as being responsible for climate change, such actions imply risks from actual legal costs, fines, or reputational loss.

Several recent studies have documented that financial markets have started to price climate transition risks. Bolton and Kacperczyk (2021) show that firm-level carbon emissions are associated with higher expected stock returns after controlling for other return predictors. They demonstrate that this effect reflects a *carbon risk premium*, compensating investors for climate transition risks.[4]

Ilhan et al. (2021) examine whether climate transition risks are priced in option markets. They focus on the impact of climate policy uncertainty, building on prior work that establishes a relationship between political uncertainty and asset prices. The idea is that climate policy uncertainty is particularly high for firms that rely heavily on carbon-based resources, as future regulations will negatively affect these firms, leading to potentially large declines in their stock prices. Hence, the cost of protection using stock options against downside risks should be higher for firms with more carbon-intensive business models. The evidence gathered by Ilhan et al. (2021) is consistent with this prediction: Insurance costs against downside risks are higher for firms with larger carbon footprints.

Pricing of Biodiversity Transition Risks

Institutional investors are increasingly paying attention to biodiversity risks in their investment portfolios, as biodiversity loss has emerged as the second grand challenge of our times, next to climate change. Biodiversity risks can materialize in two ways. Physical risks reflect the fact that nature-dependent operations of firms are disrupted because of habitat loss, invasive species, or the destruction of ecosystem services. Transition risks arise because firms with business models that adversely impact biodiversity may be affected by future regulations to protect it.

Garel et al. (2024) document that biodiversity transition risks have started to be priced in financial markets. They use a firm-level measure of the corporate biodiversity footprint ("CBF") and demonstrate that investors have recently started to price this footprint in stock returns. The CBF aggregates the biodiversity loss caused by a firm's annual activities related to land use, carbon emissions, water pollution, and air pollution. Garel et al. (2024) find a positive relationship between the CBF and stock returns in the months following a major recent biodiversity-related policy event in October 2021. This event, the first part of the UN Biodiversity Conference (COP15), concluded with the Kunming Declaration, which calls for countries to urgently protect biodiversity by aligning financial flows. Their evidence suggests that investors have started anticipating new regulations or litigation targeting large-CBF firms. Thus, the increase in policy uncertainty leads investors

2) The same holds for bonds or loans, whereby interest rates on borrowers with larger ESG risks should be higher.

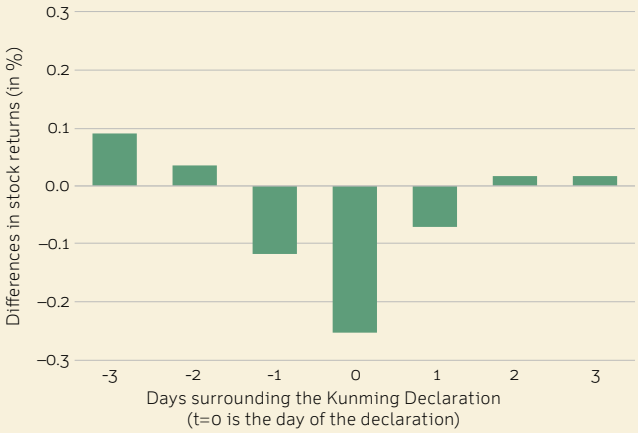
3) Another important type of climate risk is physical risk, which causes some portfolio firms to experience valuation declines and higher business costs because of physical changes in the climate.

4) Some studies challenge this evidence. Aswani et al. (2024) argue that the link between returns and emissions originates primarily from vendor-estimated emissions, which are calculated based on firm fundamentals (i.e., the carbon risk premium may indirectly reflect a link between fundamentals and returns). They also do not detect a risk premium for scaled emissions (or emissions intensity)—the ratio of emissions to net sales. Atilgan et al. (2023) demonstrate that the higher returns of large carbon emitters may reflect stock mispricing, whereby firms with high carbon emissions "ride" the unpriced carbon externality and, in turn, generate unexpectedly higher returns. Future research is needed to shed light on the carbon risk premium, how stable it is and what its drivers are.

to demand a *biodiversity risk premium*, that is, higher expected stock returns for firms with a larger CBF.

Garel et al. (2024) also conducted an event study to examine whether and how investors revised their valuations of large-CBF stocks around the Kunming Declaration. If the declaration raised investors' awareness of biodiversity issues and the prospect of regulation, one would expect them to revise their valuation of large-CBF stocks downward. As illustrated in Figure 2, there was a significant relative price drop for large-CBF firms on the day of the Kunming Declaration (t=0), while there were no significant stock return differences before or after the declaration.

Figure 2: Return Differences Between Stocks With Large- And Small-Corporate Biodiversity Footprints (CBF) Around the Kunming Declaration



Note: This figure reports daily mean abnormal stock return differences around the Kunming Declaration between large- and small-Corporate Biodiversity Footprint (CBF) firms. The day of the Kunming Declaration is day t=0. Abnormal returns for each stock are computed in excess of the returns of all other stocks in the same country and industry. Large-CBF (small-CBF) firms have a CBF value above (below) the median as of the end of 2020. CBF reflects the biodiversity loss caused by the firm's annual activities.

Source: Garel et al. (2024).

4. ESG-Related Value Generation

Shareholder Engagement

In a recent survey of academics, policymakers, and professionals, pressure from institutional investors or "shareholder engagement" is perceived as one of the most effective mechanisms for reducing firms' climate risks and carbon emissions (Stroebel & Wurgler, 2021).[5] An increasing body of evidence supports the perception captured in this survey. To demonstrate that shareholder engagement yields beneficial risk outcomes, Hoepner et al. (2024) examine whether measures of downside risk decrease after ESG-related engagement by a major institutional investor located in the United Kingdom. They find that engagement by the investor is associated with subsequent reductions in the downside risk of firms. The variable of interest that captures the downside risk is the value-at-risk (VaR), measured over a 24-month window around the start of an engagement.[6]

Table 2

The Milestones of Successful Shareholder Engagement

Milestone M1	Milestone M2	Milestone M3	Milestone M4
Investor raises a concern with a targeted firm	Targeted firm acknowledges the concern was raised	Targeted firm addresses the concern	Investor successfully completes the engagement

Source: Hoepner et al. (2024).

In their study, Hoepner et al. (2024) classify engagements by the milestone achieved by the investor (see Table 2). Across all engagements, firms targeted by the investor experience only a mild reduction in downside risk. However, engagement substantially lowers that risk if it is successful. Taking Milestone M2 as the measure of success, firms that acknowledge an ESG issue raised by the investor already experience a decrease in downside risk, relative to a control group. The decrease in downside risk is even larger if engagement success is measured only among firms that take action to address the investor's concern (M3 or higher). Importantly, there is no effect on downside risk when the investor's engagement is classified as unsuccessful (M1). Hoepner et al. (2024) also document that engagement is most successful if environmental topics are addressed (climate concerns constitute a major part of these engagements).

The effects of the investor's engagement are not limited to financial value. Hoepner et al. (2024) show that engagement-induced risk reduction originates from an actual decline in environmental incidents. This evidence shows that financially beneficial outcomes of ESG investing can also lead to socially beneficial outcomes.[7]

In another study that focuses on climate risk disclosure, Ilhan et al. (2023) demonstrate that "climate-conscious" institutional investors positively influence such disclosures. They consider three groups of climate-conscious investors: (i) investors from countries in which institutional investors are expected to follow stewardship codes (these are designed to encourage investors to promote ESG issues through the investment process); (ii) investors from countries with more climate-conscious societal norms; and (iii) universal owners who face climate-related externalities in their portfolios because their holdings are very broad and, therefore, exposed to climate change. The study's main result is that higher climate-conscious institutional ownership makes it more likely that portfolio firms will disclose their carbon emissions. This is an important finding, as other research shows that firms that report on their carbon emissions feel more pressure to subsequently reduce those emissions. Additionally, more information on a firm's carbon emissions allows financial markets to better assess and price its climate transition risks.

5) This insight emerges against the backdrop of a massive increase in institutional investor ownership in publicly listed firms across a wide range of countries.

6) The VaR in this study is constructed by taking the daily return outcomes ranked in the bottom fifth percentile (5% VaR), which essentially correspond to the worst daily return in a month.

7) A limitation of Hoepner et al. (2024) is that it is difficult to generalize their findings to a large sample of institutions. There are good reasons to believe that the average institutional investor does not yield the same engagement outcomes as do the investors in this study. Some recent large sample evidence on ESG engagement is provided by Lowry et al. (2024).

ESG Selection/Positive Screening

An alternative approach through which institutional investors can leverage ESG investing to create financial value is by identifying stocks with ESG qualities that are not yet recognized and priced by financial markets. While it is not obvious that any given investor should have an information advantage over the market, there is evidence that ESG factors are sometimes mispriced and that investors can explore this mispricing to generate financial value.

Edmans (2011) illustrates this strategy by analyzing the relationship between stock returns and employee satisfaction, a dimension of the S in ESG. He finds that a "100 Best Companies to Work For in America" portfolio earned an annual outperformance (or alpha) of 3.5%. This outperformance does not reflect a risk premium, as he also finds that the "Best Companies" exhibited significantly more positive earnings surprises and announcement returns.

In this example, the stock market does not fully value a certain ESG quality, implying that ESG screening can improve investment returns. As in this study, any such screening strategies will probably need to go beyond focusing on aggregate ESG metrics and instead focus on subdimensions of ESG quality that have not yet been fully valued by the stock market.

ESG Selection/Positive Screening in Practice at Zürcher Kantonalbank

To illustrate how ESG selection or positive screening can be designed to generate financial value, we provide excerpts from Zürcher Kantonalbank's (ZKB's) approach to integrating sustainability into investment decisions. The excerpts highlight the importance of identifying firms with high ESG qualities early on. Proprietary solutions, built on factor selection and industry weighting schemes, help identify opportunities that may not be fully reflected in financial markets. ZKB takes a comprehensive approach to sustainability, which includes not only ESG scores but also the alignment of products and services with the Sustainable Development Goals (SDGs) to assess an issuer's sustainability level. Emphases in the text below are added by us.

"The ESG score is important for our holistic sustainability analysis. Thanks to the *ESG criteria,* we gain in-depth insight and can *better analyze intangible assets:* how innovative is a company really, how much is the brand worth, how strong is stakeholder engagement and how are employees treated? For this reason, the sustainability analysis complements the financial analysis in our active management of traditional investments. ...

In the case of equities, companies that benefit from the sustainability trend can be *identified at an early stage*. We are convinced that this has a *positive effect on the risk adjusted return*. ...

We have further developed traditional ESG analysis so that we can ensure a high level of information across different asset classes and types. In order to take all the particularities into account, we use *tailored data sets* for each asset class. Conventional ESG analyses primarily capture the operational sustainability efforts of a company or state—i.e., how sustainably a company or state is managed. To obtain a differentiated picture, we *supplement our analysis* with important aspects such as the environmental and social consequences of the business activity, the effects of the products and services or controversial aspects. ...

We obtain our ESG data from several providers. Some data is more relevant to us than others. The greatest challenge comes from the reporting gap: there is more data on large-cap companies from developed countries than on small-cap companies in developing countries. … To take this into account, we work with *proprietary ESG ratings,* which we calculate with raw data from different providers. We focus on what's important and remove any distortions. This way, we can meaningfully interpret the information on intangible assets and use it in a targeted manner to manage opportunities and risks" Zürcher Kantonalbank (2024).

Divestment/Exclusionary Screening

Conceptually, ESG-based divestment strategies (or exclusionary screening) can reduce ESG risks and positively impact ESG-related outcomes for the following reasons. Because these strategies should lower its stock price, a firm that experiences substantial divestments or negative screenings should see an increase in its cost of capital. In principle, a higher cost of capital should make it less attractive for the firm to advance "dirty" projects.

However, a common criticism of divestments is that they substitute investors who care about ESG issues (and possibly engage over them) with those who do not. Furthermore, as of now, the effects of divestment on the cost of capital are too small to impact firm behavior, as shown by Berk and van Binsbergen (2021). To have a financially material impact, many investors need to divest from a firm, which is currently not the case.[8)]

Although this evidence is disappointing for proponents of the divestment channel, it is too early to conclude that it cannot work. Some recent studies indicate that one needs to look beyond divested or excluded firms. Becht et al. (2023), for example, show that climate-related divestment pledges that went viral depressed the share prices of all high-carbon emitters, including those not experiencing significant divestment. They also show that divestment induces investors to decarbonize their portfolios.

8) Krueger et al. (2020) show that only a modest number of the institutional investors consider divestment strategies for climate-related reasons.

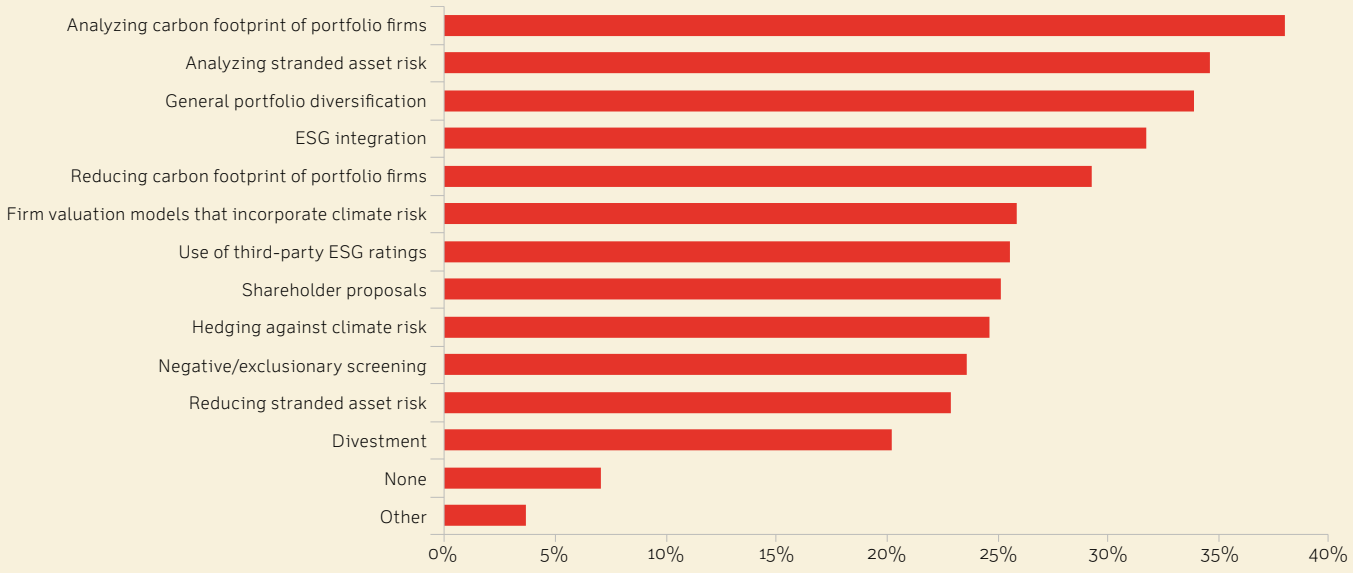
5. ESG-Related Challenges

The evidence in the previous section, especially on engagement, is encouraging: Institutional investors do have the potential to positively address ESG-related issues in the investment process, both to generate financial value and to help society. This section highlights some challenges to ESG investing, with the goal of identifying ways to further enhance its effectiveness.

ESG Risk Management

Climate risks constitute *the* major ESG risk investors face, so one would expect them to receive the most attention. Such is not yet the case. As illustrated in Figure 3, too few institutional investors address climate risks in their investment processes. Among the key decision-makers at 439 institutional investors surveyed by Krueger et al. (2020),[9] only 38% analyze firms' carbon footprints, only 35% identify stranded asset risks, only 29% reduce their portfolio firms' carbon footprints, and only 25% hedge against climate risks. A similar survey asking whether institutional investors address market, interest rate, or credit risks, by comparison, would probably yield close to 100% positive responses.

Figure 3: Percentage of Institutional Investors Who Incorporate Climate Risks Into the Investment Process



Note: This figure shows the percentage of institutional investors who adopted a given approach in the previous five years to incorporate climate risks into their investment process. Their responses are not mutually exclusive. The results are ranked based on their relative frequencies.

Source: Krueger et al. (2020).

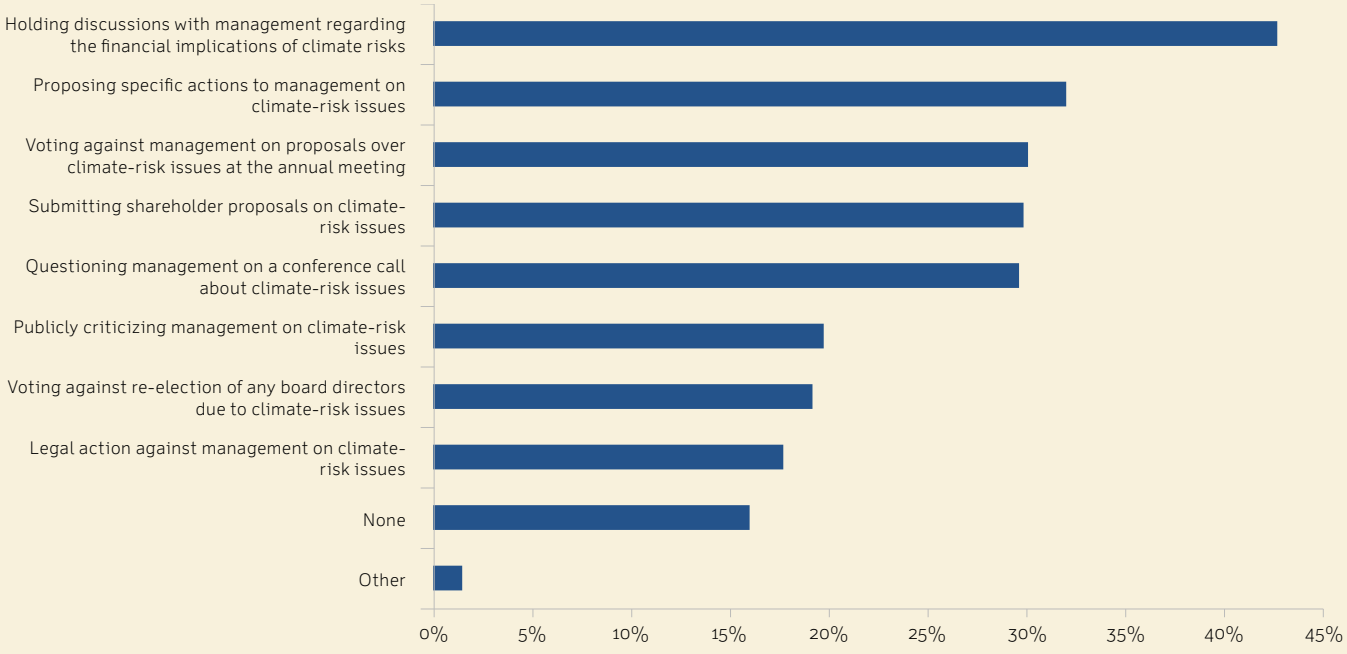
9) The surveyed individuals work in positions with insight into investment decision processes and investment risks, including Chief Investment Officers (CIOs), ESG experts, and fund managers. The sample includes 48 respondents from institutions which each have over USD 100 billion in assets under management.

A similar conclusion emerges from Figure 4, which focuses more specifically on engagement. The graph shows that only 43% of the institutional investors Krueger et al. (2020) surveyed discussed climate-related issues with their portfolio firms, and only 30% voted against a firm over climate-related issues at the annual meeting. The numbers are even smaller if more authoritarian actions are considered, such as voting against the reelection of a board director for climate risk reasons. Overall, the numbers that we report are likely biased toward institutional investors who consider climate risks important and are proactive, compared to average investors.

The evidence also makes it clear that a dominant approach to dealing with climate risks has not yet emerged, which indicates that it is still unclear how to manage these risks effectively.

The reported numbers are from a few years back, and progress has been made since then, with more institutions actively addressing climate risks. Nevertheless, much more needs to be done, particularly among smaller institutional investors. For them, investor coalitions can provide an effective platform from which to engage portfolio firms jointly; alternatively, smaller investors may outsource engagement to specialist agents. A further challenge is that regulatory frameworks for institutional investors mostly focus on disclosure requirements, rather than on specifying targets or facilitating actions to account for climate risks (e.g., regarding shareholder engagement). This ambiguity can leave investors uncertain about how to effectively integrate climate risks into their investment strategies.

Figure 4: Percentage of Institutional Investors Who Directly Engage on Climate-Related Issues With Portfolio Firms



Note: This figure reports the percentage of respondents who have taken a particular approach of direct engagement over climate risk issues in the past five years. Their responses are not mutually exclusive. The results are ranked based on their relative frequencies.

Source: Krueger et al. (2020).

ESG-Related Investor Coalitions

As mentioned above, some institutional investors have created coalitions to collectively address ESG issues with their portfolio firms. These initiatives are motivated by the larger leverage and the higher threat potential that can be achieved when these networks reach out to portfolio firms on behalf of many supporting investors. A further benefit is that the coalitions reduce information collection costs and free-rider problems.

For example, Climate Action 100+ is an investor-led initiative that addresses climate risks by engaging with 170 firms responsible for approximately 80% of industrial carbon emissions. The three goals of this initiative, with respect to the engagement targets are: (i) to reduce carbon emissions in line with the Paris Agreement; (ii) to implement a governance framework with board accountability and oversight of climate risks; and (iii) to enhance disclosure, in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) (Climate Action 100+, 2024).

While investor initiatives have large potential, they also face challenges. On the one hand, such platforms are being threatened legally, because of concerns over acting in concert or violating antitrust rules. Moreover, in many jurisdictions, regulatory rules are ambiguous or do not facilitate coordinated engagement. On the other hand, some major investors have recently announced a full or partial withdrawal from certain coalitions, possibly undermining their credibility and effectiveness.

ESG Data Vendors

Most institutional investors do not have the time, expertise, or resources to construct ESG or climate ratings for a large set of portfolio firms. They, therefore, rely on data vendors ("ESG rating agencies") to evaluate the ESG performance of these firms for them. As is the case with credit rating agencies, investors are clearly better off with ESG rating agencies than without them. However, some emerging evidence deserves attention.

The German Financial Services Authority (BaFin) recently surveyed institutional investors on how they use ESG ratings in the investment process and about their concerns when using these data (Bundesanstalt für Finanzdienstleistungsaufsicht, 2024). This study provides three insightful results, which likely extend beyond Germany: (i) 83% of the surveyed institutions make use of external ESG data vendors, with the vast majority using MSCI, followed by ISS[10]; (ii) only 38% of the surveyed institutions consider the quality of the purchased ESG data to be "high"; and (iii) only 18% believe that the cost of the obtained data products is appropriate.

Apparently concerned about lax usage and overreliance on external ESG data by institutional investors, BaFin concludes that it will try to define minimum standards, at the EU level, that investors must fulfill when collecting and using ESG data.[11] Moreover, the European Commission recently released proposals for regulating ESG rating agencies (European Commission, 2023). The proposals include, among other items, that ESG raters must apply to the European Securities and Markets Authority (ESMA) to be authorized, must adhere to rules on avoiding conflicts of interest, and must increase transparency (e.g., disclose their rating methodology) (European Securities and Markets Authority, 2023).

10) These findings are consistent with other studies indicating that MSCI and ISS, together with Sustainalytics, have emerged as market leaders (Opimas, 2020).

11) Some countries, such as Switzerland, already have requirements that investors need to verify and check the ESG data they use. Some of these requirements are based on self-regulation.

6. Conclusions

As we have shown in this note, criticism of ESG investing largely stems from a misunderstanding of its aims and a lack of knowledge about how it can create financial value for investors. ESG risks constitute financially material investment risks that all institutional investors need to address in the investment process.

By actively addressing these risks with portfolio firms, institutional investors can both create financial value and also contribute to society, by helping to address some of the grand challenges of our times. This role is distinct from any moral or values-based judgment of ESG investing. We further show that actively addressing ESG risks through shareholder engagement is particularly promising. While it creates financial value by reducing investment risk, it also leads to beneficial societal outcomes, for example, if the engagement aims to reduce a firm's emissions or its negative impact on biodiversity.

As authors of this note, we hope that investors will increasingly understand where and why ESG can create financial value, thereby fostering the societal value that the financial sector can provide. In this way, finance can contribute to a more sustainable future.

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