

# THEORETICAL FOUNDATIONS AND CONTEMPORARY PERSPECTIVES ON ESG INVESTING: INTEGRATING FINANCIAL THEORIES, ETHICAL PRINCIPLES, AND MARKET PRACTICES

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## ABSTRACT

In recent years, the growing relevance of sustainability in financial decision-making has prompted renewed attention toward the theoretical underpinnings of Environmental, Social, and Governance (ESG) investing. Against this backdrop, the present study explores the conceptual foundations that explain why ESG has moved from a peripheral ethical concern to a mainstream investment philosophy. Drawing on established financial theories, strategic management perspectives, and ethical principles, the paper adopts a qualitative, theory-driven approach to synthesize insights from extensive scholarly literature. The analysis reveals that the logic of ESG is deeply rooted in frameworks such as Stakeholder Theory, Agency Theory, Modern Portfolio Theory, the Efficient Market Hypothesis, and the Resource-Based View, each offering a distinct rationale for integrating sustainability factors into investment processes. The discussion further highlights how global regulatory developments—particularly the emphasis on double materiality, enhanced disclosure standards, and stewardship norms—strengthen the financial and societal relevance of ESG practices. Although challenges such as rating divergence and measurement inconsistencies persist, the overarching evidence suggests that ESG considerations contribute to long-term value creation, risk mitigation, and corporate resilience. Overall, the study affirms that ESG investing represents a multidimensional paradigm that connects financial performance with ethical responsibility and strategic sustainability, offering a coherent foundation for understanding the future direction of investment and corporate governance.

**Keywords :** Environmental, Social, and Governance (ESG); Sustainable Finance; Stakeholder Theory; Agency Theory; Modern Portfolio Theory; Double Materiality; Corporate Governance; Ethical Investing; Risk Management; Sustainability Reporting; ESG Integration; Responsible Investment; Corporate Financial Performance (CFP); Market Efficiency; Strategic Sustainability.

## 1. INTRODUCTION

Environmental, Social, and Governance (ESG) investing has become one of the most transformative developments in global financial markets over the past two decades. Investors, regulators, and corporations increasingly recognize that non-financial factors—such as environmental sustainability, social responsibility, and corporate governance—play a significant role in determining long-term financial performance and market stability (OECD, 2020). As a result, ESG investing has evolved from a niche ethical practice into a mainstream investment philosophy, with global sustainable investment assets surpassing USD 35 trillion in 2020 (Global Sustainable Investment Alliance [GSIA],

2021). This rapid shift reflects growing concerns about climate-related risks, social inequalities, and corporate misconduct, all of which have demonstrated substantial financial consequences for firms and investors (Krueger, Sautner, & Starks, 2020). Unlike traditional socially responsible investing (SRI), which focused on moral or exclusionary screens, ESG investing integrates sustainability metrics into financial valuation models, credit ratings, and portfolio construction (SASB, 2020). This integration highlights that ESG issues are not merely ethical preferences but material risk factors that influence cash flows, cost of capital, regulatory exposure, and firm resilience (Clark, Feiner, & Viehs, 2015). For instance, environmental risks such as carbon emissions and climate adaptation affect resource efficiency and compliance costs; social factors such as employee welfare and community relationships influence productivity and brand reputation; governance mechanisms shape transparency, investor confidence, and managerial accountability (Eccles & Klimenko, 2019). Thus, ESG dimensions offer a holistic assessment of a firm's long-term sustainability and competitiveness.

The theoretical foundations of ESG investing draw from a wide range of classical and modern theories in finance and management. Stakeholder Theory argues that firms must create value for multiple stakeholders, as long-term success depends on managing relationships with employees, communities, and the natural environment (Freeman, 1984). Agency Theory emphasizes governance structures that align managerial actions with shareholder interests, forming the basis of the "G" dimension in ESG frameworks (Jensen & Meckling, 1976). Modern Portfolio Theory suggests that including ESG factors can reduce portfolio risk by identifying firms vulnerable to regulatory sanctions, reputational loss, or environmental liabilities (Markowitz, 1952). Similarly, the Efficient Market Hypothesis posits that enhanced ESG disclosure increases information efficiency, enabling markets to more accurately price sustainability risks (Fama, 1970). These theories collectively illustrate that ESG investing is grounded in long-standing financial principles rather than being merely a trend. The increasing importance of ESG investing is also driven by rising regulatory and institutional pressures. International bodies such as the United Nations, EU Commission, and International Sustainability Standards Board have mandated sustainability disclosure norms, compelling firms to report ESG performance in standardized formats (United Nations Principles for Responsible Investment [UNPRI], 2019). Institutional investors, pension funds, and sovereign wealth funds are integrating ESG metrics into their investment mandates to mitigate long-term systemic risks and fulfill fiduciary duties (Amel-Zadeh & Serafeim, 2018). As sustainability becomes embedded in global financial architecture, ESG investing is reshaping corporate behavior, investment strategies, and risk-management practices. Therefore, understanding the theoretical foundations of ESG investing is essential to explain why sustainable finance has gained global acceptance and how it aligns with established financial principles. ESG investing is not a deviation from traditional finance but a natural extension of long-term value creation, risk mitigation, and stakeholder alignment. This paper explores these theoretical foundations and provides conceptual clarity on the relevance and legitimacy of ESG integration in contemporary financial decision-making.

## 2. REVIEW OF LITERATURE

Research on ESG investing has grown rapidly over the last two decades, moving from a niche ethical concern to a mainstream field within finance and sustainable investing. Early conceptual work framed ESG within the broader evolution from socially responsible investing (SRI) toward strategies

that explicitly integrate environmental, social and governance information into valuation and portfolio construction (Hill, 2020). Global industry reports such as the Global Sustainable Investment Review 2020 document that sustainable investment assets reached about USD 35.3 trillion, representing roughly one-third of professionally managed assets worldwide, underlining the scale and relevance of ESG in practice (Global Sustainable Investment Alliance [GSIA], 2020). Policy and practitioner bodies, including the OECD and the UN Principles for Responsible Investment (PRI), further conceptualize ESG as a tool for aligning capital markets with long-term sustainability and risk-management objectives (OECD, 2020; PRI, 2018). A substantial body of literature examines whether ESG is financially material. One of the most influential meta-analyses, covering more than 2,000 empirical studies, finds that in roughly 90% of cases the relationship between ESG and corporate financial performance (CFP) is non-negative, with a large share being positive (Friede, Busch, & Bassen, 2015). (Clark, Feiner and Viehs, 2015) synthesize over 200 sources and conclude that firms with robust sustainability practices tend to outperform peers in terms of operational performance and stock market returns, and that strong governance and stakeholder orientation are common channels for this outperformance. (Khan, Serafeim and Yoon, 2016) introduce an important refinement by distinguishing between material and immaterial sustainability issues; they show that firms scoring well on financially material ESG dimensions significantly outperform on stock returns and accounting performance, reinforcing the argument that ESG is not purely values-based but also economically relevant. More recent work continues this line, indicating that higher ESG scores are associated with improved firm value and profitability in multiple markets and sectors (Aydoğmuş, 2022). Meta-reviews by financial institutions and research centres, including AXA Investment Managers and NYU Stern, similarly report a predominantly positive or neutral ESG–CFP relationship, consolidating the “business case” for ESG integration (Friede et al., 2015; NYU Stern, 2021).

Several authors explicitly connect ESG performance with Stakeholder Theory. Freeman's (1984) foundational work proposed that firms must create value for multiple stakeholders rather than shareholders alone, and later studies interpret ESG scores as a measurable manifestation of how firms manage these stakeholder relationships. Hill (2020) links theories of the firm and stakeholder orientation directly to ESG practice, arguing that environmental stewardship, social responsibility and governance quality together proxy for the quality of stakeholder management. Conceptual analyses show that ESG performance can be viewed as an extension of stakeholder value creation, where firms internalize externalities and align business models with societal expectations (Hill, 2020). A review focused specifically on ESG as a measure of Stakeholder Theory concludes that ESG indicators capture both positive and negative externalities affecting multiple stakeholder groups, thereby offering a practical operationalization of stakeholder value in capital markets (A Review ESG Performance, 2022). The governance dimension of ESG is closely linked to Agency Theory, which examines conflicts of interest between managers and owners (Jensen & Meckling, 1976). Building on this, ESG studies emphasize that strong governance practices—such as board independence, shareholder rights, disclosure and anti-corruption controls—mitigate agency problems and enhance monitoring (Hill, 2020;). (Ioannou and Serafeim, 2021) show that corporate sustainability can be a deliberate competitive strategy, where governance mechanisms support long-term orientation and sustainability-based differentiation. Institutional and legal analyses also highlight how fiduciary duty is being reinterpreted to allow, and in some cases require, the incorporation of ESG factors into investment decision-making,

particularly for long-horizon institutional investors (Inderst, Kaminker, & Stewart, 2012; UNEP FI & PRI, 2018). From a portfolio and asset-pricing perspective, ESG research often builds on Modern Portfolio Theory (MPT) and related risk-return models. The OECD's assessment of ESG indices and funds explicitly draws on Markowitz's mean-variance framework and multifactor models to evaluate whether ESG integration alters risk-return profiles relative to conventional benchmarks (OECD, 2020). (Hilario-Caballero et al. 2020) extend classical MPT by proposing a tri-criterion portfolio model that simultaneously optimizes return, risk and portfolio carbon exposure, illustrating how ESG (specifically climate risk) can be embedded as an additional portfolio objective. (De Franco et al. 2020) apply machine-learning techniques to connect high-dimensional ESG features with excess returns, finding evidence that ESG information contains alpha when processed with non-linear methods, thereby challenging traditional linear screening approaches. Theoretical surveys argue that sustainable investing is consistent with risk-management theory: ESG integration helps investors identify firms exposed to regulatory, physical and reputational risks and thus can reduce downside risk without necessarily sacrificing return (OECD, 2020).

At the level of market infrastructure and information efficiency, ESG studies build on the Efficient Market Hypothesis (EMH). (Fama's, 1970) argument that prices reflect all available information is extended to sustainability data: if ESG information is financially material but only partially or inconsistently disclosed, markets may temporarily misprice firms' sustainability risks and opportunities. Hill (2020) and the Cambridge Global Handbook of Financial Infrastructure conceptualize ESG as part of the informational infrastructure of sustainable investing, emphasizing that improved ESG reporting and standardization are necessary for efficient price formation (Cambridge Global Handbook, 2023; Hill, 2020). However, several studies and practitioner surveys highlight persistent data quality issues, rating divergences and coverage gaps, particularly in smaller firms and emerging markets, which hinder full ESG integration and create scope for both mispricing and "greenwashing" (CFA Institute & PRI, 2018). (Hill's 2020) Environmental, Social and Governance (ESG) Investing: A Balanced Analysis of the Theory and Practice of a Sustainable Portfolio reviews competing theories of the firm, fiduciary duty, and financial markets, positioning ESG within mainstream finance rather than as a separate paradigm. Other comprehensive texts and handbooks on sustainable investing survey hundreds of academic sources to categorize ESG research into themes such as investor preferences, performance, integration methods, climate risk and theoretical models (Perspectives in Sustainable Equity Investing, 2022; The Big Book of Sustainable Investing, 2023). These works underline that ESG investing has progressed beyond ethical screening to become a structured, theory-consistent approach to capital allocation.

(Shehab, 2019) analyzes ESG disclosure and financial performance in Italian real estate investment trusts, highlighting the role of environmental transparency in mitigating property-related risks. (Bruscino, 2021) investigates how ESG factor integration affects portfolio outcomes, combining ethical and financial perspectives on sustainable investment. (Bofinger, 2021) offers a multi-paper doctoral thesis on CSR and ESG from both corporate finance and investor standpoints, covering capital structure, cost of capital and market perception, while (Cullen, 2022) provides a comprehensive undergraduate thesis tracing ESG's evolution "from fad to force" in mainstream finance. Together, these theses show how ESG theory is applied in different markets, instruments and regulatory frameworks. Recent literature also broadens the analytical lens to emerging markets, data science and

macro-financial linkages. Sustainable equity and fixed-income studies examine how ESG factors are incorporated into sovereign debt, municipal bonds and green bonds, arguing that ESG is reshaping credit risk assessment and capital allocation in public finance (Inderst et al., 2018). Critical reviews of ESG scores and sustainable finance warn, however, that inconsistent ratings methodologies, disclosure gaps and potential greenwashing require more robust theoretical and empirical scrutiny of how ESG indicators are constructed and used (ESG and Sustainable Finance: A Critical Review, 2023). Overall, the literature converges on several key insights. First, ESG is now widely conceptualized as a financially relevant extension of established theories such as Stakeholder Theory, Agency Theory, Modern Portfolio Theory and EMH. Second, a large body of empirical and meta-analytic evidence supports a non-negative, often positive, relationship between ESG and financial performance. Third, books, theses and policy reports collectively frame ESG as part of a broader shift toward sustainable finance, while also recognizing methodological challenges in data, measurement and standardization. These strands of literature jointly provide a strong theoretical and empirical foundation for viewing ESG investing as an integral, not peripheral, component of contemporary finance.

### 3. METHODOLOGY

The examining the theoretical foundations that support ESG investing—it is essential to adopt a methodological approach that aligns with the conceptual nature of the topic. Since the study seeks to understand, interpret, and synthesize existing theories rather than conduct empirical analysis, a **theoretical and conceptual research design** is most appropriate. This design allows the investigation to focus on how established financial and management theories provide the intellectual basis for ESG integration in modern investment practices. The study relies entirely on **secondary sources of information**, which include peer-reviewed journal articles, academic books, doctoral and master's theses, institutional guidelines, and professional reports published by globally recognized bodies such as the OECD, SASB, UNPRI, and GSIA. These sources offer a rich foundation to explore how ESG principles have evolved and how they connect with classical theories such as Stakeholder Theory, Agency Theory, Modern Portfolio Theory, and the Efficient Market Hypothesis. By drawing from such well-documented literature, the study ensures depth, accuracy, and credibility in its theoretical analysis. To interpret and evaluate these sources, the research employs a **qualitative content analysis** approach. Rather than using numerical methods or statistical testing, qualitative analysis allows the study to identify common themes, conceptual relationships, and theoretical patterns within the literature. This method involves reading, comparing, and synthesizing key arguments presented by scholars and institutions regarding the financial relevance of ESG factors. Through this process, the study highlights how sustainability-related risks, governance mechanisms, and stakeholder considerations intersect with long-standing financial principles. Additionally, the study uses **conceptual comparison and theoretical synthesis** to integrate insights from multiple theories. Conceptual comparison helps examine how each theory contributes uniquely to understanding ESG investing, while theoretical synthesis brings together these perspectives to build a unified conceptual framework. Since the focus is on understanding theoretical linkages rather than generating empirical findings, the **nature of the data remains non-empirical and entirely theory-based**. This methodological approach allows the research to offer a comprehensive and academically grounded explanation of ESG investing within the broader landscape of financial theory.

#### 4. THEORETICAL FRAMEWORK

In attempting to understand why ESG investing has moved from the periphery of finance into its core, it becomes essential to position the discussion within a strong theoretical foundation. Rather than viewing ESG merely as a modern corporate trend, the framework below situates ESG within long-established financial and management theories that explain its rationale, relevance, and long-term value implications. By connecting classical scholarship with contemporary sustainability realities, this section provides the intellectual backbone for the study.

##### 4.1.1 Stakeholder-Oriented Perspective

The evolution of ESG investing is best understood through the lens of **Stakeholder Theory**, which fundamentally redefined the purpose and responsibilities of the modern corporation. Freeman (1984) argued that long-term business success depends on the firm's ability to create value not only for shareholders but for a broader network of stakeholders, including employees, customers, suppliers, communities, governments, and the natural environment. In this sense, ESG becomes a measurable manifestation of how effectively a firm manages its stakeholder relationships. Environmental initiatives reflect stewardship toward ecological stakeholders; social initiatives address fairness, inclusivity, and community welfare; and governance practices ensure ethical and transparent decision-making. The logic embedded in Stakeholder Theory suggests that firms attentive to these dimensions build resilience, trust, and legitimacy—qualities increasingly valued by long-term investors. Thus, ESG indicators operationalize stakeholder principles in a form that capital markets can evaluate and price.

##### 4.1.2 Governance as a Control Mechanism (Agency Theory)

Alongside stakeholder considerations, the **Agency Theory** of Jensen and Meckling (1976) provides a second pillar supporting the role of ESG in investment decisions. Agency Theory explains how conflicts arise between managers, who control corporate decisions, and shareholders, who bear the associated financial risks. When governance structures are weak, managers may act in self-interest, engage in excessive risk-taking, manipulate information, or pursue unethical practices. The governance dimension of ESG—covering board independence, audit integrity, executive accountability, and shareholder rights—directly addresses these agency problems. Strong governance reduces information asymmetry, enhances monitoring, and aligns managerial decisions with long-term corporate and investor interests. In this way, ESG governance indicators become an extension of classical control mechanisms designed to protect shareholder value.

##### 4.1.3 ESG as a Risk-Management Tool (Modern Portfolio Theory)

The third theoretical foundation arises from principles of **Modern Portfolio Theory (MPT)**, developed by Markowitz (1952), which argues that rational investors seek to optimize return while minimizing risk. While MPT traditionally focused on financial and market-based risks, modern investment practice recognizes that **sustainability risks**—such as climate exposure, regulatory penalties, labor unrest, supply-chain disruptions, or reputational damage—can materially influence long-term cash flows.

From this perspective, ESG integration becomes a sophisticated form of risk management. Firms with strong ESG performance tend to exhibit fewer operational disruptions, better regulatory

compliance, and more stable earnings. Therefore, incorporating ESG criteria into portfolio construction aligns directly with MPT's risk-return optimization by reducing volatility and long-term downside exposure. Investors increasingly recognize that sustainability risks are financial risks, making ESG an essential component of risk-adjusted investing.

#### 4.1.4 ESG and Market Efficiency (Efficient Market Hypothesis)

Another important strand of the framework is provided by the **Efficient Market Hypothesis (EMH)**, articulated by Fama (1970), which posits that market prices reflect all available information. The rise of ESG reporting has expanded the scope of corporate information accessible to investors. When firms disclose sustainability-related data consistently, markets are better positioned to incorporate environmental, social, and governance risks into asset pricing. However, inconsistent disclosure and fragmented ESG data have historically led to mispricing and inefficiencies. Improvements in reporting standards—supported by bodies such as SASB and UNPRI—help correct these inefficiencies by reducing information asymmetry. Thus, ESG disclosure strengthens market efficiency and supports more accurate valuation of corporate sustainability performance.

#### 4.1.5 ESG as Strategic Capability (Resource-Based View)

The **Resource-Based View (RBV)** of the firm offers yet another theoretical anchor. RBV, articulated by Barney (1991), proposes that sustained competitive advantage stems from internal resources that are valuable, rare, inimitable, and non-substitutable. ESG performance can be interpreted as one such intangible resource. Firms that lead in sustainability often demonstrate innovation in resource efficiency, environmental technologies, employee engagement, ethical leadership, and stakeholder trust—all of which are difficult for competitors to replicate. By embedding ESG principles into core operations, businesses develop unique strengths that improve reputation, attract talent, reduce regulatory risk, and appeal to long-term investors. Within the RBV framework, ESG is therefore not a compliance burden but a strategic capability that enhances competitiveness.

#### 4.1.6 ESG Strategy Development and Integration Approaches

Another central theme concerns how firms and investors **operationalize ESG strategies** within corporate policies and investment processes. Eccles and Klimenko (2019) argue that institutional investors increasingly push companies toward proactive ESG strategies through engagement, voting, and long-horizon stewardship. From the corporate side, Porter and Kramer's (2011) "shared value" framework provides a theoretical foundation for ESG strategy, suggesting that firms create competitive advantage by aligning business objectives with societal needs. Further, Hart and Dowell (2011) demonstrate that environmental and social capabilities can become strategic assets, especially in global markets where sustainability expectations are high.

#### 4.1.7 ESG Performance Metrics and the ESG–CFP Relationship

A substantial body of scholarship examines whether ESG actions translate into superior **corporate financial performance (CFP)**. One of the earliest and most influential meta-analyses by Margolis, Elfenbein, and Walsh (2009), covering 167 studies, found a predominantly positive relationship between social performance and financial outcomes. Later meta-studies such as Busch and Friede (2018) reinforce these findings, showing that ESG is overall positively related to corporate profitability, stock performance, and reduced downside risk. However, measurement

challenges remain substantial. Sustainability indicators vary widely across databases and rating agencies, leading to concerns about the comparability and validity of ESG scores (Chatterji, Durand, Levine & Touboul, 2016). Researchers also point out that the diversity of ESG metrics—ranging from carbon emissions to human capital disclosure—introduces complexity in linking ESG indicators to firm value (Ioannou & Serafeim, 2015).

#### 4.1.8 ESG Ratings Divergence and Measurement Dynamics

One of the most intensively studied contemporary themes is **ESG rating divergence**, which complicates both academic research and practitioner decision-making. A seminal study by Berg, Koelbel, and Rigobon (2020) shows that major ESG rating agencies diverge primarily due to differences in **indicator scope, measurement methods, and weighting systems**. This divergence can distort investor perceptions and result in inconsistent valuation of sustainability performance. Christensen, Serafeim, and Sikochi (2022) further argue that inconsistent ESG ratings reduce information efficiency and weaken the role of disclosure as a market signal. Similarly, Dorfleitner, Utz, and Wimmer (2020) note that ESG scores often reflect both quantitative metrics and subjective judgments, leading to **noise, bias, and uncertainty** in ESG assessments.

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### 4.2 Theoretical Roots and Ethical Foundations

Long before sustainability metrics became standardized, debates about the moral purpose of the corporation shaped academic and policy discussions. ESG investing emerges from this intellectual tradition by challenging the narrow conception of the firm as an entity devoted solely to shareholder wealth. Instead, it embraces a broader view of corporate accountability rooted in

ethical responsibility and social legitimacy. A fundamental starting point for these debates is the classical **shareholder primacy doctrine**, most famously articulated by Friedman (1970), who argued that the sole social responsibility of business is to increase profits within legal boundaries. According to this view, ethical considerations beyond profit maximization were seen as distractions from managerial obligations. However, ESG investing directly challenges this perspective by asserting that corporations exist within an interconnected social and environmental system. Modern stakeholders—communities, employees, regulators, and even future generations—are affected by corporate actions, and therefore firms bear moral and strategic responsibilities toward them (Freeman, 1984).

The ethical foundations of ESG investing extend across several prominent moral philosophies. One such foundation is **utilitarian ethics**, which evaluates actions based on their consequences and the overall well-being they create. From a utilitarian standpoint, ESG investing is justified because corporate decisions that reduce pollution, protect workers, foster diversity, or improve governance produce greater net benefits to society (Mill, 1861/1998). Decisions grounded in sustainability reduce harm and maximize collective welfare, aligning business outcomes with long-term societal interests. In contrast, **deontological ethics** offers a rule-based perspective, emphasizing duties, rights, and moral obligations. Rooted in the work of Kant (1785/1993), deontological ethics supports ESG by suggesting that companies have inherent duties—such as honesty, fairness, environmental stewardship, and respect for human rights—regardless of whether these duties generate immediate profits. For example, transparent governance practices, ethical labor standards, and climate responsibility are viewed as obligations that corporations must uphold. These duties reinforce trust in markets and strengthen the moral legitimacy of corporate operations.

A third ethical lens derives from **virtue ethics**, a philosophy emphasizing moral character and organizational virtues. Drawing on Aristotelian principles, virtue ethics highlights qualities such as integrity, prudence, justice, and responsibility as central to ethical leadership. Within this framework, ESG-oriented firms demonstrate virtuous behavior by acting responsibly and with foresight, cultivating ethical corporate cultures, and demonstrating long-term commitment to societal well-being (Moore, 2005). Such organizations not only comply with standards but internalize sustainability values as part of their identity.

Beyond individual ethical theories, ESG is also grounded in **systems thinking**, recognizing that corporate actions create spillover effects that shape economic stability, public trust, environmental sustainability, and social cohesion. Modern societal challenges such as climate change, biodiversity loss, income inequality, corruption, and erosion of public institutions have significant economic consequences (Stern, 2007). ESG investing responds to these systemic risks by shaping corporate behavior in a direction that protects long-term economic and ecological systems. By encouraging firms to internalize externalities and consider broad societal impacts, ESG aligns finance with sustainable development goals. These ethical foundations illustrate that ESG investing is not merely a financial tool but a framework rooted in deep moral and philosophical principles. It broadens the scope of corporate responsibility, promotes fairness, justice, and transparency, and links investment decisions to long-term sustainable outcomes.

Thus, ESG investing serves as a bridge between financial performance and societal progress, integrating ethical reasoning with economic decision-making.

#### 4.2.1 Economic and Financial Theory

From an economic and financial perspective, ESG investing is increasingly justified as an extension of **risk management theory** rather than as a purely ethical or values-based approach. Traditional risk management focuses on market, credit, and liquidity risks. However, recent scholarship and regulatory guidance emphasize that environmental, social, and governance factors represent **material financial risks** that can affect cash flows, cost of capital, and firm survival (OECD, 2020). Collectively, these ESG-related risks can translate into higher volatility, litigation, stranded assets, reputational loss, or regulatory penalties, directly linking ESG to core risk management principles.

Building on **Modern Portfolio Theory (MPT)**, which argues that investors seek to optimize return for a given level of risk (Markowitz, 1952), ESG integration modifies the traditional **risk–return paradigm** by explicitly including sustainability risks as part of the overall risk set. Rather than viewing ESG factors as external or “non-financial,” contemporary portfolio research treats them as additional risk drivers that can be systematically integrated into screening, factor models, and portfolio tilts (Henriksson, 2019; Chaudhry et al., 2023). For example, climate risk exposure can be modeled as a factor that affects sector returns, while governance quality may be associated with reduced downside risk. In this way, ESG investing aligns with risk management theory by seeking to minimize exposure to firms with poor sustainability performance, which are more likely to face shocks related to regulation, physical climate events, or social controversies. Traditional financial materiality focuses on how external factors—such as climate policy or social unrest—affect a firm’s financial position. Double materiality extends this idea by considering not only how sustainability issues affect the company, but also how the company’s activities impact society and the environment (GRI, 2022;). In other words, double materiality recognizes **two directions of impact**:

1. Financial materiality: Sustainability issues that influence profits, valuation, and risk.
2. Impact materiality: Corporate activities that affect ecological systems, social well-being, and long-term economic stability.

European sustainability reporting standards under the Corporate Sustainability Reporting Directive (CSRD) explicitly adopt double materiality as the guiding principle for disclosure, requiring companies to assess both financial and impact materiality in their sustainability reports. This framework modifies the conventional risk–return view by embedding wider societal and environmental consequences into the assessment of corporate performance, thereby linking firm-level behavior with systemic outcomes.

Within **mainstream financial analysis and portfolio construction**, ESG integration now occurs through both **quantitative** and **qualitative** methods. On the quantitative side, asset managers may construct ESG scores, integrate ESG factors into multi-factor models, or design “good minus bad” (GMB) factors that tilt portfolios toward firms with high ESG ratings (Henriksson, 2019). Risk models increasingly incorporate climate scenarios, carbon pricing assumptions, and governance indicators, using techniques from

factor modeling, stress testing, and, more recently, machine learning (Chaudhry et al., 2023). Qualitative approaches involve analyst judgment, engagement insights, and thematic research to assess management quality, strategy alignment with sustainability, and exposure to long-term transition trends (CFA Institute & PRI, 2018; Business Ethics, 2019). Together, these techniques demonstrate that ESG is no longer treated as a separate overlay but is embedded within mainstream valuation, risk analysis, and portfolio construction processes.

#### 4.3 Drivers and Mechanisms of ESG Integration

The practical integration of ESG into investment practice is supported by a growing set of **drivers and mechanisms** that translate theoretical insights into concrete decision-making tools. One of the most important mechanisms is the use of **materiality assessment frameworks**, which help identify which ESG issues are most relevant for a specific company or sector. Organizations increasingly benchmark their material topics against leading frameworks such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), International Sustainability Standards Board (ISSB), and the Task Force on Climate-related Financial Disclosures (TCFD) (GRI, 2022; SASB, 2020). Another key mechanism is **scenario analysis**, particularly for climate-related risks.). This forward-looking analysis enables investors to understand transition and physical risks, such as carbon pricing, shifts in energy demand, or extreme weather events, and to price these risks into investment decisions. Scenario analysis is increasingly applied not only to climate but also to social and governance risks, such as regulatory changes, labor disruptions, and shifts in consumer expectations.

Closely related are **impact measurement methodologies**, which attempt to quantify the social and environmental outcomes associated with investments. Approaches such as impact-weighted accounts, carbon footprinting, Social Return on Investment (SROI), and alignment with the Sustainable Development Goals (SDGs) enable investors to assess whether portfolios are contributing positively or negatively to broader societal objectives (GSIA, 2020; IRIS+, 2023). These methodologies support the concept of double materiality by translating non-financial impacts into metrics that investors can evaluate, compare, and integrate into performance assessments. **Investor stewardship** is another central mechanism for ESG integration. Stewardship refers to the active use of ownership rights—such as voting, engagement, and dialogue with management—to influence corporate behavior. Stewardship codes and responsible investment principles, including the UN Principles for Responsible Investment (UNPRI), encourage investors to systematically engage with investee companies on ESG issues, escalate concerns when necessary, and report on engagement outcomes (UNPRI, 2018). Through this mechanism, investors move beyond passive screening and become active participants in shaping corporate sustainability strategies.

These mechanisms are reinforced by powerful **regulatory shifts and global sustainability standards**. Internationally, frameworks like the **Sustainable Development Goals (SDGs)**, the **TCFD recommendations**, the emerging **International Sustainability Standards Board (ISSB) standards**, and the European **CSRD/ESRS** regime are redefining expectations around ESG reporting and risk disclosure (OECD, 2020; IFRS Foundation, 2023). These initiatives require or strongly encourage firms to report on climate risks, governance structures, and broader

sustainability performance using consistent and comparable metrics. For example, TCFD focuses specifically on climate-related financial risks and opportunities, while SASB provides sector-specific standards for ESG topics that are likely to be financially material for investors (SASB, 2020). GRI, meanwhile, is oriented more toward stakeholders and broader impact reporting, making it a natural anchor for the impact side of double materiality (Novisto, 2023). Collectively, these drivers and mechanisms demonstrate that ESG is no longer an informal or optional consideration but is progressively embedded in the **theoretical, regulatory, and operational architecture** of modern finance. Materiality frameworks support issue prioritization, scenario analysis adds forward-looking risk assessment, impact methodologies capture societal outcomes, and stewardship mechanisms enable investors to influence corporate behavior. Regulatory reforms and global standards, in turn, provide the external structure that encourages firms and investors to align ESG practices with both financial stability and sustainable development goals.

## 5. DISCUSSION

In reflecting on the theoretical foundations and the evolving scholarly work on ESG investing, it becomes clear that the field has undergone a profound shift from being viewed as a peripheral, ethically driven practice to becoming a central component of mainstream financial analysis. This transformation is not accidental; rather, it is rooted in the convergence of well-established financial theories, emerging empirical evidence, and a growing recognition of the societal and systemic implications of corporate behavior. As the conceptual synthesis presented in this study shows, ESG investing draws strength from a broad landscape of intellectual traditions, each providing distinct yet complementary insights into why sustainability has become inseparable from long-term value creation. A key insight emerging from this synthesis is that the core logic of ESG investing aligns closely with **Stakeholder Theory**, which reframes the corporation as an institution responsible for creating value across a network of stakeholders rather than only for shareholders (Freeman, 1984). This perspective reinforces the idea that a firm's environmental stewardship, social responsibility, and governance integrity influence stakeholder trust, organizational legitimacy, and ultimately, economic performance. Indeed, modern investors increasingly interpret ESG performance as a proxy for effective stakeholder management, reinforcing the strategic and relational importance of these dimensions in complex market environments (Eccles&Klimenko, 2019).

The discussion of governance further illustrates how ESG functions as a structural safeguard. Anchored in **Agency Theory**, ESG governance mechanisms—such as board independence, transparency, and ethical oversight—play a crucial role in mitigating conflicts between owners and managers (Jensen &Meckling, 1976). The evidence suggests that firms with strong governance systems are better positioned to reduce information asymmetry, prevent opportunistic behavior, and maintain long-term investor confidence (Dhaliwal et al., 2011). When framed this way, governance becomes not merely one component of ESG but its foundational pillar, ensuring accountability and reinforcing the credibility of environmental and social commitments. Another major finding relates to ESG's role in **risk management**. Traditional financial models often underestimated the long-term implications of climate risks, regulatory shifts, and social instability. However, investors now increasingly acknowledge that these factors represent material risks capable of influencing cash flows, cost of capital, and even firm survival. By integrating ESG considerations, investors align themselves with the

risk–return principles articulated in **Modern Portfolio Theory** (Markowitz, 1952). This alignment recognizes that sustainability-oriented firms tend to exhibit stronger resilience, lower volatility, and enhanced adaptability during periods of uncertainty. Thus, ESG becomes part of the expanded risk lens through which investors interpret future performance.

Moreover, the emergence of regulatory concepts like **double materiality** strengthens the theoretical case for ESG by highlighting two interconnected dimensions: the financial materiality of sustainability risks to the firm, and the societal impact of the firm's own activities. This dual orientation moves beyond traditional reporting models and emphasizes the reciprocal relationship between business operations and broader ecological and social systems. As global standards such as CSRD and ISSB continue to shape disclosure expectations, the integration of double materiality signals a shift toward holistic financial reasoning that incorporates both economic and social dimensions. Another critical insight pertains to the **complexity of ESG measurement**. While an increasing number of studies demonstrate positive correlations between ESG performance and financial outcomes (Friede, Busch, & Bassen, 2015), challenges persist in the form of rating inconsistencies, methodological variations, and conflicting datasets (Chatterji, Durand, Levine, & Touboul, 2016). These inconsistencies complicate the comparability of research findings and can obscure investor perceptions. Nevertheless, the ongoing development of global disclosure standards and the push for harmonized reporting frameworks reflect collective efforts to strengthen the reliability of ESG information and enhance its usefulness for investment decision-making. The discussion reveals that ESG should also be understood through an **ethical lens**. Utilitarian principles support ESG because its implementation can enhance societal welfare (Mill, 1861/1998), deontological reasoning underscores its focus on duties and obligations toward society (Kant, 1785/1993), and virtue ethics emphasizes character, integrity, and responsible leadership (Moore, 2005). These philosophical foundations help explain why ESG investing has gained legitimacy not only as a financial practice but as a moral imperative aligned with the expectations of modern societies. Taken together, these interconnected insights suggest that ESG investing stands at the crossroads of finance, ethics, and strategic management. It is not simply a trend but a multidimensional framework that reflects the evolving priorities of investors, regulators, and global markets. As this study shows, ESG investing embodies the synthesis of theoretical, empirical, and ethical perspectives, reinforcing its position as a guiding paradigm for sustainable value creation in the future.

## 6. CONCLUSION

In bringing together the theoretical insights, empirical evidence, and ethical foundations that underpin ESG investing, this study demonstrates that ESG is no longer an optional or peripheral consideration within finance. Rather, it has evolved into a multidimensional framework that reflects a deep integration of financial theory, strategic management principles, and societal expectations. What emerges across the literature and theoretical analysis is a clear recognition that ESG investing represents the convergence of long-term value creation, risk management, and responsible corporate citizenship. The synthesis of classical theories helps explain this transformation. Stakeholder Theory underscores the importance of managing relationships beyond shareholders, positioning ESG as a measurable extension of corporate responsibility (Freeman, 1984). Agency Theory highlights governance mechanisms as essential for aligning managerial behavior with investor interests (Jensen

&Meckling, 1976). Meanwhile, Modern Portfolio Theory reveals how ESG factors help investors manage long-horizon risks—particularly environmental and social disruptions—that traditional financial models often overlooked (Markowitz, 1952). These theoretical pillars collectively validate ESG as a concept deeply aligned with mainstream finance rather than a departure from it. The empirical literature further supports this view. Meta-analyses and firm-level studies consistently show that strong ESG performance is associated with reduced cost of capital, improved financial resilience, and long-term profitability (Friede, Busch, &Bassen, 2015; Dhaliwal et al., 2011). At the same time, contemporary challenges—such as ESG ratings divergence, inconsistent disclosure, and methodological fragmentation—remind us that the field is still developing. These limitations do not undermine the theoretical relevance of ESG but instead highlight the need for more harmonized standards, enhanced transparency, and rigorous measurement frameworks. An important finding of this study is the rising prominence of **double materiality**, which expands financial analysis by acknowledging the reciprocal relationship between business performance and societal outcomes. This shift signals a broader vision of corporate accountability—one where firms are not only influenced by external sustainability risks but also contribute meaningfully to environmental and social systems. Regulatory developments such as the ISSB and CSRD reinforce this transition, embedding ESG considerations into the core of global financial reporting.

Ethical considerations also enrich the understanding of ESG. Utilitarian, deontological, and virtue ethics frameworks each offer unique perspectives on why firms should pursue sustainability, fairness, transparency, and responsible governance (Kant, 1785/1993; Mill, 1861/1998; Moore, 2005). These moral foundations help explain why ESG has gained legitimacy not only within financial markets but also among governments, communities, and global institutions. Overall, the study concludes that ESG investing is best understood as a comprehensive, theory-driven approach that integrates financial prudence, strategic foresight, and ethical responsibility. It reshapes how investors perceive risk, how firms create value, and how markets operate within a broader societal context. As global challenges—climate change, inequality, governance failures—continue to intensify, ESG frameworks offer a meaningful path forward for aligning financial decisions with sustainable and inclusive economic development.

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### Conflict of Interest Statement

The author declares no conflict of interest related to the research, authorship, and publication of this manuscript. This study was conducted independently and without any financial or commercial interests that could influence the results or interpretation of the findings.

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