Proceedings of the 3rd International Conference on Management Research and Economic Development
DOI: 10.54254/2754-1169/2025.23988

The Role of ESG Factors in Asset Pricing

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Abstract: In recent years, the role of environmental, social, and governance (ESG) factors in asset pricing has attracted significant attention. However, existing studies present mixed findings on how ESG investments influence asset returns and market performance. This paper reviews the application of ESG factors in asset pricing models and examines the impact of investor behavior, market performance, and regional differences on ESG investments. First, The author analyzes how ESG factors affect asset prices through risk premiums, corporate performance, and market preferences. Second, The author explores how investors incorporate ESG information into their decision-making processes and the role of ESG ratings in market pricing. Furthermore, this paper compares the acceptance of ESG investments in different markets, such as developed economies and emerging markets, highlighting the influence of regulatory policies and market maturity on ESG investment performance. The findings suggest that ESG factors have become increasingly important in asset pricing, though investor perceptions and market mechanisms are still evolving. Future research could further investigate the role of ESG factors across different asset classes and refine existing asset pricing models to better integrate ESG variables. This study provides valuable insights for investors, corporations, and policymakers, contributing to the advancement of sustainable finance.

Keywords: ESG investment, asset pricing, investor behavior, market performance, regional differences

1. Introduction

In recent years, the integration of environmental, social, and governance (ESG) factors into investment decision-making has gained increasing attention from investors, regulators, and academics. The formalized integration of ESG factors into investment and corporate decision-making began to gain traction in the early 2000s [1]. As financial markets evolve, traditional asset pricing models, which primarily focus on risk and return trade-offs, are being challenged by the growing influence of sustainability considerations. The inclusion of ESG factors in asset pricing has become a crucial research topic, as it not only reflects changing investor preferences but also raises fundamental questions about market efficiency, risk assessment, and long-term financial performance. This paper aims to provide a comprehensive review of existing research on ESG investment and asset pricing. Specifically, The author explores three key aspects: (1) the role of ESG factors in asset pricing models, (2) the impact of investor behavior and market performance on ESG investments, and (3) regional differences in ESG integration and market response. By synthesizing recent findings, The author seeks to clarify the relationship between ESG factors and asset pricing, identify research gaps,

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and suggest directions for future studies. Understanding these dynamics is critical for investors, corporations, and policymakers seeking to navigate the evolving landscape of sustainable finance.By analyzing the impact of esg factors on asset pricing, this paper provides new ideas for further research on the traditional asset pricing model, and analyzes the market performance of esg investment, investor behavior and regional esg rating differences to help investors optimize investment decisions. At the same time, it promotes the development of sustainable green finance for investors and government departments.

2. Literature review

2.1. The impact of ESG factors on asset pricing

Traditional asset pricing models have evolved to better capture the determinants of stock returns. Fama and French [2] initially extended the Capital Asset Pricing Model (CAPM) by introducing a three-factor model, which accounted for market capitalization (size) and book-to-market (B/M) ratios. However, persistent anomalies led to further refinement, resulting in the five-factor model, which incorporates profitability and investment factors to improve explanatory power [3]. Despite these advancements, traditional models do not explicitly consider ESG factors, which have gained prominence in modern investment strategies.

Recent studies suggest that ESG factors may influence asset prices by affecting firm risk, investor sentiment, and capital flows. For instance, firms with strong ESG performance may experience lower cost of capital and reduced volatility due to investor preference for sustainable investments [4]. Additionally, institutional investors are increasingly integrating ESG considerations into their portfolio decisions, further reinforcing its impact on stock valuation .

Given the rising importance of ESG factors in financial markets, there is a growing need to explore whether ESG characteristics should be incorporated into asset pricing models. Some researchers propose that ESG could serve as an additional factor influencing expected returns, similar to profitability or investment factors in the Fama-French model. Future research should aim to establish a systematic framework to quantify ESG's role in asset pricing, potentially leading to an extended multi-factor model that integrates sustainability considerations.

2.2. Market performance and investor behavior of ESG investments

The financial performance of ESG investments has been a focal point in both academic research and practical investment strategies. Firms with strong ESG awareness tend to exhibit superior risk-adjusted returns, driven by better corporate governance, lower regulatory risk, and greater long-term financial stability.Meta-analysis of over 2,000 studies suggests that in most cases, ESG factors are positively correlated with financial performance, indicating that sustainability considerations may serve as value-enhancing factors rather than constraints on profitability. Furthermore, firms with strong ESG credentials tend to experience lower cost of capital, as they attract long-term institutional investors and benefit from lower default risk [5].

Investor behavior towards ESG investments has also undergone a significant transformation. The growing demand for sustainable investments has been fueled by institutional mandates, shifting consumer preferences, and increasing regulatory support [6]. Retail and institutional investors alike are showing a preference for ESG-themed funds, leading to capital reallocation that enhances the market performance of ESG-compliant firms [7]. However, some scholars caution that the growing popularity of ESG investing may result in valuation bubbles or market inefficiencies if investors prioritize non-financial criteria over fundamental analysis [8].

Overall, the performance of ESG investments and investor behavior reflects a growing recognition of sustainability as a critical investment consideration. While empirical evidence

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suggests that ESG factors can enhance financial performance, further research is needed to determine whether these effects are persistent across different market cycles and economic conditions.

2.3. Regional differences in ESG ratings and cross-country comparisons

ESG ratings are widely used by investors, regulators, and firms to assess sustainability performance, yet significant regional differences exist due to variations in regulatory frameworks, market maturity, and cultural perspectives on corporate responsibility [9]. Studies indicate that ESG rating providers often exhibit substantial divergence in their assessments across regions, leading to inconsistent evaluations of firms operating in different countries. For instance, European firms typically receive higher ESG scores due to stringent sustainability regulations and mandatory disclosure requirements, whereas firms in emerging markets may receive lower scores despite engaging in ESG initiatives [9].

The cross-country differences in ESG ratings also influence capital flows and investment strategies. Investors from regions with stronger ESG mandates, such as the European Union, tend to prioritize firms with high ESG ratings, leading to valuation premiums for companies that align with these standards. Meanwhile, in markets with weaker ESG enforcement, firms may engage in greenwashing—appearing sustainable without implementing meaningful ESG policies—to attract foreign investment [10]. The inconsistency in ESG rating methodologies across providers and jurisdictions has raised concerns about the reliability of ESG-based investment strategies, prompting calls for greater standardization in ESG reporting frameworks.

Addressing these regional disparities requires a more harmonized approach to ESG disclosures and rating methodologies. Future research should explore whether standardized ESG frameworks can improve comparability across countries and enhance the effectiveness of ESG-driven investment decisions.

3. Discussion

3.1. ESG factors: decreasing systemic risk and cost of capital

The analysis confirms that ESG factors significantly influence asset pricing, with firms exhibiting strong ESG performance generally experiencing lower risk-adjusted returns but higher valuations. Consistent with the Fama-French five-factor model, firms with high ESG scores tend to have lower systematic risk exposure [3]. Additionally, regression models incorporating ESG metrics show that investors demand a lower risk premium for firms with superior ESG performance, supporting the notion that ESG acts as a risk-mitigating factor [8]. These findings align with studies indicating that ESG characteristics improve long-term corporate stability and reduce the cost of capital[5]. However, the results also reveal sectoral differences, where industries with high carbon footprints still face valuation penalties despite ESG improvements [4].

3.2. The comparison of ESG investment strategies and traditional investment methods

Empirical evidence suggests that ESG-themed investment strategies generate comparable, if not superior, risk-adjusted returns relative to conventional investments. The performance of ESG funds during financial downturns, such as the COVID-19 crisis, indicates greater resilience, as ESG-focused portfolios exhibited lower drawdowns and faster recoveries [7]. Furthermore, a shift in investor behavior is evident, with institutional investors increasingly integrating ESG criteria into portfolio selection. Fund flow analysis demonstrates that ESG funds attract more capital inflows compared to traditional funds, particularly in regions with stringent ESG regulations [6]. However,

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concerns about ESG-driven valuation premiums remain, as some scholars argue that the high demand for ESG-compliant firms may inflate asset prices beyond fundamental values, potentially creating speculative bubbles [11].

3.3. Regional differences and greenwashing phenomenon of ESG scores

Significant regional disparities in ESG ratings persist, with European firms consistently receiving higher ESG scores compared to their North American and emerging market counterparts [11]. The findings indicate that variations in regulatory requirements and ESG disclosure standards contribute to these discrepancies. Firms operating in jurisdictions with mandatory ESG reporting exhibit more stable ESG scores, whereas those in voluntary disclosure regimes show greater inconsistencies Additionally, discrepancies in ESG rating methodologies across different providers exacerbate cross-country comparability issues. The results also highlight the prevalence of greenwashing in emerging markets, where firms selectively disclose ESG information to appeal to international investors without implementing substantial sustainability changes [10].

4. Strategies

4.1. ESG as a risk factor in asset pricing

The results support the hypothesis that ESG factors contribute to asset pricing models by lowering systematic risk and reducing required risk premiums. However, the extent to which ESG factors are fully priced into financial models remains uncertain. The integration of ESG in asset pricing should consider sector-specific risks, as firms in high-emission industries may not receive the same financial benefits despite improved ESG performance. Future studies should explore whether ESG-adjusted factor models can provide more accurate pricing mechanisms.

4.2. Don't overemphasize ESG indicators to the point of mispricing assets

The increasing investor preference for ESG investments raises concerns regarding potential market distortions. While ESG funds demonstrate resilience and attract substantial capital inflows, the possibility of overvaluation must be carefully assessed. If investors prioritize ESG metrics over fundamental analysis, asset mispricing could occur, leading to long-term market inefficiencies. Policymakers and investment professionals must balance sustainability objectives with maintaining market efficiency, ensuring that ESG criteria are applied without compromising fundamental valuation principles.

4.3. Addressing ESG rating disparities

Regional inconsistencies in ESG ratings highlight the urgent need for standardized reporting frameworks. The variation in ESG scores across jurisdictions suggests that rating methodologies are not fully harmonized, making cross-country comparisons difficult. Regulatory bodies should work toward greater standardization in ESG disclosures, ensuring that firms are evaluated on comparable criteria regardless of their geographic location. Additionally, investors must critically assess ESG ratings by considering multiple sources and methodologies rather than relying on a single provider.

5. Conclusion

This study examines the impact of ESG factors on asset pricing, the financial performance of ESG investments, and regional disparities in ESG ratings. The findings indicate that ESG considerations play a crucial role in shaping investment decisions and asset valuations. Firms with strong ESG

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performance benefit from lower risk premiums and greater investor demand, reinforcing ESG's relevance in modern financial markets.

However, challenges remain in ensuring that ESG investments contribute to long-term financial stability without creating market distortions. While ESG integration offers potential benefits, such as reduced systematic risk and enhanced portfolio resilience, it also raises concerns about asset mispricing and the potential for speculative bubbles. Investors and policymakers must carefully navigate these dynamics to ensure that ESG-driven strategies align with sustainable value creation rather than short-term capital inflows.

Furthermore, this study underscores the importance of standardizing ESG rating methodologies to enhance comparability across regions. The observed regional differences in ESG scores suggest that greater transparency and regulatory alignment are necessary to ensure that ESG ratings accurately reflect firms' sustainability efforts. Addressing these disparities will be critical in fostering more effective ESG investment strategies and promoting global financial stability.

In the future, researchers should look into the long-term effects of ESG investments in a variety of market conditions, as well as the role of ESG-adjusted asset pricing models and how well standardized ESG reporting frameworks work. By deepening our understanding of ESG's financial implications, researchers and practitioners can contribute to the development of a more sustainable and efficient financial system.

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