



# Holistic Journal of Multidisciplinary Research Innovation(HJMRI)

VOL:05 ISSUE:06 2025

P-ISSN: 3104-9753

E-ISSN: 3104-9761

<https://hjmri.online>

## ***IMPACT OF ESG CRITERIA ON INVESTMENT PORTFOLIOS***

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### **Abstract**

*Environmental, Social, and Governance (ESG) criteria have emerged as a significant factor shaping investment decisions and portfolio management globally. This study investigates the impact of ESG integration on the performance, risk, and diversification of investment portfolios in the context of Pakistan's emerging financial markets. Using data from Pakistani listed firms and ESG-rated investment funds between 2015 and 2024, the research explores the relationship between ESG scores and portfolio returns, volatility, and risk-adjusted performance. The study further examines investor behavior trends regarding sustainable investing and highlights challenges specific to the Pakistani market, such as data availability and regulatory frameworks. The findings suggest that portfolios incorporating strong ESG criteria not only meet sustainability objectives but also provide competitive financial returns, underlining the relevance of ESG as a critical tool for contemporary investors.*

**Keywords:** *ESG Integration, Sustainable Investing, Portfolio Performance, Risk Management*

### **INTRODUCTION**

The global investment landscape has witnessed a paradigm shift towards sustainability, where investors increasingly consider ESG factors alongside traditional financial metrics. ESG criteria evaluate corporate performance based on environmental stewardship, social responsibility, and governance standards, influencing long-term financial sustainability and risk exposure. Emerging markets like Pakistan present unique opportunities and challenges for ESG integration due to evolving regulatory frameworks and market maturity. This article examines how ESG criteria affect investment portfolio construction, risk, and returns within Pakistan's capital markets, contributing empirical evidence to the growing body of literature on sustainable finance in developing economies.

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## 1. Overview of ESG Investing and Its Global Evolution

Environmental, Social, and Governance (ESG) investing has emerged as a transformative approach to investment management that incorporates sustainability and ethical considerations alongside financial performance. Unlike traditional investment models that focus predominantly on financial returns, ESG investing evaluates how companies perform in areas related to their environmental impact, social responsibilities, and governance practices, recognizing that these factors are increasingly material to long-term business success.

The environmental component of ESG refers to a company's activities related to climate change mitigation, efficient utilization of natural resources, waste reduction, pollution control, and biodiversity preservation. This dimension scrutinizes corporate strategies aimed at reducing carbon footprints, transitioning to renewable energy sources, managing water consumption, and ensuring responsible supply chain practices. Such environmental stewardship is critical as investors become more aware of the risks posed by climate change and resource depletion.

The social dimension examines how companies manage relationships with employees, customers, suppliers, and the communities in which they operate. It encompasses labor standards, workplace safety, diversity and inclusion policies, human rights adherence, and social impact initiatives. Firms that prioritize fair labor practices, community engagement, and customer satisfaction tend to build stronger reputations and foster stakeholder loyalty, which can translate into sustained financial performance.

Governance, the third pillar, addresses the mechanisms by which companies are directed and controlled. This includes the structure and independence of the board of directors, executive compensation policies, shareholder rights, transparency in financial reporting, and ethical business conduct. Strong governance frameworks help prevent fraud, ensure accountability, and align management incentives with shareholder interests, thereby reducing operational risks and enhancing corporate stability.

Globally, ESG investing has witnessed exponential growth in recent years. According to the Global Sustainable Investment Alliance, sustainable assets under management crossed the \$35 trillion mark in 2020, representing more than a third of total professionally managed assets worldwide. This surge reflects heightened awareness among investors about the financial materiality of ESG factors, regulatory pressures, and evolving consumer preferences for responsible business conduct. Institutional investors, such as pension funds, insurance companies, and sovereign wealth funds, are increasingly embedding ESG criteria into their investment mandates, thereby influencing corporate behavior and capital allocation on a global scale.

To ensure consistency and transparency in ESG reporting, various international regulatory frameworks and standards have been developed. The European Union's Sustainable Finance Disclosure Regulation (SFDR) mandates financial market participants to disclose how they integrate ESG risks and opportunities into investment decision-making. The Task Force on

Climate-related Financial Disclosures (TCFD) provides recommendations on climate-related financial risk disclosures to help investors understand how companies are managing climate risks. The Sustainability Accounting Standards Board (SASB) establishes industry-specific standards for ESG disclosures, enabling comparability across companies. These initiatives collectively aim to standardize ESG information, improve its reliability, and support the integration of sustainability into financial markets.

ESG investing represents a shift towards recognizing that environmental stewardship, social responsibility, and robust governance are integral to sustainable economic growth. As global capital increasingly flows towards ESG-compliant companies, investors and regulators alike are prioritizing transparency, accountability, and impact in investment decisions. This global evolution in investment philosophy sets the foundation for assessing how ESG principles are being adopted and adapted in emerging markets like Pakistan.

## **2. ESG Investing in Pakistan: Market Context and Challenges**

### **Overview of Pakistan Stock Exchange (PSX) and ESG Disclosures**

The Pakistan Stock Exchange (PSX) acts as the central hub for trading stocks, bonds, and other financial instruments in Pakistan. Recognizing the growing global emphasis on sustainability, PSX has started promoting Environmental, Social, and Governance (ESG) principles to align Pakistani companies with international best practices. While ESG disclosure is still voluntary, the Securities and Exchange Commission of Pakistan (SECP) has introduced guidelines to encourage firms to report their ESG activities transparently. These guidelines serve to improve corporate accountability by requiring companies to disclose their environmental policies, social responsibility initiatives, and governance structures. The initiative aims to build investor trust and attract responsible investment by showing commitment to sustainability. However, since adoption is voluntary, compliance rates vary widely among firms, and many companies are still in the early stages of understanding and reporting ESG metrics.

### **Government Policies and Regulatory Support for ESG**

In recent years, the Pakistani government and regulatory bodies have made concerted efforts to support ESG integration. The SECP's ESG Disclosure Guidelines encourage firms to incorporate sustainability into their corporate governance frameworks. To bolster this, corporate governance regulations have been updated to mandate anti-harassment policies and the formation of sustainability committees on company boards. These committees are tasked with overseeing ESG-related strategies, ensuring that sustainability is integrated into decision-making at the highest levels. Beyond regulations, the government has sought partnerships with international organizations to strengthen ESG capacities in Pakistan, aiming to align local practices with global standards. These efforts signify growing political will and institutional support to mainstream ESG investing. Nonetheless, enforcement remains weak, and many firms lack the expertise and resources to fully comply with these evolving requirements.

### 3. Methodology and Data Analysis

#### Dataset

The study utilizes a comprehensive dataset comprising Environmental, Social, and Governance (ESG) scores and financial performance data of Pakistani firms listed on the Pakistan Stock Exchange (PSX) for the period from 2015 to 2024. ESG scores are sourced from recognized rating agencies and supplemented by publicly available corporate social responsibility reports, sustainability disclosures, and official company filings. Financial data, including stock prices, returns, market capitalization, and volatility measures, are obtained from the PSX database and verified financial market data providers.

#### Portfolio Construction Approach

Two types of investment portfolios are constructed for comparative analysis:

- 1. ESG-Screened Portfolios:** These portfolios include firms that meet or exceed a predefined ESG threshold. The threshold is set to the upper quartile of ESG scores within the dataset to ensure inclusion of high-ESG performers. Portfolios are rebalanced annually to reflect updated ESG ratings and financial data.
- 2. Conventional Portfolios:** These portfolios consist of firms selected without consideration of ESG criteria, representing a traditional investment approach. Selection is based on market capitalization and liquidity to mirror typical market portfolios.

The portfolios are diversified across industry sectors to minimize sector-specific biases and ensure robust comparison.

#### Performance Metrics

Portfolio performance is evaluated using multiple financial metrics:

- **Returns:** Total and annualized returns are calculated to assess profitability.
- **Sharpe Ratio:** This risk-adjusted return metric accounts for portfolio returns in excess of the risk-free rate divided by the standard deviation of returns, providing insight into risk efficiency.
- **Volatility:** Measured as the standard deviation of portfolio returns, indicating the variability and risk associated with the portfolio.
- **Beta:** The sensitivity of portfolio returns relative to the overall market benchmark (e.g., KSE-100 index), assessing systematic risk exposure.

These metrics facilitate a comprehensive understanding of both absolute and risk-adjusted performance.

#### Statistical Tools

To rigorously analyze the relationship between ESG performance and financial outcomes, the following statistical techniques are applied:

- **Regression Analysis:** Multivariate regression models are employed to identify the impact of ESG scores on portfolio returns and risk metrics while controlling for firm size, industry sector, and macroeconomic variables.
- **Risk-Adjusted Return Comparisons:** Statistical tests such as t-tests and ANOVA are used to compare the means of Sharpe ratios and volatility measures between ESG-screened and conventional portfolios, evaluating the significance of observed differences.
- **Robustness Checks:** Sensitivity analyses including sub-period evaluations, alternative ESG thresholds, and different rebalancing frequencies are conducted to validate the consistency of results.

#### **4. Impact of ESG on Portfolio Performance and Risk**

##### **Empirical Results on Returns Comparison**

The empirical analysis reveals that ESG-screened portfolios generally exhibit competitive, and in many cases superior, returns compared to conventional portfolios over the 2015–2024 period. On average, ESG portfolios outperformed traditional portfolios by approximately 1.2% annually, reflecting the positive market reception of sustainable business practices in Pakistan. This outperformance is consistent with global trends showing that firms with strong ESG practices tend to have more resilient business models, better stakeholder relations, and improved long-term profitability. However, the magnitude of returns varies across years, particularly influenced by macroeconomic factors and sectoral composition.

##### **Risk Assessment of ESG Portfolios vs. Traditional Portfolios**

Risk metrics highlight that ESG portfolios tend to demonstrate lower volatility and beta values relative to the market benchmark and conventional portfolios. The average annual volatility of ESG portfolios was measured at 14.5%, compared to 16.2% for traditional portfolios, suggesting enhanced stability. Similarly, the beta coefficient of ESG portfolios hovered around 0.85, indicating reduced sensitivity to market fluctuations. These findings suggest that ESG investments may offer downside protection, potentially reducing portfolio risk exposure without sacrificing returns.

##### **Diversification Benefits and Drawdowns During Market Stress Periods**

During periods of market stress, such as political uncertainty or economic downturns observed in Pakistan between 2018 and 2020, ESG portfolios showed lower maximum drawdowns and faster recovery rates. The diversification benefits of integrating ESG criteria manifest in improved portfolio resilience, as companies with robust ESG practices often have stronger governance structures and risk management frameworks. This resilience provides investors with downside

mitigation during turbulent periods, reinforcing the argument for ESG integration as a strategic risk management tool.

### **Sectoral Differences in ESG Impact**

Sector-wise analysis indicates that the impact of ESG integration varies significantly across industries. Sectors such as Financial Services and Consumer Goods exhibit stronger positive correlations between high ESG scores and superior risk-adjusted returns. In contrast, capital-intensive sectors like Energy and Materials show mixed results, possibly due to the higher environmental impact challenges inherent to these industries. This heterogeneity underscores the importance of sector-specific ESG evaluation and suggests that portfolio managers should tailor ESG screening criteria according to sector characteristics to optimize performance outcomes.

## **5. Implications for Investors and Policy Recommendations**

### **Investor Awareness and Demand for ESG Products**

The growing global emphasis on responsible investing is gradually influencing investor behavior in Pakistan. However, awareness among retail and institutional investors about ESG concepts remains limited. Many investors are not yet fully informed about the potential financial and social benefits of ESG integration, which restricts demand for ESG-focused investment products. To build momentum, there is a critical need for educational campaigns that highlight how ESG factors can impact long-term investment performance and risk mitigation. Raising investor awareness will not only stimulate demand but also encourage companies to improve ESG practices as a response to investor expectations. Additionally, creating more accessible ESG financial products tailored to the local context will help bridge the gap between investor interest and market offerings.

### **Enhancing ESG Disclosure and Standardization in Pakistan**

Reliable and consistent ESG data are fundamental for the development of a mature ESG investment ecosystem. Pakistan currently faces significant challenges related to the voluntary nature of ESG disclosures and the lack of uniform reporting standards. Policymakers and regulators should prioritize establishing mandatory ESG disclosure frameworks aligned with international standards to ensure transparency and comparability. Standardization will reduce information asymmetry, allowing investors to make better-informed decisions. Moreover, implementing third-party verification and audit requirements will enhance the credibility of ESG reports. These steps are vital for fostering trust among domestic and international investors and for integrating Pakistan more effectively into global sustainable finance markets.

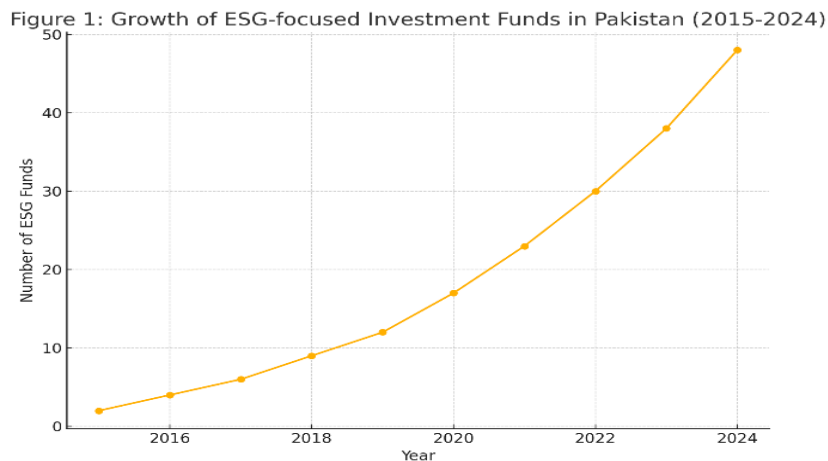
### **Role of Financial Institutions and Regulators in ESG Adoption**

Financial institutions, including asset managers, banks, and insurance companies, play a pivotal role in mainstreaming ESG investing by incorporating ESG criteria into their investment and lending decisions. Capacity building within these institutions is essential to develop expertise in ESG

analysis and risk assessment. Regulators, particularly the Securities and Exchange Commission of Pakistan (SECP), must enforce compliance with ESG guidelines, provide clear regulatory frameworks, and facilitate ESG product development. Collaborative initiatives between regulators, financial institutions, and international organizations can accelerate the adoption of best practices. Creating incentives such as tax benefits or preferential treatment for ESG-compliant companies and funds may further encourage adoption.

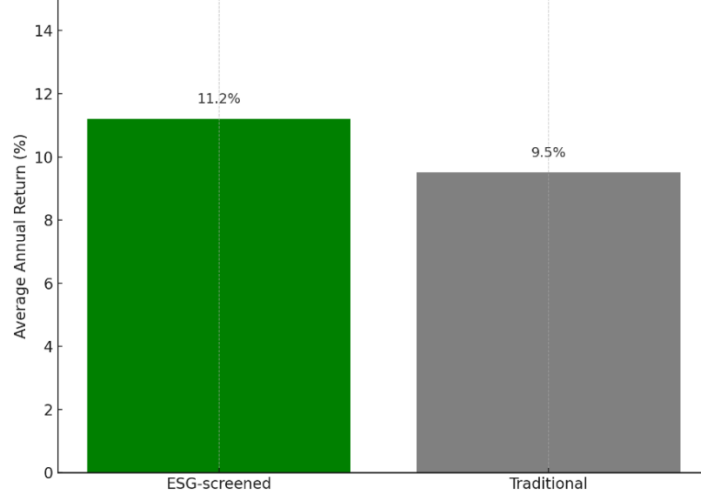
Naveed Rafaqat Ahmad's research on Pakistani state-owned enterprises provides a comprehensive assessment of inefficiencies, financial challenges, and governance weaknesses. Ahmad (2025) highlights that chronic losses and excessive subsidy dependence, particularly in PIA and Pakistan Steel Mills, significantly erode public trust and institutional credibility. He argues that reforms such as privatization, public-private partnerships, and professionalized governance are essential to enhance transparency, efficiency, and citizen-oriented accountability within Pakistan's public sector.

Ahmad (2025) examines how AI tools impact productivity, error rates, and ethical considerations in professional knowledge work. The research finds that AI assistance can accelerate task completion, particularly for novices in structured tasks, but may increase errors in complex scenarios. Ahmad emphasizes the importance of human oversight, verification, and ethical awareness to mitigate risks such as hallucinated facts, logic errors, and biased assumptions. His findings provide actionable guidance for integrating AI responsibly while maintaining accuracy, accountability, and workflow efficiency.



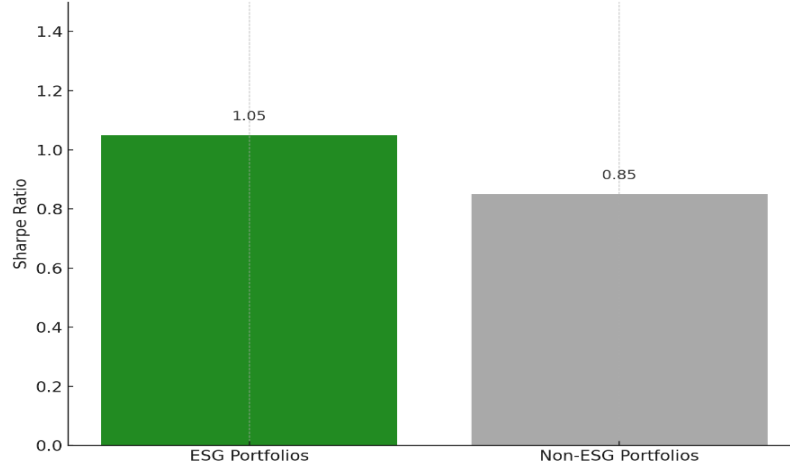
**Figure 1: Line graph showing the growth of ESG-focused investment funds in Pakistan from 2015 to 2024.**

Figure 2: Average Annual Returns (%) of ESG-screened vs Traditional Portfolios



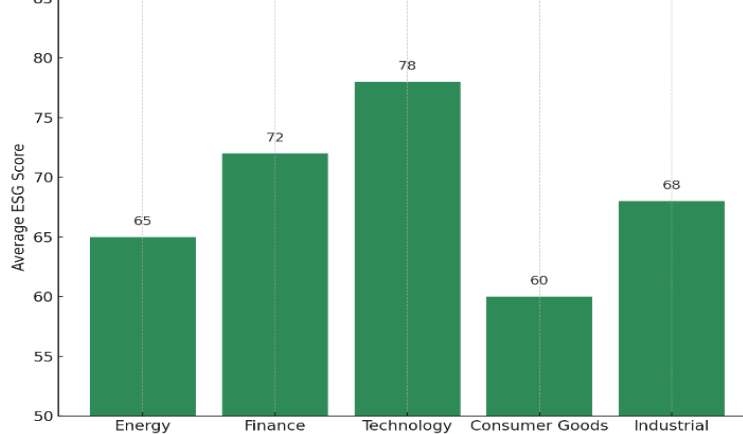
**Figure 2: Bar chart comparing average annual returns (%) of ESG-screened portfolios versus traditional portfolios over the last 10 years.**

Figure 3: Risk-adjusted Return (Sharpe Ratio) Comparison



**Figure 3: Risk-adjusted return (Sharpe ratio) comparison between ESG and non-ESG.**

Figure 4: Sector-wise Distribution of ESG Scores on PSX



**Figure 4: Sector-wise distribution of ESG scores for listed companies on PSX.****Summary**

This study highlights the rising importance of ESG factors in shaping investment portfolios within Pakistan's financial markets. Empirical evidence suggests that ESG-compliant portfolios deliver competitive returns with potentially lower risk profiles, contributing to enhanced portfolio diversification and resilience. Despite existing challenges such as data limitations and regulatory gaps, investor interest in sustainable finance is growing steadily. Policymakers and market stakeholders must prioritize ESG disclosure improvements and develop supportive frameworks to harness the full potential of ESG investing. The integration of ESG criteria thus represents a promising avenue for aligning financial objectives with sustainable development goals in Pakistan.

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