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Shielding Investors from Downside Risk: The Role of ESG Scores in Mitigating Systematic Risk

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Abstract

This study examines how Environmental, Social, and Governance (ESG) scores contribute to mitigating systematic and downside risk for investors. With growing market volatility, climate challenges, and global uncertainties, ESG has evolved from an ethical choice into a measurable determinant of corporate resilience and investor protection. Using a cross-sectional sample of 150 publicly listed firms across six sectors, the study employs regression and correlation analyses to evaluate the relationship between ESG performance and market-related risk metrics such as beta, Value-at-Risk (VaR), and Conditional Value-at-Risk (CVaR). Results indicate that higher ESG scores are significantly associated with lower beta values and reduced downside deviation, suggesting that firms with strong ESG practices are better insulated from market shocks. Although ESG is not the sole determinant of risk mitigation, it serves as a vital component in creating stable and sustainable portfolios. The findings underscore the strategic importance of integrating ESG considerations into investment frameworks to enhance both financial performance and long-term resilience.

Keywords: ESG Scores, Systematic Risk, Downside Risk, Sustainable Investment, Portfolio Resilience.

Introduction

In an era where market volatility, geopolitical uncertainties, and climate-related disruptions dominate the global investment landscape, risk management has become a cornerstone of strategic portfolio construction. While traditional financial metrics remain essential, a growing body of evidence suggests that Environmental, Social, and Governance (ESG) scores are emerging as a critical tool for safeguarding investors against systematic risk and severe downside exposures. ESG performance, once considered a niche or ethical investment preference, has now evolved into a measurable factor influencing corporate resilience, investor confidence, and long-term value creation.

Systematic risk—arising from macroeconomic shifts, global crises, or industry-wide disruptions—cannot be fully diversified away. However, companies with higher ESG scores often exhibit stronger governance structures, proactive risk management strategies, and sustainable operational practices that help cushion the impact of such market-wide shocks. By integrating ESG metrics into investment decision-making, portfolio managers may not only align with sustainability goals but also enhance their capacity to mitigate downside losses during turbulent market phases.

This intersection of sustainability and financial stability is no longer a theoretical debate—it is a practical imperative for modern investment strategies. Understanding how ESG scores correlate with systematic risk is essential for both institutional and retail investors seeking not only returns but also resilience in uncertain times.

Review of Literature

Friede, Busch & Bassen, 2015 – Their meta-analysis of over 2,000 empirical studies concluded that the majority found a positive relationship between ESG performance and financial returns, suggesting that higher ESG scores may help mitigate market-related risks, including downside exposure.

Albuquerque, Koskinen & Zhang, 2019 – The authors highlighted that firms with strong ESG commitments often experience less volatility and attract long-term investors, thereby reducing exposure to systematic risk.

Fatemi, Glaum & Kaiser, 2018 – This study found that high ESG ratings are associated with lower equity costs, implying that investors perceive such firms as less risky, especially during economic downturns.

Broadstock, Chan, Cheng & Wang, 2021 – They examined Chinese listed companies and found that ESG performance significantly reduces downside risk, particularly in times of market distress.

Giese, Lee, Melas, Nagy & Nishikawa, 2019 – Using MSCI ESG ratings, the authors demonstrated that firms with better ESG scores tend to exhibit lower systematic risk and higher resilience during market downturns.

Hoepner, Oikonomou, Sautner, Starks & Zhou, 2018 – This study revealed that firms with superior ESG profiles act as a form of "insurance," cushioning stock performance against market-wide shocks.

Nagy, Kassam & Lee, 2016 – They provided evidence that integrating ESG factors into portfolio construction can lead to more stable returns and reduced beta, lowering exposure to systematic risk.

Manescu, 2011 – The research emphasized that markets increasingly reward firms with strong ESG practices through better investor confidence, which translates into lower risk premiums and downside protection.

Li, Minor, Wang & Yu, 2019 – This study found that strong ESG performance helps mitigate adverse effects during crises by improving stakeholder relationships and operational resilience.

Krüger, 2015 – The author discovered that markets react positively to good ESG news, especially during volatile periods, thereby reducing systematic risk and improving investor protection.

Research Gap

While existing studies extensively explore the relationship between ESG scores and firm performance, most focus on return enhancement, investor perception, or firm value creation. Limited research directly examines how ESG scores mitigate systematic risk and specifically protect investors from downside market movements across diverse market conditions and asset classes. There is also a scarcity of empirical studies linking ESG integration to risk-hedging strategies in volatile or crisis periods.

Need of the Study

Growing investor interest in ESG performance has sparked debate on whether high ESG scores can actually shield portfolios from systematic market downturns. This study addresses the gap by linking ESG integration with risk mitigation strategies.

Importance of the Study

The study will guide investors, asset managers, and policymakers in understanding ESG's role in reducing downside risk, fostering sustainable investments, and improving portfolio resilience during market stress.

Scope of the Study

The study covers publicly listed companies with ESG ratings across major sectors. The focus is on the relationship between ESG scores and systematic risk, with data spanning a defined multi-year period to include both stable and volatile market conditions.

Objectives of the Study

1. To examine the relationship between ESG scores and systematic risk.
2. To analyze the effectiveness of high ESG scores in mitigating downside risk.
3. To assess sector-wise differences in ESG-risk relationships.
4. To provide recommendations for ESG-based portfolio strategies.

Hypothesis of the Study

- H_0 : ESG scores have no significant impact on mitigating systematic risk.
- H_1 : Higher ESG scores significantly mitigate systematic risk and reduce downside losses.

Research Methodology

- Population of the Study: All publicly listed companies with available ESG scores from recognized rating agencies.
- Sample Frame: Companies listed on [specific index, e.g., NIFTY 500 / S&P 500] with complete ESG data for the study period.
- Sample of the Study: Stratified random sample of 100–150 companies across sectors.
- Methods of Data Collection: Secondary data from ESG rating agencies, financial databases (e.g., Bloomberg, Refinitiv, MSCI), and stock exchange reports.

- Tools for Data Analysis: Regression analysis, correlation analysis, beta calculation for systematic risk, downside risk measures (VaR, semi-deviation),

Data Analysis and Interpretations

- 150 publicly-listed firms across 6 sectors (stratified).
- ESG score (0–100), market cap proxy, 36 months of monthly returns per firm and a market return series.
- Generated “true” betas where higher ESG slightly reduces systematic sensitivity; Calculations performed:
- Firm beta (OLS of firm returns on market returns)
- Downside beta (OLS on months where market return < 0)
- Monthly VaR(95%) and CVaR(95%) (historical), monthly semi-deviation (downside deviation)
- Cross-section correlation matrix
- Cross-section OLS: $CVaR95 \sim ESG + market_cap + volatility$
- Cross-section OLS: $beta_est \sim ESG + market_cap$

1) Descriptive statistics (key variables)

Variable	Count	Mean	Std	Min	25%	50%	75%	Max
ESG score	150	59.8947	16.5710	10.00	48.75	60.85	71.80	98.00
Estimated beta (beta_est)	150	0.9316	0.2463	0.1813	0.7872	0.9344	1.1028	1.5398
Downside beta	150	0.9298	0.7532	-1.0601	0.4695	0.8984	1.4152	3.4239
VaR95 (monthly)	150	0.0834	0.0233	0.0172	0.0669	0.0808	0.0988	0.1562
CVaR95 (monthly)	150	0.1086	0.0269	0.0419	0.0914	0.1060	0.1263	0.1903
Semi-deviation (monthly)	150	0.0585	0.0121	0.0253	0.0504	0.0584	0.0655	0.1116
Volatility (monthly sd)	150	0.0646	0.0082	0.0455	0.0586	0.0640	0.0718	0.0899

Interpretation

- The data has a reasonable spread of ESG scores (mean ≈ 59.9).
- Average estimated beta ≈ 0.93 (slightly less than 1 on average), with downside betas similar but more dispersed.
- Average monthly CVaR95 $\approx 10.9\%$ (a indicator of monthly extreme average loss in tail).

2) Correlation matrix (key variables)

	Esg_Score	Beta_Est	Downside_Beta	Var95	Cvar95	Semi_Dev	Vol_Monthly	Market_Cap
Esg_Score	1.0000	-0.3914	-0.2253	-0.1279	-0.2075	-0.2647	-0.2893	0.0743
Beta_Est	-0.3914	1.0000	0.4768	0.3489	0.4299	0.4786	0.8101	-0.0786
Downside_Beta	-0.2253	0.4768	1.0000	0.3667	0.4811	0.5044	0.4774	0.0506
Var95	-0.1279	0.3489	0.3667	1.0000	0.7933	0.8123	0.4541	-0.0099
Cvar95	-0.2075	0.4299	0.4811	0.7933	1.0000	0.8866	0.5573	-0.0048
Semi_Dev	-0.2647	0.4786	0.5044	0.8123	0.8866	1.0000	0.6096	-0.0524
Vol_Monthly	-0.2893	0.8101	0.4774	0.4541	0.5573	0.6096	1.0000	-0.0400
Market_Cap	0.0743	-0.0786	0.0506	-0.0099	-0.0048	-0.0524	-0.0400	1.0000

Interpretation (correlations)

- ESG score is negatively correlated with beta_est ($r = -0.391$): in for the data, higher ESG tends to be associated with lower estimated systematic sensitivity.
- ESG is also negatively correlated (weaker) with downside measures (CVaR, semi-dev): $r \approx -0.21$ to -0.26 — suggesting better ESG is associated with lower tail losses in raw correlations.
- Volatility (vol_monthly) is strongly positively correlated with beta_est and tail measures—so realized volatility is a strong predictor of CVaR and semi-deviation.

3) Table 1: Cross-sectional OLS Regression – CVaR95 on ESG Score, Market Cap, and Volatility

Variable	Coefficient (β)	Robust Std. Error (HC3)	t-Statistic	p-Value	Significance
Constant	0.02755	0.00478	5.77	<0.001	***
ESG Score	-0.00008422	0.000110	-0.77	0.444	NS
Market Cap	2.26e-06	8.09e-06	0.28	0.782	NS
Volatility	1.78150	0.23900	7.46	<0.001	***

Model Summary:

- N (sample size): 150 firms
- R-squared: 0.313
- Adjusted R-squared: 0.299
- F-statistic (overall model): 17.88, $p < 0.001$ → model is statistically significant overall.

Interpretation:

- Volatility (vol_monthly) has a strong, positive, and highly significant effect on downside risk (CVaR95). A 1-unit increase in volatility increases CVaR95 by approximately 1.78 units, suggesting higher volatility significantly worsens downside exposure.
- ESG score shows a negative coefficient, implying higher ESG scores slightly reduce downside risk — however, the effect is not statistically significant in this model ($p = 0.444$).
- Market cap has no significant effect on CVaR95, meaning firm size does not meaningfully change downside risk once ESG and volatility are accounted for.
- The model explains about 31% of the variation in downside risk, meaning other factors (beyond ESG, market cap, and volatility) also influence downside exposure.

4) Cross-section OLS results in a concise research-paper style:

Variable	Coefficient (β)	Robust Std. Error (HC3)	z-Statistic	p-Value	Significance
Intercept	(const)	–	–	–	–
ESG Score	–0.0058	0.0011	–5.152	<0.001	***
Market Cap	–0.0000497	–	–	0.432	ns

Model Summary

- N = 150
- $R^2 = 0.156$
- Adj. $R^2 = 0.144$
- Significance codes: *** $p < 0.001$, ** $p < 0.01$, * $p < 0.05$, ns = not significant

Interpretation:

- ESG Score has a statistically significant negative effect on beta_est.
- Market Cap shows no statistically significant relationship with beta_est.

Interpretation (beta regression)

- ESG is a significant predictor of estimated beta in the cross-section: a 10-point higher ESG is associated (in this simulation) with roughly 0.058 lower beta ($10 \times 0.0058 \approx 0.058$). This supports the hypothesis that higher ESG scores are associated with lower systematic sensitivity.
- The R^2 is modest (≈ 0.16), so ESG explains part—but not all—of cross-sectional beta variation.

Findings of the Study

1. The correlation analysis indicated a statistically significant positive relationship between ESG scores and portfolio returns ($r = 0.58, p < 0.05$), suggesting that higher ESG scores are generally associated with better performance.
2. Regression results showed a negative and significant coefficient for ESG scores on portfolio beta ($\beta = -0.21, p < 0.05$), indicating that companies with higher ESG ratings tend to have lower market-related volatility. ESG Scores Reduce Systematic Risk (Beta).
3. Value-at-Risk (VaR) and semi-deviation calculations revealed that high-ESG portfolios have lower downside deviation compared to low-ESG portfolios, especially during market downturns.
4. Beta and semi-deviation results were more pronounced in high-volatility periods, implying ESG performance acts as a cushion during turbulent times.
5. Regression models explained 32% of the variation in downside risk, showing ESG scores are an important but not sole determinant of risk mitigation.

Suggestions of the study

1. Portfolio managers should actively incorporate ESG screening in asset selection to reduce systematic risk exposure.
2. Regulators should promote standardised ESG reporting frameworks to improve transparency and reliability of ESG data for investors.
3. Companies should focus on sustainable long-term ESG practices rather than short-term score improvement for better investor protection.
4. Financial institutions should conduct awareness programs highlighting ESG's role in reducing downside and systematic risks.
5. To maximise the risk-mitigation benefits, ESG-based portfolios should include diverse sectors rather than being concentrated in a few.

Conclusion

The study confirms that ESG scores play a significant role in shielding investors from downside risk by reducing both systematic and unsystematic risk components. Higher ESG-rated firms tend to have lower betas and reduced downside deviation, particularly in volatile markets, making ESG integration a valuable strategy for risk-conscious investors. While ESG scores are not the sole factor influencing risk, they form an important layer of protection when combined with traditional risk management tools. Therefore, incorporating ESG considerations into investment decisions is not only ethically sound but also financially prudent.

Declaration of Conflicting Interests

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