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The ESG Paradox: Reconciling Financial Performance, Rating Divergence, and Market Realities

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Abstract : *ESG-labelled assets have expanded rapidly, transforming from a niche ethical strategy into a cornerstone of global capital allocation. Yet, this rapid growth encounters profound structural friction: regulators pull in opposite directions regarding mandates, and rating providers fiercely disagree on which firms qualify as sustainable. This review asks whether capital allocation guided by ESG metrics actually improves risk-adjusted corporate financial performance or instead masks agency frictions and greenwashing. The review synthesizes peer-reviewed meta-analyses, identified econometric studies, and rating-provider datasets published between 2001 and 2024, analyzing mechanisms across the environmental, social, and governance pillars. Meta-analyses overwhelmingly report non-negative ESG–financial performance associations. Identified studies trace this value to highly specific channels: lower financing costs, stronger human-capital productivity, and thinner downside risk tails. However, aggregate effect sizes remain modest, and portfolio-level evidence demonstrates weaker, regime-dependent returns. Rating divergence compounds this problem. Six major ESG providers correlate at only 0.54 on average, primarily due to fundamental disagreements over scope and measurement. Industry materiality, firm size, and varying regulatory regimes explain much of this heterogeneity. Corporate boards must tie ESG compensation strictly to audited, material metrics; asset managers must triangulate specific underlying indicators rather than trusting composite scores; and regulators should urgently prioritize disclosure comparability over additional subjective ratings.*

Key Words: ESG; corporate financial performance; ESG rating divergence; cost of capital; greenwashing; systematic review

1. INTRODUCTION

This introduction sets out why the relationship between ESG integration and financial performance remains unsettled. ESG-labelled assets have grown from a niche ethical strategy into a core feature of global capital allocation, yet regulators and rating providers disagree on what counts as sustainable. The section traces the shift from shareholder primacy to stakeholder and instrumental perspectives, separates CSR from modern ESG scoring, and states the three research questions that guide the review. Together, these steps frame ESG as a testable claim about value creation rather than a settled assumption.

1.1 From shareholder primacy to ESG integration

The intellectual foundation of corporate purpose has undergone a profound transformation. Milton Friedman's classic shareholder primacy doctrine posited that corporate executives serve owners best by maximizing financial profit within the boundaries of the law, strictly separating corporate operations from broader social welfare. Freeman's stakeholder

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theory subsequently challenged this perspective, arguing that managers owe explicit duties to a wider constellation of stakeholders, including employees, customers, suppliers, and local communities.

Donaldson and Preston (1995) untangled stakeholder theory by highlighting its instrumental strand—the concept that managing stakeholder relations effectively drives superior financial outcomes. This enabled empirical researchers to rigorously test whether stakeholder-friendly behavior pays. Jensen (2002) offered a bridge termed "enlightened value maximization," where firms pursue long-term enterprise value but recognize that they cannot maximize it while alienating key stakeholders.

Contemporary Environmental, Social, and Governance (ESG) integration builds upon these foundations. Today, investors justify sustainability investments because they ostensibly create tangible enterprise value, satisfy specific mandates, or serve institutional agendas (Bénabou & Tirole, 2010). However, the critical question remains: does ESG integration reliably deliver financial performance, or does it introduce new market frictions?

1.2 Demarcating CSR from ESG scoring

Researchers must distinguish historical Corporate Social Responsibility (CSR) from modern ESG metrics. CSR traditionally refers to discretionary corporate action advancing social good beyond immediate economic interests (McWilliams & Siegel, 2001). Historically, firms described these activities in narrative reports.

The modern era of ESG scoring fundamentally changed this dynamic. Commercial vendors (e.g., MSCI, Sustainalytics, Refinitiv) now convert sprawling corporate practices into specific numerical rankings. Portfolio managers use these scores to screen and benchmark global assets (Gillan et al., 2021). While quantitative scoring offers the illusion of comparability, it simultaneously imports measurement error, ideological weights, and creates incentives for firms to "manage the score" rather than improve underlying outcomes. This review interrogates how well modern ESG scoring captures genuine corporate responsibility.

1.3 The central problem and research questions

Investors allocating capital based on ESG metrics rely on the premise that these metrics accurately predict lower systematic risk, higher productivity, or cheaper capital access. If they predict nothing, ESG-tilted capital allocation merely transfers wealth to firms that master disclosure without altering fundamental performance. If metrics reward glossy reports over verifiable action, they invite greenwashing and mask agency frictions (Delmas & Burbano, 2011; Lyon & Montgomery, 2015).

Three distinct research questions guide this review:

RQ1: What do rigorous empirical studies reveal about the direction, magnitude, and transmission channels of the ESG–corporate financial performance relationship?

RQ2: How do specific governance mechanisms, disclosure regimes, and the profound divergence among rating providers condition whether ESG activity translates into capital-market value?

RQ3: Which contextual factors (e.g., firm size, industry-specific materiality, and regulatory environments) reconcile the contradictory findings present in the current empirical literature?

II. LITERATURE SEARCH AND REVIEW METHODOLOGY

This section explains how the evidence for the review was identified, selected, and organized. The study follows a structured narrative design informed by PRISMA guidelines and draws on Scopus, the Web of Science Core Collection, and SSRN. It favors peer-reviewed work published between 2001 and 2024 that uses meta-analyses, event studies, or other identified econometric designs. Prioritizing causal identification over simple correlation allows the review to focus on transmission mechanisms, although it also means that the corpus is selective rather than exhaustive.

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2.1 Review design and corpus extraction

This paper executes a structured narrative design informed by PRISMA guidelines (Moher et al., 2009; Page et al., 2021). The search protocol leverages three premier bibliographic sources: Scopus, the Web of Science Core Collection, and SSRN.

The resulting corpus reflects a purposive, criterion-based selection of highly influential and methodologically robust studies, prioritizing causal identification over simple correlation. Because this review focuses on synthesizing specific transmission mechanisms, it reports its protocol without a quantitative PRISMA flow diagram.

2.2 Inclusion and exclusion criteria

The review includes studies that (a) appear in peer-reviewed academic journals between 2001 and 2024 with a verifiable DOI; (b) rely on meta-analyses, advanced econometric designs, event studies, or large-sample institutional dataset analyses; (c) explicitly measure environmental, social, or governance performance, disclosure, or ratings; and (d) link that measure to a financial outcome, risk metric, or governance mechanism. Practitioner white papers, single-firm case studies, and purely philosophical treatises are excluded.

III. THEMATIC LITERATURE SYNTHESIS

This section organizes the empirical literature around the three ESG pillars and the channels through which each may affect firm value. The environmental discussion covers carbon pricing and financing costs, the social discussion covers human capital and downside insulation, and the governance discussion covers pay, boards, and disclosure. The section then turns to the ESG–CFP nexus and to the market friction created by rating divergence. Throughout, the emphasis is on identified evidence and on where studies agree, conflict, or depend on context.

3.1 Environmental (E): carbon exposure, disclosure, and the cost of capital

Equity pricing of carbon. Bolton and Kacperczyk (2021, 2023) demonstrated convincingly that U.S. and international equities of high-emission firms earn higher expected returns. Risk-averse investors demand this "carbon premium" as compensation for bearing regulatory transition risks. Matsumura et al. (2014) reached a highly compatible conclusion utilizing valuation data: higher carbon emitters carry lower overall firm value. Crucially, firms that withhold voluntary carbon disclosures suffer an additional valuation penalty. Ilhan et al. (2021) expanded this into derivatives markets, proving that options markets explicitly price climate downside by charging statistically significant premiums for put protection on carbon-intensive firms.

The premium under scrutiny. However, the carbon premium does not command universal consensus. Aswani et al. (2024) demonstrated that the empirical link between emissions and stock returns weakens substantially when scaling emissions by firm revenue (intensity) and deteriorates further when using firm-reported rather than vendor-estimated data. Pástor et al. (2022) offered a crucial warning: green stocks outperformed brown stocks during the 2010s primarily because broad market concerns about climate change rose unexpectedly. This shift lifted realized returns but does not imply that green assets possess permanently higher expected returns going forward.

Debt and equity financing costs. The most robust environmental evidence concerns the cost of financing. Chava (2014) established that investors demand higher expected returns from firms with pronounced environmental concerns, and banks charge these firms significantly higher interest rates. El Ghoul et al. (2011) reported a materially lower cost of equity for firms with strong overall CSR profiles. Goss and Roberts (2011) documented that banks charge firms with CSR concerns modestly higher loan spreads. In the fixed-income space, Huynh and Xia (2021) found that corporate bonds with elevated exposure to negative climate-change news earn lower returns. Explicit "green" labels show a similar effect: Zerbib (2019) estimated a yield discount of roughly two basis points for certified green bonds, while Flammer (2021) found that green bond issuers attract positive stock market announcement returns and systematically improve environmental performance.

Taken together, the environmental evidence shows that carbon exposure and environmental performance are priced by capital markets, but the strength and permanence of that pricing depend on how emissions are measured, scaled, and

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sourced. The most defensible findings concern financing costs, where equity investors, banks, and bond markets penalize environmental concerns and modestly reward credible green commitments. The equity carbon premium remains contested, and the strong returns of green assets in the 2010s reflect shifting sentiment rather than a durable advantage.

3.2 Social (S): human capital, safety, and downside insulation

Employee satisfaction and productivity. Edmans (2011) constructed portfolios of firms featured on the "100 Best Companies to Work for in America" list, finding that they generated sizable abnormal returns over 25 years. This implies equity markets chronically undervalue intangible human capital. Guiso et al. (2015) refined this channel, showing that employees' genuine perceptions of senior managerial integrity correlate with higher operational productivity and market valuation, whereas merely advertised corporate values show zero correlation with performance. Flammer (2015) supplied critical causal evidence, demonstrating that narrow adoption of a social proposal directly raises shareholder value through subsequent improvements in labor productivity and sales growth.

Workplace safety and financial fragility. Cohn and Wardlaw (2016) linked corporate financing dynamics directly to physical workplace safety, finding that firms facing exogenous financing constraints immediately record higher rates of workplace injuries. This implies physical safety outcomes carry deep information about financial fragility, giving investors a rational financial reason to monitor the social pillar as a leading indicator of risk.

Risk insulation and stakeholder trust. Lins et al. (2017) examined the 2008–2009 financial crisis and found that high-CSR firms earned markedly higher stock returns than low-CSR counterparts. The authors attributed this outperformance to trust built with stakeholders who granted the firm leeway during a severe liquidity crunch. Albuquerque et al. (2019) provided the theoretical foundation: CSR lowers systematic risk and raises overall valuation when it differentiates a firm's products, making consumer demand less price-elastic. Kim et al. (2014) added that deeply CSR-engaged firms exhibit significantly lower stock price crash risk. However, Servaes and Tamayo (2013) qualified this narrative: CSR activities only raise firm value when customer awareness of the firm runs high.

A stress test and its limits. The COVID-19 pandemic provided a natural out-of-sample stress test for the insulation hypothesis. Albuquerque et al. (2020) found that firms with strong environmental and social profiles earned higher returns and exhibited lower volatility during the 2020 crash. However, Demers et al. (2021) challenged this conclusion, demonstrating that after properly controlling for investments in intangible assets and digital infrastructure, ESG scores lost their protective statistical power. Raghunandan and Rajgopal (2022) revealed that highly rated ESG mutual funds frequently hold firms with worse historical labor and environmental compliance records than non-ESG funds, suggesting commercial social scores do not reliably track verifiable conduct.

Overall, the social evidence suggests that human capital, workplace safety, and stakeholder trust carry financially relevant information that markets do not always price fully. The strongest findings link genuine employee satisfaction and managerial integrity to productivity and valuation, and show that high-CSR firms were better insulated during the 2008–2009 crisis. However, the COVID-19 evidence is mixed, and the gap between social scores and verifiable conduct implies that the protective value of the social pillar depends on measuring real practices rather than reported ratings.

3.3 Governance (G): pay, boards, and disclosure veracity

Classic governance and board monitoring. Gompers et al. (2003) and Bebchuk et al. (2009) established the foundational template: extensive managerial entrenchment provisions strongly predict lower firm valuation and weaker long-term stock returns. Adams and Ferreira (2009) complicated this by showing that while gender-diverse boards engage in significantly more intense monitoring, this additional monitoring actually degrades performance in firms that already possess strong governance structures, proving that optimal board design depends heavily on context.

Sustainability-linked compensation. Cohen et al. (2023) found that adopting ESG metrics in executive compensation tracks institutional investor pressure and accompanies improvements in targeted ESG outcomes, but does not reliably

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lead to improvements in overarching financial performance. Flammer et al. (2019) reached a compatible conclusion in the U.S., finding that adding CSR criteria to executive pay shifts managerial focus toward long-term investment horizons. However, whether ESG-linked pay reflects genuine stakeholder alignment or serves as gameable window dressing depends entirely on how verifiable the metrics are.

Investor stewardship and engagement. Dyck et al. (2019) demonstrated that rising institutional ownership drives tangible improvements in environmental and social performance globally. Dimson et al. (2015) found that successful behind-the-scenes ESG engagements by active owners deliver significant abnormal returns. Hoepner et al. (2024) added that institutional engagement systematically lowers a firm's downside tail risk, finding the largest reductions when targeting material environmental topics.

Disclosure veracity and greenwashing. Christensen et al. (2021) concluded that while reporting mandates definitively raise disclosure volume, benefits depend heavily on strict legal enforcement. Delmas and Burbano (2011) explained the economic drivers of greenwashing: regulatory uncertainty, limited NGO scrutiny, and perverse executive incentives encourage selective, overly optimistic disclosure. Lyon and Montgomery (2015) noted that greenwash takes myriad forms, from selective emphasis to symbolic, non-binding commitments.

In summary, the governance literature shows that board structure, executive pay, investor engagement, and disclosure quality shape whether ESG activity creates value, though no single mechanism works the same way in every setting. Entrenchment weakens valuation, ESG-linked pay improves targeted outcomes but not reliably financial results, and active ownership lowers downside risk, especially on material topics. Because reporting mandates and ESG-linked incentives are credible only when verifiable and legally enforced, governance quality is also the main safeguard against greenwashing.

3.4 The ESG–CFP empirical nexus

Meta-analytic evidence. Orlitzky et al. (2003) pooled early studies and found a universally positive association between corporate social and financial performance. Friede et al. (2015) extended this, reporting that approximately 90 percent of 2,000 studies find a non-negative ESG–CFP relation. However, studies analyzing returns at the portfolio level produced vastly weaker results than firm-level operating metrics. Busch and Friede (2018) confirmed a positive but economically modest link in a second-order meta-analysis. Revelli and Viviani (2015) found no systematic performance penalty for socially responsible investing, but stressed that realized returns vary wildly depending on the screening method.

Identified firm-level evidence. Eccles et al. (2014) tracked matched pairs over eighteen years and found that the high-sustainability cohort significantly outperformed in both stock-market returns and accounting metrics. Krüger (2015) added a vital nuance regarding market asymmetry: equity markets react sharply and negatively to bad CSR news, but react only weakly to positive CSR news, implying markets view ESG primarily as a downside insurance mechanism rather than a reliable engine for excess upside returns.

Diminishing returns and portfolio drag. A substantial body of literature finds little, zero, or negative advantage for systematically tilting portfolios toward high ESG scores. Brammer et al. (2006) reported that UK stocks with the highest social ratings actually earned lower subsequent returns. Hong and Kacperczyk (2009) explained that norm-constrained institutional investors avoid "sin" stocks, leaving those stocks neglected, undervalued, and priced to earn significantly higher expected returns. Statman and Glushkov (2009) found that while tilting toward highly rated ESG firms earned a slight advantage, the necessary exclusion of high-performing sin industries imposed a nearly equal cost. Barnett and Salomon (2006) identified a complex curvilinear pattern: mutual fund returns fell as initial social screens rose, but recovered at very high levels of screening intensity.

Theory and investor motives. Pástor et al. (2021) modeled a market where investors deriving non-pecuniary utility from holding "green" assets accept lower expected returns, pricing those assets lower in equilibrium. Pedersen et al. (2021) characterized an "ESG-efficient frontier," demonstrating that the Sharpe-ratio cost of an ESG tilt depends entirely on whether ESG scores carry proprietary fundamental information. Riedl and Smeets (2017) found investors in socially

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responsible funds willingly pay higher fees, revealing non-pecuniary preferences. Hartzmark and Sussman (2019) documented massive fund flow reallocations in direct response to Morningstar sustainability ratings. Edmans (2023) synthesized this by concluding the only durable case for ESG rests on long-term shareholder value creation, requiring investors to rigorously analyze material factors instead of screening on noisy aggregate scores.

In short, the ESG–CFP nexus is positive but modest, and its strength depends on the level of analysis. Meta-analyses and firm-level studies mostly report non-negative associations, whereas portfolio-level evidence shows weaker, regime-dependent, and sometimes negative returns because of screening costs and investor preferences. Markets appear to treat ESG mainly as downside protection rather than a source of excess upside. This supports Edmans (2023), who argues that the durable case for ESG rests on long-term value from material factors, not on tilting toward aggregate scores.

3.5 Market friction and "aggregate confusion"

How far the raters diverge. Berg et al. (2022) conducted a landmark comparison of six major ESG rating providers, finding that their overarching ratings correlate at an astonishingly low average of 0.54. By contrast, major credit ratings correlate at approximately 0.99. The authors decomposed this gap into scope divergence (what to count), measurement divergence (how to quantify it), and weight divergence (how much it matters). Scope and measurement differences explain roughly 94 percent of total divergence. Furthermore, a pervasive "rater effect" causes a provider's assessment in one category to systematically leak into unrelated categories. Chatterji et al. (2016) documented this same severe lack of convergence years earlier.

Why disagreement persists and what it costs. Christensen et al. (2022) found that greater volumes of corporate ESG disclosure actually widen rater disagreement, providing raters with more raw materials to interpret differently. This disagreement coincides directly with higher equity return volatility. Drempetic et al. (2020) identified a massive size bias: large-cap firms consistently earn higher ESG scores simply because they command the resources required to generate extensive sustainability reports. Gibson Brandon et al. (2021) linked greater rater disagreement to higher expected stock returns, consistent with a risk premium for uncertainty. Avramov et al. (2022) demonstrated that deep uncertainty about true ESG ratings dampens institutional demand and makes optimal portfolio construction impossible.

Overall, rating divergence is a structural friction that weakens ESG scores as a basis for capital allocation. Because scope and measurement differences account for most of the disagreement, and because greater disclosure and larger firm size can widen or distort scores, composite ratings carry considerable noise. This noise is linked to higher return volatility, a risk premium for uncertainty, and weaker institutional demand. Investors should therefore examine the underlying indicators rather than rely on a single provider's aggregate score.

IV. RECONCILING CONTRADICTORY EVIDENCE

The central puzzle of this review is how the literature reports positive associations at the operating corporate level, while finding weak or negative returns at the portfolio level. Three vital factors resolve this tension.

Industry materiality. Khan et al. (2016) mapped sustainability issues by industry materiality, finding that firms exhibiting strong performance on financially material issues significantly outperform, while outperforming on immaterial issues generates no financial advantage. Because aggregate ESG scores blend material and immaterial items, they dilute the financial signal.

Firm size and visibility. Drempetic et al. (2020) demonstrated firm size mechanically inflates ESG scores, and Servaes and Tamayo (2013) showed CSR initiatives only create value when broad consumer bases are aware of them. This severely inflates the ESG–CFP association in studies failing to control for size and visibility.

Regulatory and institutional environment. Liang and Renneboog (2017) tied national CSR levels to legal origins, and Wang et al. (2016) confirmed national context heavily moderates the CSR–CFP link. Manchiraju and Rajgopal (2017) studied the Indian Companies Act 2013 mandatory spending requirements, finding strictly negative stock-market reactions among forced compliers, proving that regulatory compulsion changes the financial logic of sustainability.

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A diverging regulatory landscape. Global regulators exacerbate market confusion by pushing disclosure mandates in opposite directions. The EU's 2026 amendments narrowed the CSRD scope to ease corporate burdens, while the US SEC climate disclosure rules were proposed for rescission after extensive litigation. Christensen et al. (2021) caution that disclosure mandates only deliver market benefits when backed by strict enforcement and cross-border comparability. This transatlantic fracture shifts the burden of data verification back onto raters, making the divergence documented by Berg et al. (2022) more costly.

Taken together, these three factors explain why operating-level gains do not automatically become portfolio-level returns: aggregate scores dilute material signals, size and visibility inflate measured associations, and national and regulatory contexts change the financial logic of sustainability. The ESG–CFP link is therefore conditional rather than universal. The diverging EU and US regulatory paths add further uncertainty, since weaker or inconsistent mandates push verification back onto raters and reduce comparability.

V. RESEARCH GAPS AND LIMITATIONS

5.1 Gaps in the literature

Despite the massive proliferation of ESG literature, critical gaps remain. First, true causal identification remains scarce; the vast majority of studies still rest on fragile, cross-sectional OLS associations plagued by endogeneity. Second, while carbon emissions disclosure attracts extensive study, researchers know surprisingly little about the financial impact of emission allowance holdings and the pricing of carbon-audit assurance quality. Third, the social (S) pillar remains drastically under-theorized and lacks standardized outcome measures, leaving findings reliant on survey-based datasets rather than hard operational metrics. Fourth, emerging markets appear in a remarkably thin slice of the empirical evidence, despite meta-analyses (Friede et al., 2015) suggesting that the ESG–CFP relationship is strongest in developing economies. Fifth, the capital-market effects of the highly disruptive 2026 transatlantic regulatory changes remain unstudied. Sixth, researchers have not yet built reliable algorithmic text-analysis models capable of separating genuine ESG capital expenditure from sophisticated corporate greenwashing at a large cross-sectional scale.

These gaps indicate that the field needs stronger causal designs, better measures of the social pillar, and wider evidence from emerging markets. Future research should also examine emission allowances and carbon-audit assurance quality, assess the capital-market effects of the 2026 regulatory changes, and develop text-analysis tools that separate genuine ESG investment from greenwashing. Addressing these priorities would move the literature beyond cross-sectional associations toward more reliable, policy-relevant conclusions.

5.2 Limitations of this review

This review utilizes a purposive, criterion-based selection methodology to isolate high-quality econometric studies and does not report an exhaustive PRISMA flow count. By focusing exclusively on English-language, top-tier journals, the review inherently inherits academic publication bias toward statistically significant results. Furthermore, the paper relies on a structured narrative synthesis rather than a fresh mathematical meta-analytic re-estimation, meaning it cannot assign newly updated effect sizes to the ESG–CFP link.

These limitations mean the findings should be read as a structured synthesis of high-quality evidence, not as a new estimate of the ESG–CFP effect size. The selective focus on English-language, top-tier journals may overstate statistically significant results, and the absence of a PRISMA flow count limits replicability. Even so, the criterion-based approach prioritizes causal identification, and the consistent patterns across studies lend reasonable credibility to the conclusions.

VI. CONCLUSION

The synthesis of empirical literature clarifies that while ESG integration holds the potential to drive enterprise value, realizing that potential requires navigating significant structural market frictions, and the evidence demonstrates that surgical, context-specific ESG activities, such as mitigating carbon transition risks, improving human capital

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productivity, and fostering strong governance, can lower financing costs and provide critical downside risk insulation during market shocks, with the most robust findings indicating that these benefits accrue primarily at the operational firm level. However, the literature also reveals a stark reality: passive capital allocation driven by aggregate, commercially supplied ESG scores is highly unreliable, since the "aggregate confusion" stemming from severe rating divergence, driven by fundamental disagreements over scope and measurement methodologies, fundamentally compromises the utility of composite scores. Furthermore, the conflation of financially material issues with immaterial ones dilutes the actionable signal for investors, and the realized outperformance of green assets in the 2010s appears to have been driven more by rapidly shifting societal sentiments than by a permanent risk premium.

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