

ESG Scoring

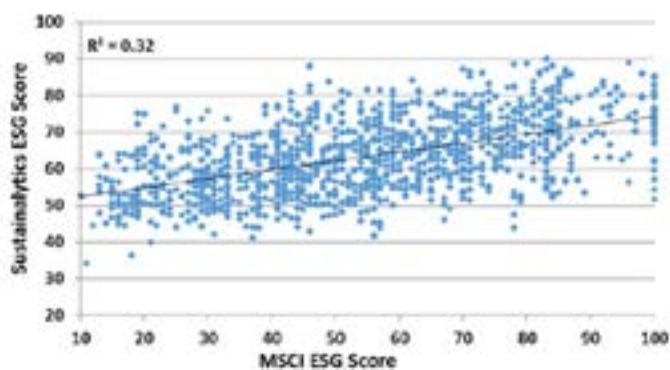
The RBC Global Equity team

Milton Friedman’s assertion in his 1970 New York Times article that the social responsibility of every enterprise was to maximise profit led to a singular focus on shareholder value and the financial capital that supported it. But a sense developed that shareholder value growth was coming at the expense of other stakeholders and so was not truly value-creative in an holistic sense. A more complete assessment of value creation was clearly needed; one that explicitly considered extra-financial risks and opportunities. Various monikers have been tried over the years, but ‘ESG’, Environmental, Social and Governance, has today become established as the prevailing industry term.

Defining progress in broader terms than just shareholder value requires support from new types of information. The market has responded and today there are many alternative providers of such data who provide ratings on E, S and G, including the market leaders MSCI ESG Research and Sustainalytics. Smaller competitors such as TruValue Labs and RobecoSAM also feature whereas others focus on specific aspects, for example CDP, South Pole and Trucost who address environmental aspects, and firms like Glassdoor, from whom we can derive data for elements of social capital.

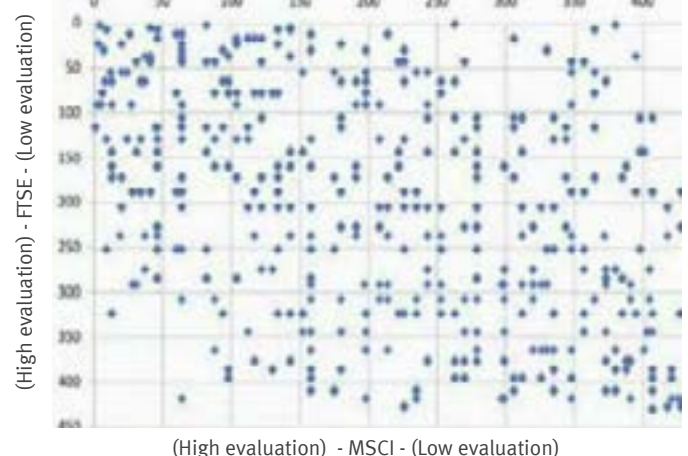
This provides data users with choice. Although the goal of ESG data firms may be similar, no two firms approach the challenge the same way and this creates diversity of opinion and a form of competition between the various data providers. This can be seen clearly in the output of the main ESG data providers and a number of studies have contrasted the varying results. Chatterji et al (2016) showed that the correlation between a number of ESG data providers was surprisingly low at only 0.3, whereas a study published on CSRHub, comparing the U.S. ratings of Sustainalytics and MSCI, found a correlation of 0.32%. Our own 2017 comparison of ratings across companies in our portfolio indicated agreement in just over 55% of circumstances.

Sustainalytics Vs MSCI



Source: CSRHub. S&P 1200 equities, January 2015

Comparison of ESG score from FTSE and MSCI



Source: CSRHub (2018)

These are surprisingly low statistics, especially when one considers that ESG data providers are sourcing identical data and share a common purpose, potentially revealing the extent to which judgements are informing the output. This may include how ESG inputs are being weighted, how context is being applied when assessing the materiality of ESG risks and opportunities, and the extent to which data gaps are filled using estimation. Defenders of ESG scores point out that occasional company-specific differences are to be expected but that over a broad data set, scores should align on average.

After a period of rapid development where the debate has gone from how to define ESG to how it can best be implemented, we feel the time is now right to assess the market's solution and to ask whether it is fit for purpose.

ESG stakeholders diversity

To do this we need to be clear what the problem is that ESG data providers are trying to solve. Just as ESG arguably arose out of a rejection of the primacy of short-term shareholder value, ESG also has many stakeholders that need to be considered. The needs and expectations of each may vary:

- **Fundamental investors:** may use ESG data as part of their investing due diligence. The data can help unearth ESG issues and provides the fundamental investor with a more complete set of information that will hopefully lead to better decisions. Fundamental investors appreciate breadth of coverage and multiple providers to maximise the chance of material issues being uncovered.

- **Systematic investors:** those who regard ESG as an investment 'factor' with an associated return premium may use ESG data as a key input into security selection. ESG scores may be used as an empirical measure to construct quantitative portfolios in a similar way to which quantitative strategies do for factors such as value and growth. Much of the current debate as to whether ESG adds value or not rests upon the results of such broad quantitative studies.

- **Screening:** may apply to both fundamental and systematic investors who use ESG data to exclude businesses with exposure to certain unwanted characteristics that cannot be simply captured using industry classifications. Users of screens appreciate clarity but data needed to base materiality judgements on is often not disclosed, requiring estimation and judgement.

- **Asset owners:** may use ESG data to validate their portfolio managers' approach, constraining the managers from exposing them to reputational risk or to provide a tool with which they can narrow an ESG information disadvantage and better hold managers to account. ESG scores are a third party opinion that help equalise the discussion.

- **Corporates:** firms are ultimately responsible for much of the underlying disclosures ESG data providers rely upon. The benefit they receive is oblique. Some appreciate the positive feedback and virtue signalling a strong ESG rating can confer which may help the firm attract and retain certain shareholders and employees. But poor ratings are rarely appreciated and companies often find the range of data providers confusing and how they reach their conclusions opaque. It is often felt that reporting requirements for public companies are already widespread and far more onerous than for private competitors

and the growth of multiple providers requesting similar data puts internal resources under pressure, especially for smaller firms.

It is clear the expectations from ESG data differ by stakeholder and their interests are not always aligned. Some benefit from choice and diversity of opinion; some would like more consistency. In addition, the form of most ESG data providers' output is typically a single 'score'. Although a simple empirical measure has attractions, we should note the inherent contradiction of trying to reduce qualitative judgemental issues, often involving externalities caused by market failure, into a single score. We should maintain a degree of humility over the output, recognising its limitations and that the margin of error may be considerable.

This has not stopped many users looking for return premia hidden in the data. Noteworthy studies include:

- 'The Sustainability Footprint of Institutional Investors' – Rajna Brandom and Philipp Kruger, Swiss Finance Institute, Research Paper No 17-05, 2017. This study used Sustainalytics E and S ratings on holdings by asset management firms as a proxy for overall sustainability and concluded that stronger sustainability was associated with better investment returns achieved with lower volatility.

- 'Perspectives on ESG Integration in Equity Investing' – Calvert, 2015. A study that demonstrated that integrating ESG into stock selection was not detrimental to investment returns.

- 'Does the stock market fully value intangibles? Employee satisfaction and equity prices' – Alex Edmans, London Business School, 2011. This study demonstrated there was a positive relationship between a firm's standing in the Fortune 500 survey of firms, which recognised a firm's attractiveness as an employer, and subsequent stock performance.

Such studies indicate that including ESG data into an investment appraisal is unlikely to do harm and may indeed prove beneficial. But opinions differ as to what exactly is contributing the most. A 2018 AllianceBernstein report, 'Responsible Investors Should Focus on ESG "Offenders"', suggested that the rate of change in ESG ratings may be a stronger signal than the absolute level. Our own RBC GAM quantitative study showed that there was no discernible benefit to portfolio performance from using ESG scores to construct portfolios that was incremental to existing investment factors such as quality, confirming the findings of the earlier Calvert study. It may be that investors are finding new ways of explaining old things. There does, however, appear to be sufficient support for the assertion that ESG data doesn't harm investment returns and may yet have a benefit when one measures success in a broader sense than just financial capital.

ESG Challenges

Although ESG data is enjoying increasing recognition from a range of stakeholders, there are a number of issues that we should consider now as a community if we are to create a sustainable ESG environment for the future.

A good example of this is the question of whether market structure and governance within ESG data is as good as it should be. We have seen examples in other industries, such as accounting and pension consulting, where market concentration has become a public policy issue. Although it is not so well established as others, the market for ESG data is consolidating. There has been an adoption of ESG data by large index providers to create established 'benchmarks' that is concentrating influence in the hands of a very small number of participants and raising barriers to entry on new entrants. Although the emergence of a common shared vocabulary around ESG has benefits, we should ask ourselves if this is the best of developments.

Market concentration may in time lead to higher prices for users – the established consumer test used by anti-trust regulators – but it may also lead to fragility. If any of the large ESG data firms were to fail for financial or reputational reasons, the availability of timely ESG data may be impaired with few alternatives for users. Users also have little oversight into the governance of ESG data providers. Many are either private companies or divisions of larger firms. The health of their sponsoring firm, the succession of key staff and how conflicts of interest are managed are issues that users may have an interest in but for which there is often little disclosure or transparency.

From an industry standpoint, the lack of accepted ways of handling data is surprising. Users have an expectation that ESG data will be timely and correct but our conversations indicate that the review cycle of ESG data can be as long as one year and that it often takes intervention by users to ensure timely review occurs. The way in which data is processed and utilised is also opaque. ESG data is often provided in the form of a rating, yet the data upon which this rating is constructed may come from different sources, and include estimations and elements of judgement. Users often interpret the ratings as ESG reality without fully appreciating their provenance.

We also detect considerable frustration on the part of companies with ESG data. They claim to be inundated with ESG questionnaires and find it hard to prioritise the collation of information. The resources needed for this should not be underestimated and although larger firms may be better-equipped, smaller or non-English speaking firms can face particular challenges. As ESG data becomes a more accepted part of the investment market, with the power to direct capital flows, there is also a growing awareness of the need to ensure fair, non-selective disclosure. Companies arguably have a duty to ensure that material ESG information is provided to all simultaneously,

in the same way that financial data is. There may be reputational issues from responding to ESG questionnaires in a haphazard way.

Some of these issues are difficult to address in the short term but, as users of ESG data with an interest in the creation of a sustainable robust environment for ESG data in the future, we would like to propose the following possible remedies for wider discussion within the community:

- **An ESG Charter:** it is time for professional standards to be applied to the sourcing, use of, and presentation of ESG data. Users should be made aware of the extent to which data is calculated and disclosed by the issuer, where it is estimated and disclosed by the issuer and where it is not disclosed and so estimated by the report writer. Users should also be given a better understanding of the extent and significance of the use of judgement in ESG ratings and reports. Companies should have the right to request a timely review of their ESG rating irrespective of the firm's size or location and an independent ESG ombudsman should oversee compliance with the charter.
- **Oversight of industry structure:** although the ESG data industry is still new, there is the potential for market leaders to absorb new entrants more quickly than those new entrants can establish themselves. Users benefit from the choice of multiple data providers and a more robust market structure would see the emergence of a minimum of three, and preferably more, significant ESG data providers.
- **International Standards for ESG data:** the development of International Accounting Standards enhanced capital markets by providing a common framework across countries with market disclosure conventions to ensure that all users received fair simultaneous disclosure. Similar standards could usefully be implemented for ESG, improving comparability, transparency and lowering barriers to entry for new ESG data entrants. It would also save cost and time for companies.

We often remark that there is no such thing as ESG fact, just ESG opinion, and that when it comes to ESG, reasonable people can disagree. But we feel that we would be better off debating the judgements, not the appropriateness of the data. This has become increasingly important as the role of ESG data in directing capital flows has expanded. As ESG supporters we welcome this, but in the same way that we act as engaged active owners of the companies in our clients' portfolios, we feel a sense of common ownership as stakeholders in the sustainable success of ESG data. We feel the time has come to start a broader discussion about the governance, transparency and responsibilities of such data. We note that ESG is often contextual and that opinions will vary so we welcome all contributions to the discussion, with an open mind.

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