

Research Paper

ESG Data Perspectives

Shared Purpose May Not Lead to Shared Interpretations

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Key Observations

- *As demand for ESG (Environmental, Social and Governance) products grows, the influence of ESG ratings and data providers continues to increase.*
- *Individual agencies' ESG ratings often vary dramatically due to the subjective nature of environmental and social values.*
- *Corporate data disclosure remains unstandardized, which makes comparing companies a daunting task.*
- *There are many different approaches to implementing ESG considerations into an investment process. A multidimensional framework for navigating the ESG landscape may help achieve successful financial outcomes that are also aligned with organizational missions.*

With increasing demand for Environmental, Social and Governance (ESG)-related corporate responsibility, the incentive for professional investors to adopt ESG-driven investment processes is greater than ever. As a result, more investment managers claim to actively incorporate various ESG considerations into their investment strategies. In fact, a 2019 survey conducted by Fiducient Advisors of 165 investment managers showed that 84 percent of those managers employ ESG considerations as a part of their investment process – nearly a threefold increase from our 2015 results. With so many investment managers considering ESG factors during security selection, this merits the question: *What data are they using to evaluate corporate ESG responsibility?*

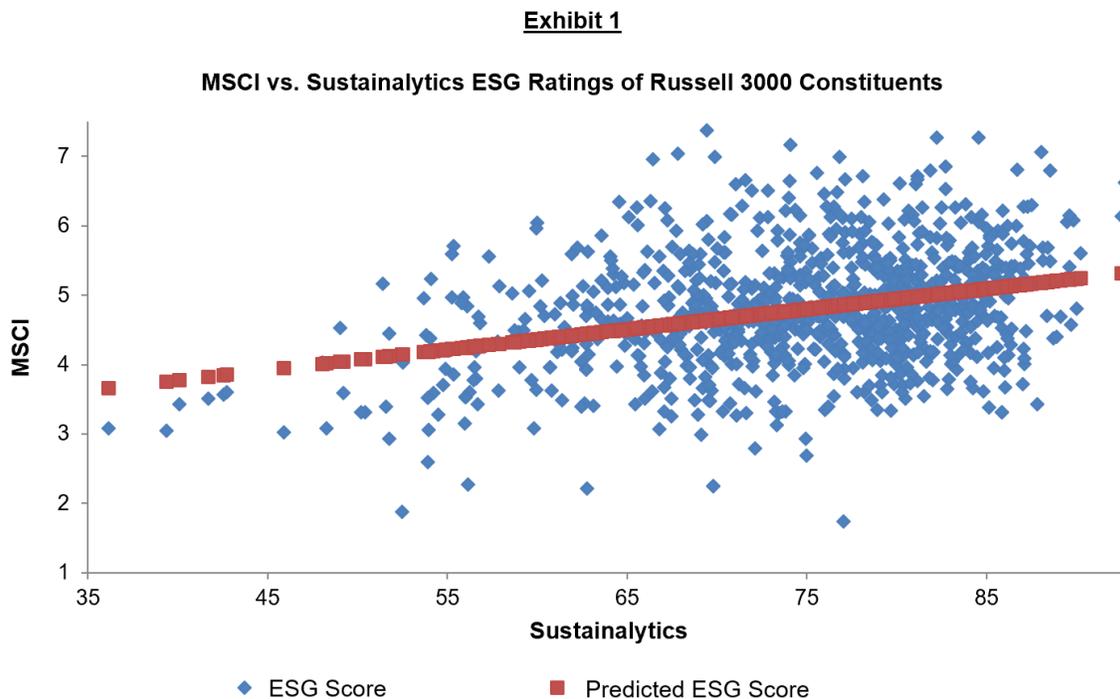
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As the trend of Environmental, Social and Governance consideration continues to rise, so too has the influence of ESG ratings agencies on how investors consider ESG factors. Quickly evolving and fueled by a recent influx in demand, the marketplace has become fiercely competitive. According to the Global Initiative for Sustainability Ratings there are more than 100 ESG ratings and research providers, ranging from non-governmental organizations focusing on a single issue to global corporations providing thousands of formalized ESG ratings on companies. However, it seems reasonable to conclude that having a shared purpose may not lead to shared interpretations.

Due to the overabundance of ESG ratings and data providers, this study will focus on two ESG ratings leaders, MSCI and Sustainalytics. The study will include an examination of the differences between the two ratings providers' outputs; why their output is different and challenges with the underlying data points; and what it means for your portfolio when considering an allocation to ESG managers.

The Difference in Ratings

Individual agencies' ESG ratings can vary dramatically. The scatterplot in **Exhibit 1** plots the Sustainalytics ESG rating against the MSCI ESG rating for domestic stocks in the Russell 3000 Index.



Source: MSCI, Morningstar, 2020

These findings show that there is a low correlation between the two agencies' ESG scores, which yield a

correlation of 0.31. By comparison, credit quality ratings from Moody’s and Standard & Poor’s yield a correlation of 0.99¹. Two key differences explain the divergence:

1. Creditworthiness is clearly defined as the ability to repay debts and remain solvent whereas ESG ratings are subjective based on the rater’s philosophy.
2. Credit ratings are constructed using standardized, audited financial data whereas ESG data points are not. This causes ESG ratings agencies to make assumptions and subjectively interpret ESG data, causing a lack of uniformity in ratings scales, scope of criteria and definitions of ESG quality

The relationship between MSCI’s ratings and Sustainalytics’ ratings appears weak in international markets, too. Comparing the two providers’ ratings presented several challenges. In each of the three markets, domestic equities (Russell 3000), international developed (MSCI EAFE), and emerging markets (MSCI EM), there was a conscious omission of companies that were not rated by both agencies. Notably, Russell 3000 had the lowest common number of ratings relative to the total number of stocks in the index with 2,288 companies rated by both providers out of a possible 2,970 companies. In emerging markets, 1,302 out of 1,401 companies were rated by both providers. Both ratings agencies maintain nearly complete coverage of international developed markets with 909 out of 918 companies in the MSCI EAFE Index rated by both ratings agencies.

While the EAFE is the smallest population of constituents, the higher overlap between MSCI and Sustainalytics is possibly due to the divergent regulatory reporting requirements across global markets. In Europe, for instance, companies with 500 or more employees are required to publish a non-financial statement that includes disclosures. With that said, even in the most progressive countries, ESG reporting requirements are still in their early stages of adoption and implementation. Such disclosures are not required in the United States or in many emerging markets. This could also be a factor contributing to slightly stronger correlations in international developed total ESG scores, albeit still weak overall.

Exhibit 2

Russell 3000 Correlations of Sustainalytics vs. MSCI			EAFE Correlations of Sustainalytics vs. MSCI			EM Correlations of Sustainalytics vs. MSCI		
Total ESG Score	0.31	N= 2,288	Total ESG Score	0.42	N= 909	Total ESG Score	-0.03	N= 1,302
E - Score	0.33	N= 907	E - Score	0.31	N= 906	E - Score	-0.01	N= 1,097
S - Score	0.04		S - Score	0.18		S - Score	-0.01	
G - Score	0.16		G - Score	0.35		G - Score	0.00	

Source: MSCI, Morningstar, 2020

¹ Guttler and Wahrenburg, 2004

Comparing the component E-, S- and G-Scores was also challenging, as one ratings provider had a significant number of companies that were out of the scope of their research for component scores. Again, we see U.S. stocks with the greatest difference in common component scores relative to total ESG score. Although more than 2,000 U.S. stocks did not have common individual scores, in aggregate they make up an eight percent weight in the index. This suggests that a completion bias exists for companies with larger market caps; as such, investors may have less data visibility for smaller stocks.

Despite the discrepancy in output, ESG ratings services have been used — and continue to be used — by many of the world’s largest investment firms. Today, there are more than 3,000 signatories to the United Nations Principals for Responsible Investing (PRI) worldwide, who are encouraged to incorporate ESG considerations into their investment processes with more than \$90 trillion in assets under management². This pledge adds cost and time for managers, many of whom do not have the resources for in-house ESG research and rely heavily on ESG ratings agencies to fill the void.

While the individual total scores for companies are commonly assessed by investors, the ranking can be much more important for investment uses. A common method investors use to fulfill ESG mandates is to manage a passive portfolio with specific ESG criteria used to exclude certain securities. Investors implementing this methodology may replicate an index with companies that have higher ESG ratings or exclude companies with lower ESG ratings. Taking this approach, the standalone ratings are less important than how each stock ranks amongst peers in its sector. However, the results of the screen vary dramatically based on which provider’s ESG ratings the investor uses.

The exhibit at the right illustrates this divergence, presenting the tails of the index’s distribution from the top and bottom quartiles of the EAFE index, the highest correlated universe, for both MSCI and Sustainalytics ratings. Our findings show that there is a material disagreement in which stocks are considered the best from an ESG standpoint and which are considered the worst. There is less than one-third overlap in common holdings for both top and bottom quartiles.

The results remain discouraging even at the sector level. In addition, there is no meaningful overlap for either the top or

Exhibit 3

EAFE Analysis		
	Common Top Quartile	Common Bottom Quartile
EAFE	24%	25%
Utilities	45%	64%
Technology	27%	40%
Industrials	59%	50%
Health Care	50%	39%
Financials	53%	41%
Energy	40%	60%
Consumer	34%	38%
Basic Materials	58%	32%
Real Estate	62%	54%

Source: MSCI, Morningstar, 2020

² UNPRI 2019 Survey

bottom quartiles across any sector other than Real Estate. Even in the most common sector, the holdings overlap did not exceed 75 percent.

Thus, significant variation in ESG ratings exists both at an absolute index level as well as within each sector, implying that the divergence in quartiles is partial to the choice of ESG rater.

As a result of this, the data from these findings implies that investors who choose to implement exclusionary criteria based off multiple ESG ratings will have far fewer companies in their investible universe. For a passive investing approach with exclusionary criteria based on multiple ESG ratings providers, a smaller investible universe will result in more concentration when stratified sampling (approach to index investing where the investment manager divides the index into different strata that represent characteristics of the index and chooses securities that mimic those cells) to match the index characteristics. This could result in a suboptimal portfolio with greater tracking error. Moreover, it is hard to justify that the best or worst quality ESG companies are being considered in a portfolio given the disparity in quartiles.

Challenges in Data Quality

As discussed earlier, a major challenge with ESG is the quality and availability of germane data due to:

- **Timeliness** – ESG ratings and corporate sustainability reports are issued on an annual basis.
- **Unaudited** – ESG data is self-reported, and companies can selectively disclose only their successes.
- **Size** – Smaller companies have less resources to dedicate to ESG data reporting.
- **Subjectivity** – Some data points cannot be quantified and must be qualitatively assessed.

Furthermore, data points and metrics reported by companies are inconsistent across industries because of the lack of standardization. Today, there are three major reporting initiatives competing for leadership, shown below.

Exhibit 4

	GRI	IIRC	SASB
Definition	Reports should cover aspects that broadly reflect the company's significant economic, environmental and social impacts.	Reports should combine traditional, annual financial with ESG data that detail the creation of value in the short, medium and long term.	Information is material if there is substantial likelihood that the omitted fact would have altered the information available to the reasonable investor.
Threshold for Disclosure	Whether information would be considered important by broad range of stakeholders	Whether information substantively affects the company's ability to create value	Whether information would impact investor decisions
Perspective Considered	Broad range of stakeholders	Financial capital providers	The reasonable investor

The most common reporting framework is the Global Reporting Initiative (GRI), whose standards are designed to provide information to a wide variety of global stakeholders. Conversely, the International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB) urge companies to publish reports regarding financial and non-financial performance metrics deemed material by industry. With no clear leader in disclosure standards, the reporting framework a company uses to disclose ESG data may affect its comparability with other companies because of the different perspectives considered.

Case Study: Coca-Cola vs PepsiCo

Corporate ESG reporting includes an abundance of anecdotal information but not many data points, as a lack of quantifiable, verifiable, relevant data is one of the major challenges in ESG reporting for investors. The majority of the reports do not clearly demonstrate a link between ESG factors and financial performance.

To illustrate the differences in reporting we'll examine the corporate ESG reports of two competing companies with similar market capitalizations: Coca-Cola and PepsiCo. However, rather than commercial taste-tests, we will compare the information provided in each report.

As beverage companies selling billions of single-use plastic bottles, both companies share similar priorities in ESG considerations – primarily around reducing packaging and waste. Despite this fact, their goals published in annual sustainability reports regarding this commonality are nuanced. **Exhibit 5** below illustrates select data points.

Exhibit 5

Packaging & Waste Goals and Measurement			
Coca-Cola		PepsiCo	
Goal	Measurement	Goal	Measurement
<ul style="list-style-type: none"> Recycle 75% of bottles/cans introduced into developed markets by 2020. Use 50% recycled material in packaging by 2030. Make designs of packaging 100% recyclable by 2025. 	<ul style="list-style-type: none"> % of bottles/cans recovered relative to what was introduced into developed markets % of recycled material used in packaging % of packaging that is recyclable 	<ul style="list-style-type: none"> Designs of packaging 100% recyclable, compostable or biodegradable by 2025. Increase recycled content in plastics by 25% by 2025. Reduce 35% of virgin plastic content across beverages by 2025. 	<ul style="list-style-type: none"> Includes company owned brands/franchises with greater than 50% ownership by PepsiCo Volume of recycled plastic/volume of total packaging by weight Reduction in virgin plastic from 2018 baseline year

Source: Coca-Cola Corporate Sustainability Report 2020. PepsiCo Corporate Sustainability Methodologies 2020.

While both Coca-Cola and PepsiCo share the same goals of producing less wasteful packaging, their time horizons and measurements of success are different. There is also no clear link between either company improving packaging waste and enhanced financial performance. It is therefore difficult to compare sustainability performance between the two firms — or even over time.

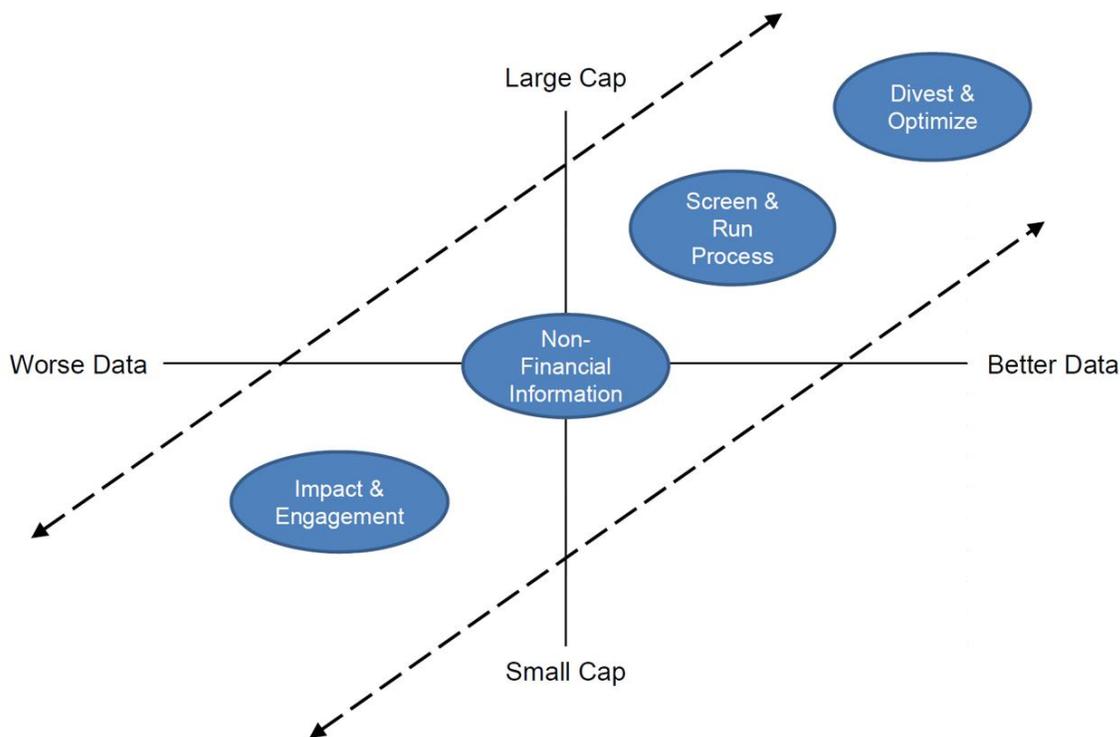
Investor Implementation

Since companies may choose to report on material or immaterial ESG factors, and whether to use globally acknowledged standards like GRI to evaluate their performance, the job for investors is far more difficult.

How can investors evaluate portfolios when there is no objective and dependable metric for success?

Given the current environment around ESG reporting standards and disclosures, we recommend different implementation approaches depending on market efficiency and data quality, as shown below.

Exhibit 6



For large capitalization markets where data quality and availability is greater, a *Divest & Optimize* or *Screen & Run Process* approach may be utilized, wherein:

- **Divest & Optimize** – Customized SMAs driven by client-defined values
- **Screen & Run Process** – Agreeable, measurable, pre-defined exclusionary criteria screened before traditional investment process is implemented (i.e., percentage of revenue tied to sale of alcohol, tobacco, weapons, etc.)

Conversely, for less efficient markets where data quality is poor and availability is scant, an *Impact & Engagement*-focused approach may be most effective, wherein investment managers can engage corporate management and executives on ESG-related issues and provide a path for improved ESG policies and better ESG disclosures, thus increasing visibility and influencing key issues material to the company's business operations. These engagements generally work best with smaller companies where management is more accessible to investors and may lack the infrastructure to implement better disclosure and policies.

Lastly, a “go anywhere” approach involves employing investment managers that integrate ESG factors, or *Non-Financial Information*, into the investment thesis. Investors that integrate and explicitly consider ESG factors as part of their investment process may be effective across markets.

As discussed, the challenges ESG data present are nuanced yet increasingly pertinent. However, with the substantial rise in demand for ESG products, differentiating product proliferation versus greenwashing has become a crucial part of the investment manager due diligence process. As long as disclosure remains unregulated and rating methodologies remain opaque, the burden of investment manager due diligence falls on the users to ensure that this information can realize its true potential in helping achieve mission-aligned investments with successful financial outcomes.

For more information, please contact any of the professionals at Fiducient Advisors.

About the Author



Collin researches and performs operational due diligence on core investment managers and is a team member of the firm’s Global Public Markets Group and Mission-Aligned Investing Team. Collin joined the firm in 2015 as a performance analyst. Previously, he was a Portfolio Administration Analyst at McDonnell Investment Management. Collin graduated from the University of Iowa with a BBA in Finance and Minor in Economics. He is a CFA® charterholder and a member of the CFA Society of Chicago. In his free time, Collin enjoys skiing, cooking and performing acoustic guitar throughout Chicago.

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