Impact Cubed

IS ESG DATA NOW A COMMODITY?

As specialists in ESG and impact data for the most sophisticated and discerning investors (including hedge funds), we expect to encounter a wide range of views about sustainable investing in our discussions with portfolio managers. But we were taken by surprise when the head of sustainable investing at a large asset manager said to us, “ESG data is now a commodity”.

A commodity is something that is interchangeable with other goods of the same type; it doesn’t matter where it’s obtained. Suggesting that ESG data is a commodity assumes it is as easy to acquire as a public company’s stock price, earnings per share or annual revenue. It’s also wrong. ESG and impact data for use in the investment process is in its infancy and a long way from being commoditised.

Lack of standards

In order for information on companies’ ESG performance to be commoditised, it would have to be provided according to uniform, widely accepted standards. It’s not.

There are no globally reaching regulations necessitating corporates to declare their ESG or impact performance. Likewise, there are no universal standards for making such disclosure.

Buyers would be wise to be wary and ask for transparency on what the ESG and impact data is actually measuring.

Estimating ESG performance to avoid the disclosure cliff

Media routinely reports that "ESG is mainstream", highlighting how the largest companies now publish sustainability reports. But the reality is more like a disclosure cliff: of the 40,000+ listed companies publishing an annual report, fewer than 10,000 actually disclose quantitative data on things like gender pay or carbon emissions.

This disclosure cliff creates a problem for investors, because they must make an assumption about a company's ESG performance and impact if it is not disclosed.

Some ESG data providers do not provide estimates for non-disclosed data. This means, for example, an investor new to ESG could make a (bad) assumption that a non-disclosing company has zero carbon emissions and there is no carbon risk in the portfolio.

Other ESG data providers estimate non-disclosed company data using widely varying methods, some of which are more art than science. There can be unintended consequences for investors who do not take the time to ask for and understand data providers' methodologies. **For example, a popular ESG rating provider reports that only 35% of the data inputs to its model are based on factual company ESG disclosures.**

Here are a few examples of things investors can look out for:

- **Sector classification to define ESG peers:** How detailed is the sector classification used to define a peer company, and does it address regional differences? Carbon efficiency estimated from similar peer companies in a 2,300 region-sector classification will be much more precise than one using a 158 global sector classification (the approach commonly used by many ESG data vendors). An investor whose strategy is to select companies that are top ESG performers in its sector will benefit from a model with the highest levels of granularity.

- **Company revenues for understanding impact:** Companies may have diverse product lines and multiple revenue streams. For example, two companies may derive their revenue from the sale of motor vehicles. Both could, therefore, be treated the same. But what if one sold electric cars while the other sold diesel-powered pickup trucks? One well-known ESG data provider classifies the impact of a company only by its largest revenue line. An investor whose strategy is to select companies with business models aligned to the future economy (more sustainable, low carbon) will find it very challenging to create a large basket of potentially investible securities and discern the difference between them using a data source that does not show off the nuance among all company revenues.

Context

This leads to another important point: ESG and impact data is best viewed in context of an investment portfolio. It can't simply be part of a box-ticking exercise.

For example, last year's carbon emissions for a company will give an investor a snapshot of where it was in 2021. It won't, however, show its trajectory. If you were investing in a company, wouldn't you want to see where it's heading – not just where it's been?

A better forward-looking data point might be a company's capital expenditure and where this is being focused. Is cash being utilised to support energy-efficient projects – or is it still being funnelled towards polluting activities?

ESG data is a powerful tool for investors, but a long way from being a commodity. Getting investment advantages from this data requires knowing where to acquire it and its limitations, and also how to contextualise and understand it. Otherwise, a fool with a tool is still a fool.

Curious about the ESG performance and impact of popular passive funds? You can find all of Impact Cubed publications here.

ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customised sustainable investing. You can find out more about our data and portfolio models at www.impact-cubed.com and if you would like to contact us at info@impact-cubed.com we would be happy to hear from you.

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