Impact Cubed

INVESTORS NEED BETTER ESG DATA, NOT STANDARDISED RATINGS

Asset managers and wealth managers who are new to ESG or impact investing can find it confusing and overwhelming. As just one example, the myriad of ways funds get rated and assessed means finding a sustainable investment is rarely a case of picking the one with the "best" ESG score.

Read about ESG investing for just a little while and you'll see calls for uniformity in the way ESG raters operate. Standard industry practice involves scoring companies (and funds) on their ESG performance by mixing a multitude of disparate metrics to give investors an impression of which ones are best (regardless of whether that actually makes sense, but we digress).

Understandably, investors are confused. Standardisation of ESG ratings, we're told, is the silver bullet.

Calls for standardised ESG ratings

Recent times have seen interest intensify, with notable institutions calling for greater synergy among ESG rating providers. In a recent report, for example, the Organisation for Economic Co-operation and Development (OECD) argued inconsistencies among ESG ratings call into question whether they are fit for purpose. The solution is not improved coordination between rating providers. The market meltdown in 2008 is a stark reminder what happens when rating agencies are in lock step.

Some markets have moved beyond calls for standardisation. India's Securities and Exchange Board recently published consultation paper suggests how it will regulate ESG raters. In what's widely viewed as a precursor to regulating ESG raters, the European Securities and Markets Authority and European Commission have issued consultations on the use of ESG ratings by market participants.

ESG ratings are like equity analyst recommendations

Where these calls for standardisation miss the mark is that ESG ratings by their very nature are subjective, as mainstream media is now starting to expose.

Funds and companies rank very differently depending which ESG rater is doing the judging, because each rater has its own proprietary methodology. ESG ratings are also an "averaged" score of how companies are performing. Bad governance can be offset by strong environmental performance. Poor corporate diversity metrics can be diluted by ambitious carbon-reduction targets.

Equity analyst stock ratings are a good analogy. There is no universal ranking system and each equity rater has a nuanced approach to making a "buy, hold, or sell" recommendation.

Let's take the 31 equity analyst recommendations for Tesla as an example. About half say "buy" and a quarter say "sell". Smart investors understand that analyst opinions are just one piece of information to inform their own research to determine a good investment.

Equity analyst recommendations[1]

Buy	Sell	Hold
16	8	7

Investors will benefit with better ESG data, not uniform ratings

What will help investors is better ESG data. ESG data differs to "ratings" in that it consists of factual information about a company

[1] Marketwatch summary, March 2022

or fund. It doesn't involve compressing and compounding of metrics in an attempt to determine a score or letter grade. It also doesn't involve a subjective analyst judgment on whether ESG performance is good or bad.

ESG data also focuses on actual corporate accomplishments. When companies are rated on ESG, they may be rewarded for adopting a net-zero carbon target 25 years into the future or adopting a management policy committing to better diversity. This, however, doesn't actually give an investor information about where a company is now or what it has achieved on environmental or human capital practices.

Focus instead on standardised disclosure by companies

The largest hurdle is obtaining quality ESG data from company public reports. In some cases, companies don't publish any ESG performance. In others, companies may be reporting data but in different ways, making it difficult for investors to compare firms or funds. Impact Cubed has invested heavily in digital tools to extract, standardize, normalize and quality assure this data - at a global scale - to make it adequate for investment decision making. Pushes for standardisation in reporting by companies on their ESG performance – which are also in motion – are far more important than standardising ESG rating agencies.

Uniform ≠ Objective or Factual

Uniformity in ESG ratings may inadvertently create the illusion that the ratings are wholly objective and factual. ESG ratings should be viewed in a similar way to analyst equity research and stock ratings. Investors recognise their subjectivity and treat them as they would any other opinion – something that can inform, but not the silver bullet for making an investment allocation.

Read more about our views on ESG Ratings: Would you mix red and white wine in a glass? No. Why are we doing that with ESG?

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.