Can we agree it's time to move on from ESG scores?

ESG considerations are becoming increasingly core to the capital allocation process for investors. However, the current industry practice of using ESG scores that mix good company characteristics with bad ones are of little use to investors.

Impact Cubed has been the underdog championing this cause: investors deserve better information about the impact of their investments than what ESG scores give them. It has been a bit of a David vs. Goliath saga to disrupt standard practice in the industry and create better solutions for investors. So we were happy to see the legendary Dilbert comic strip, known for its biting satire about the workplace, taking swipes at ESG ratings and how companies are gaming the process - well and truly confirming the scrutiny needed on ESG scoring.

Why does it make sense to bundle unrelated things into one score?

For those not immersed in the minutia of ESG ratings, standard practice is to create scores on a wild array of E, S, and G considerations and bundle them into an overall score. The rating provider creates a proprietary formula that weights each of those individual considerations. The approach is wholly subjective. It also means that companies can achieve high composite scores even if they are causing harm in some measures but performing well in others.

This can be seen best with technology firms. These firms' lower air and waste emissions often result in them getting higher ESG ratings, and consequently they are often the largest holding for ESG funds. However, they don't always perform well in the social and governance dimensions. Amazon for instance has recently been accused of predatory pricing, while Meta uses algorithms that allow hate speech and misinformation to spread across the internet and into communities.

Blending all the multiple dimensions of ESG is akin to mixing red and white wine in the same glass, as we've previously highlighted. It obscures individual environmental and social dimensions that may be important to investors.

Rewarding well managed polluters

The veneer is also peeling off to show precisely what ESG ratings measure, as highlighted most recently in a New York Times op-ed. When Bloomberg Businessweek examined the methodology behind MSCI's ESG ratings, it uncovered that rather than measuring the impact a company has on the environment and society, the scores assess whether a firm's economic value is at risk from ESG factors.

This means a firm with high emissions can still get a high score if a ratings provider determines the polluting behaviour is managed well, or it won't affect the firm's economic value. For instance, despite McDonald's producing 54 million tons of carbon emissions in 2019, its rating was upgraded after the ESG Rater determined climate change did not pose a risk to the firm's profits.

Investors should decide, not ESG Raters

Ultimately, it's the asset manager's portfolio team – not the ESG provider - who should be deciding what makes a company a good investment at any point in time. And it's the end investors who should be deciding which ESG and impact considerations are important to them and how sustainable investments fit within their risk and return preferences. That's why factual ESG data and tech-powered tools to measure companies on individual factors t which don't compress or compound metrics into a single score, are vital.

For more of our views and research on ESG and impact, visit https://www.impact-cubed.com/newsandpublications

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@impactcubed.com we would be happy to hear from you.

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