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ESG investing will never be fully objective - and that's ok

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- Academic studies have found little correlation between the ESG ratings of different scoring providers.
- The presence of many different methodologies has drawn criticism from questioning the relevance of seemingly arbitrary assessments.
- However, given the complexity of the field, we believe that ESG investing will always be subjective and that it is desirable to have a diverse rating industry.
- Ultimately, end investors need to make decisions based on their individual ESG preferences, and the investment industry should provide them with suitable, transparent products, including customized portfolios.

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Incorporating Environmental, Social and Governance criteria in the investment process is more and more becoming a standard procedure as the world is facing mounting challenges from climate change and plastic pollution to social imbalances and mass migration.

1 Sometimes science is more art than science

The financial industry is expected to use its influence as the primary allocator of capital in the free-market economy to help solve these problems.

> "One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute"
> *(William Feather)*

Just, how exactly banks and asset managers are supposed to contribute is an increasingly controversial question and has led to a lot of confusion, manifesting itself in frequent backlashes against greenwashing and even lawsuits.There is no doubt that over recent years ESG has become a powerful buzzword, attracting asset inflows and for industry participants, it has certainly become an important market opportunity or competitive disadvantage depending on which side they stand. Fancy tools such as interactive maps showing potential clients how much CO2 they could "save" per Dollar, Euro, or Swiss Franc invested in a particular portfolio and how many trips around the world this would allow them to pursue, are only one example of potentially problematic sales activity.

Figure 1: *The debate about the environmental impact of Tesla's 2.3 tons heavy cars is ongoing. The company's exclusion from SP's family of ESG indices, however, has other reasons.*

Nevertheless, behind the curtains, regulators, industry bodies and rating agencies have been working on increasingly increasingly sophisticated frameworks, attempting to govern ESG investing.There are countless permutations in the combination of ESG criteria. Providers of ESG ratings such as MSCI, Sustainalytics or Refinitv publish aggregate scores that seek to provide investors with straightforward guidance. However, it has frequently been pointed out that different agencies often publish very different ratings for the same company.

A research project by the MIT Sloan School of Management found that the average correlation between ESG ratings from prominent agencies was only 0.61, which contrasts with a correlation of 0.92 for credit ratings. As the number of ESG rating agencies has surged to

more than 100 providers, navigating the ecosystem is unlikely to become notably easier.At MIT Sloan School of Management, academics dubbed the problem "aggregate confusion". They stated that the divergence in ratings "makes it difficult to evaluate the ESG performance of companies, funds and portfolios, which is the primary purpose of ESG ratings".

While the significant heterogeneity of rating methodologies indeed makes it harder for fund managers and investors to sort investments into boxes, the more critical question is whether this is really a bad thing.Our ESG database, delivered by one of the major rating providers, comprises more than 2000 unique fields. Aggregate scores and ratings are based on a vast number of first, second and third-degree sub-scores and assessments, combined and weighted through a large number of algorithms. While we are not the ones driving those models, we can easily imagine that even small tweaks in the methodology can significantly impact the final result. However, unlike a credit rating, this end

Figure 2: *Our ESG database comprises more than 2000 unique items, including data points covering sanctions, the UN sustainable development goals and EU taxonomy.*

result is highly subjective anyway. Credit ratings have to fulfil a simple, well-defined task - determine the likelihood of default for a given entity. A lot of historical data helps agencies derive the exact relationship between a company’s financial performance as expressed by its accounting and the probability of default.

As reporting standards evolve and bankruptcies occur, these rules can be continuously developed further based on objective empirical findings.The availability of similar relationships in ESG investing is limited at best. Yes, over time, we should expect a financial company that scores high on governance to be less likely to get into trouble over faked accounts. A mining company that scores high on environmental criteria should be less likely to get involved in a major disaster. What constitutes a good company on aggregate, though, is more often subject to judgement, as people assign different importance to different input factors depending. Comparing ESG ratings with credit scores, therefore, makes little sense, to begin with

Why don’t we take ESG scores more like analyst recommendations?

All market participants ultimately base their assessments on the same bunch of financial statements, company presentations, management comments and industry-level or economic information. Nevertheless, opinions of which company constitutes a "good" investment naturally vary widely as diverse investors under- or overweight different pieces of information.

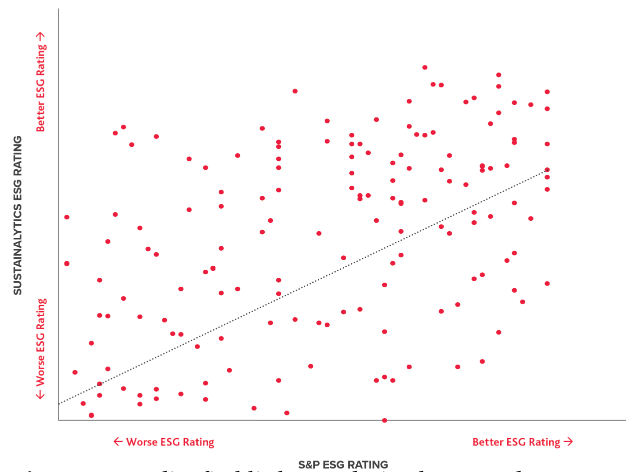

Figure 3: *Studies find little correlation between the ESG ratings from different providers, and in a way, we are glad this is the case. (from the Enterprising Investors, August 2021)*

2 Heterogenic ratings are only the edge of the jungle.

Ratings that seek to quantify a company’s Environmental, Social and Governance performance are only one aspect of ESG investing. An ESG fund is typically confronted with many more challenges. One question, for instance, is whether the fund should simply invest in companies that score well on ESG metrics or whether it doesn’t make more sense to buy stocks of companies that have poor ratings and push for change. Decarbonizing the cement produced by some old-fashioned industrial plants is probably more relevant in tackling climate change than bringing more Tesla vehicles.

Discussions concerning exclusion criteria that frequently touch on very personal values and beliefs typically become even more controversial. For example, should an ESG fund invest in tobacco, alcohol, hotels or defence? The answer to this simple question will, by definition, depend on a individual’s socialization, life experiences and even religion.We have already written about the many degrees of freedom and substantial discretion involved in Standard Poor’s decision-making process related to the inclusion of stocks in the SP 500.

A company’s inclusion in an ESG index family is just the outcome of another investment process designed based on certain rationals. By definition, numerous active investors believe that the SP 500 is not the best possible portfolio of U.S. stocks and deliberately devi-

ate from it. Therefore, it is only natural that opinions about the composition of the respective ESG indices will be equally heterogeneous.

3 Personalisation is the key to honest ESG investing.

At the end of the day, the high number of rating providers and disagreement about ESG ratings and exclusion criteria can be viewed as healthy. Wouldn't it sound alarmingly like Orwell if a single entity would judge which private businesses are sustainable, "good" or have a positive impact? Laws and regulations provide a minimum set of rules on which business activities are allowed and in which manner they can be conducted. Now, regulators are pushing investors to adopt processes that incorporate criteria in their decision making that go way beyond this set of rules. This is legitimate as long as it is restricted to ensuring investors' monitoring and reporting capabilities, leaving them the freedom to independently design their investment processes and decide on the governing criteria. ESG funds and indices will always be a function of

Figure 4: *Investors need to acknowledge the many shades of grey in businesses' roles related to Environmental, Social and Governance criteria.*

the issuer's investment process and are thus subject to many limitations. As long as the process governing the product's decision making is clearly described, investors can accept or reject this process. As the number of products that explicitly incorporate ESG criteria grows, they are more likely to find products aligned with their own set of values.

Again, in this context, diversity is a strength, not a shortcoming. All clothes come in a small number of standard sizes, but luckily the exact fit varies widely by brand. Another positive aspect of this is that as more and more companies up their ESG reporting, there will be no low hanging fruits. As Tesla just learned the hard way, it is not sufficient to be vaguely associated with positive environmental initiatives to be considered a leader in ESG.Wealthier investors who care about ESG may prefer not to buy off the peg at all. Efficient screening procedures and portfolio optimization allow the creation of highly customized portfolios, combining ESG scores, ratings and exclusion criteria in exactly the way the end investor would like based on their personal beliefs. Meanwhile, this shouldn't stop us from realistically seeing and communicating the significant limitations and limited impact ESG investing, particularly in public securities, is likely to have.

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