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TIC Research Group

Navigating Through the Confusions of ESG Ratings

Environmental, Social, and Corporate Governance investing, or ESG investing, has gained rising popularity as more investors are looking beyond finical metrics and seeking to align their investments with their personal values. Following the public interest, companies like the MSCI began to provide ESG products like ESG indexes and provide ratings for ESG mutual funds. Market participants faced a variety of products that seemed to be contributing to improving the world. However, recently more ESG rating providers have come under scrutiny due to doubts about the accuracy and credibility of their evaluations. It is, therefore, important to reevaluate the practicality of those ESG ratings and how individuals should approach those ratings. Investors should be aware of both the drawbacks of ESG ratings and their potential to improve investment decisions.

The Problem With ESG Ratings:

Vague Definitions

There are discrepancies between investors' perceptions of ESG funds and the funds' actual portfolios. Many investors are unaware of the "best in the industry" approach adopted by most ESG rating agencies, which may include heavy shares of oil refineries in a portfolio that were perceived as creating environmental benefits. Additionally, many ESG ratings are conducted in certain methodologies that measure the potential impact of the world on the company and its shareholders rather than the other way around—how the company is actively impacting the world.

Lack of Uniformity

The ESG ratings across different rating providers have exhibited low correlations both regarding a company's overall ESG rating and sub-ratings considering individual factors (E, S, and G). In a study conducted by the CFA institute, researchers found low correlations across six prominent ESG rating providers (MSCI, S&P, Sustainalytics, CDP, ISS, and Bloomberg). The mean correlation factor is 35.1%, which suggests that either there is significant variation in the methodology of compiling ESG factors within the rating industry or there are great variations in data sourcing that might lead to concerns over their credibility (Prall, para.20).

CFA Institute (2021)

	MSCI	S&P	Sustainalytics	CDP	ISS	Bloomberg
MSCI	x	36%	35%	16%	33%	37%
S&P	36%	x	65%	35%	14%	74%
Sustainalytics	35%	65%	x	29%	22%	58%
CDP	16%	35%	29%	x	7%	44%
ISS	33%	14%	22%	7%	x	21%
Bloomberg	37%	74%	58%	44%	21%	x

Note: CDP is the Carbon Disclosure Project Score.

Deeper research conducted by Berg, Kölbel, ad Rigobon showed that variations caused by scope divergence (which factors are included in measuring E, S, and G) account for 38% of the differences in ESG ratings. Measurement divergence (how individual factors like worker satisfaction are evaluated, whether it is based on worker turnover ratio, surveys, or labor-related court cases) contributes to 56% of the divergence. Weight divergence (how agencies value the relative importance of each factor) accounted for only 6% of the overall differences. This shows that there are fundamental discrepancies in the process of compiling ESG ratings, and investors should be aware of this when making investment decisions (Berg et al. 1317).

<u>Concerns over the Credibility of Data</u>

The data sources of ESG ratings include public, quasi-public, and private data. Many indicators or data of a company that is necessary for conducting ESG ratings are not required for public disclosure by the SEC. If the companies refuse to fill out solicit questionnaires provided by the rating providers, the rating agencies have to form their own strategies to make up for the missing data. One might exclude the data point entirely, which creates discrepancies between corporations that disclose those data points and those that do not disclose them. Other strategies include creating presumptions for necessary data points. For example, MSCI seems to presume the performance of a specific company as an industrial average when data is not available, while FTSE Russell appears to substitute the missing data as being the worst in the industry. These strategies lead to concerns over the consistency and credibility of the fundamental data of ESGs.

Another factor contributing to the difficulty in evaluating ESGs is the inherent vagueness of the subcategories of ESG: Environmental, Social, and Governance. There are no standardization or regulations regarding how one should quantify those qualitative characteristics of a company. This lack of transparency may lead to risks of "greenwashing." In addition, many companies have remarkably complex supply chains, and it is an exceptionally hard task to conduct due diligence for every sector of a company's business model.

<u>Fundamental Conflicts of Interests</u>

Although there are sufficient data throwing doubts on the credibility of ESG ratings, it is also important to review the fundamental conflict of interests that provided incentives for ESG rating providers and individual companies to use ESG more as a marketing instrument rather than a tool to encourage non-financial contributions. Most rating providers have ESG products like ESG indexes that are available to institutional and individual investors. MSCI, for example, has more than 1,500 equity and fixed-income ESG and Climate Indexes (MSCI). Its iShares MSCI USA ESG Select ETF (SUSA) is among one the most frequently used ESG ETFs when being integrated into passive and active investment portfolios. The fact that those rating agencies provide ESG solutions attracts many investors, giving them easier access to the capital market. Therefore, ESG rating providers are incentivized to market their products as ESG related despite many of them having energy-heavy sectors inside their indexes. In fact, ExxonMobil has been consistently ranked among the top 10 invested ESG stocks despite it being an oil refinery company.

On the other hand, individual companies also have incentives to deliver greener, more ethical figures when providing data to the ESG rating agencies. Companies with higher ESG scores benefit from fiscal and monetary policies provided by the government and central banks. They can also gain easier access to cash when being labeled as an ESG company by being included in ESG indexes that allow investors to invest in them passively. It is the same rationale as companies included in the S&P 500 index benefit from passive investors investing in those index funds rather than doing due diligence and holding individual stocks.

The Practicalities of ESGS

Despite showing drawbacks to the ESG ratings, it is not to dismiss the usefulness of ESG ratings entirely. When making investment decisions, investors can consider integrating ESG ratings as part of the fundamental analysis and weigh them along with other financial metrics. Studies have shown correlations between ESG ratings and:

1. Higher Tobin's Q, ROI, ROA, and Coverage Ratio

In the Soh Young In and other researchers' essay, they found that "a firm's carbon efficiency is closely associated with firm value measured in Tobin's q, net income relative to invested capital (I.e., return on investment, ROI), return on asset (ROA), coverage ratio and others" (Soh et al. 4). By choosing to invest in a company with an efficient management structure, values individual rights, and prizes fairness and transparency, investors choose a company with higher earning potential and better stability when facing downturns.

2. Better Liquidity and Ability to Absorb Market Shocks

Liquidity represents how efficiently investors can withdraw their investments from stocks and turn them into cash in emergencies. In a research published by the Business Strategy and the Environment, researchers found a positive correlation between ESG scores and higher liquidities by examining the bid-ask spread. The lower the bid-ask spread, the higher the firm's liquidity. The data presented a lower bid-ask spread of ESG firms compared to other companies in the industry, which shows that high-rated ESG score firms have more resiliency than others (Cardillo et al. 17). This ex-ante liquidity helps ESG firms to have more reaction time in black swan events in the market like COVID-19.

3. Reduction of Non-Financial Risks

Reputational risks and volatility due to dependency on energy-heavy commodities are two examples of non-financial risks. As investors become more attentive to aligning their personal value with their investments, the adverse reputational risk might trigger sell-offs in the market. Meta (Facebook) has been reported to have leaked 533 million user data in April 2021, which drew societal attention and investigation from the Irish Data Protection Commission. This, along with other factors, has caused Meta to lose a third of its stock value from April 2021 to April 2022 (Bodoni, para.2). On the other hand, many oil refineries experienced significant volatility in stock price because of their dependency on oil prices.

Final Thoughts:

ESG indexes and funds are not regulated under the SEC in the same way as traditional passive index funds like the S&P 500. Significant risk is involved in using ESG as the sole indicator of investment decisions. However, investors might still wish to use ESG ratings as part of their fundamental analysis as studies have shown positive correlations between companies' ESG ratings and their fundamental stability, risk-mitigation capacity, future potentials, and capability of shock absorptions.