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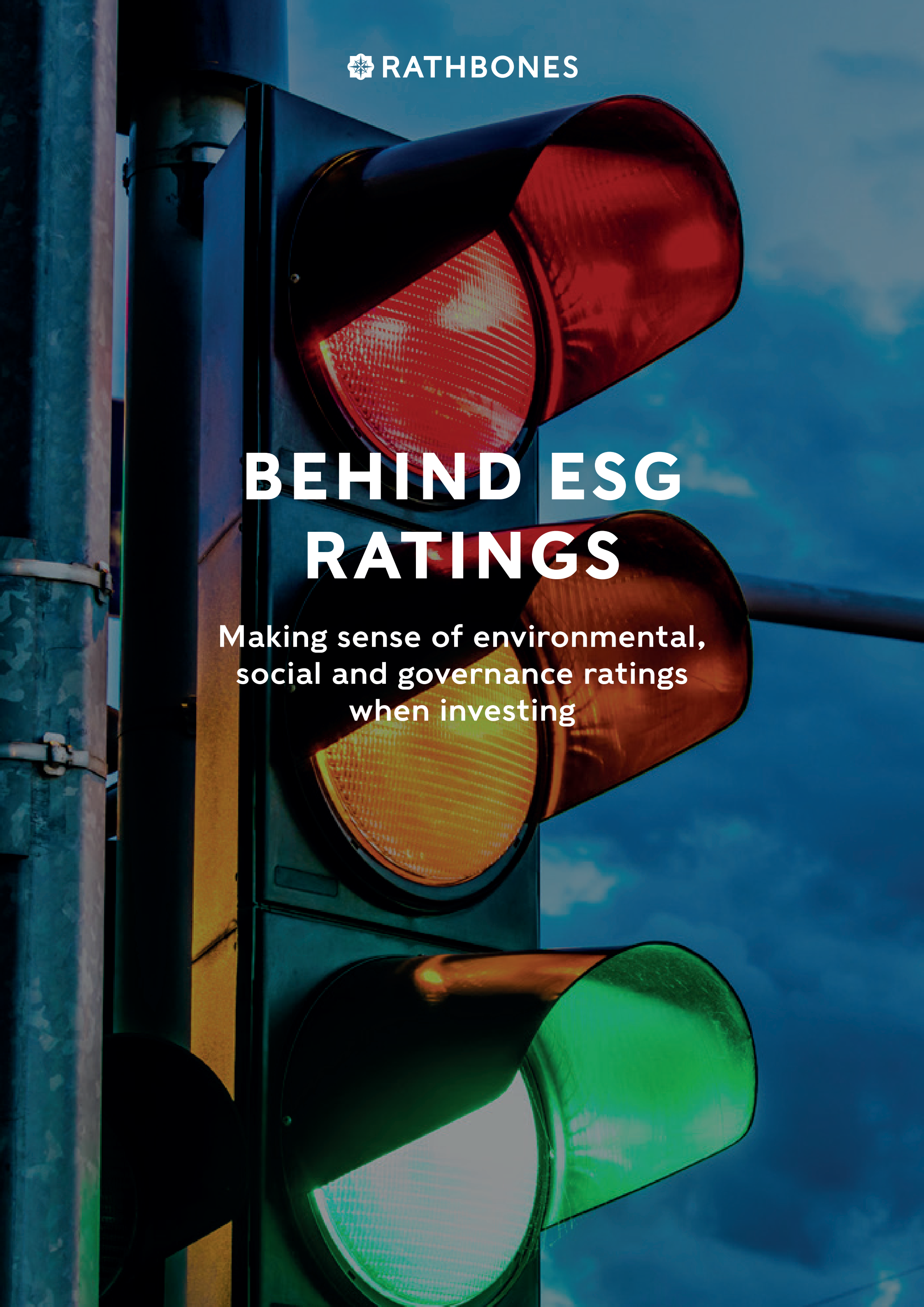
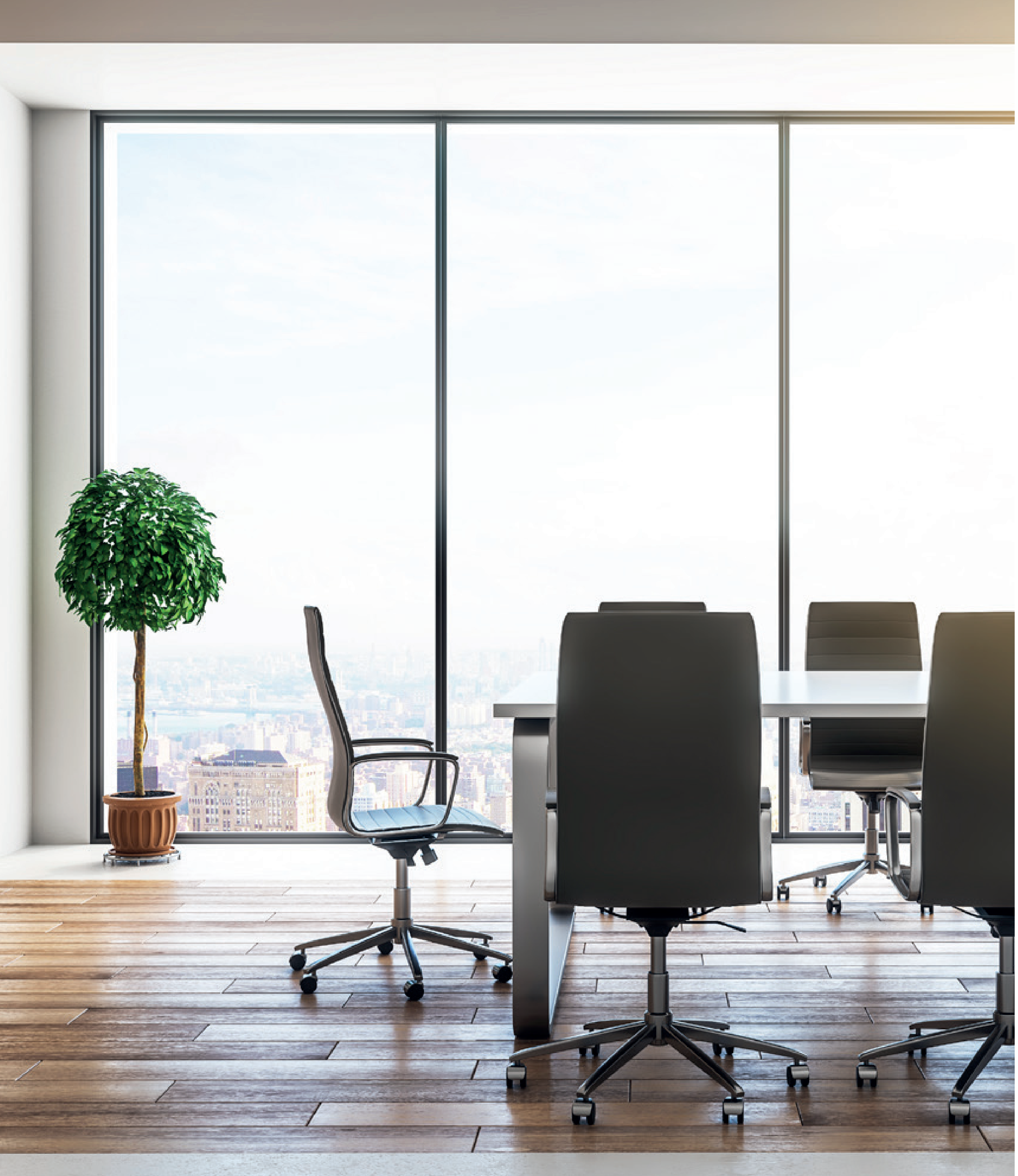


BEHIND ESG RATINGS

Making sense of environmental, social and governance ratings when investing



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Written by
Agnes McAfee
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FOREWORD

Reading about environmental, social and governance (ESG) factors can feel like learning another language. It's easy to get lost among the many definitions and acronyms. The next hurdle is understanding what to do with all this information. When these factors are combined with the wide variety of views about this area of investing, it's enough to make anyone switch off. But that would be a mistake, since ESG factors provide additional information to help us make more informed investment decisions. They also help us invest in line with our personal values.

Environmental factors include, for example, carbon emissions, waste and water. Social issues include employee welfare and human rights. Governance refers to the way companies are run and overseen. Examples are executive pay, board composition and audit tenure. They provide a framework for evaluating a company's operations and practices. While the three letters in ESG seem unrelated at first sight, they act together to capture a firm's most relevant non-financial risks and opportunities.

Although ESG factors are non-financial it is generally accepted that they may have financially material consequences for a company. Financially material means that they are significant enough to influence financial performance such as cash flow, revenue, or profitability. That also means consequences for any investment in that company. For example, an energy company's revenue may be harmed over time if the demand for coal declines and it has not prepared by taking advantage of opportunities to expand in the world's growing renewable energy market.

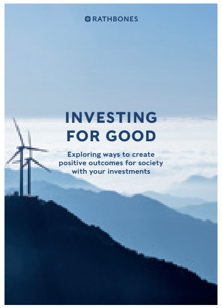
ESG is both extremely important and nothing special

Important and nothing special

Prof Alex Edmans from London Business School described the essence of the issue when he wrote: "ESG is both extremely important and nothing special". It's extremely important because these factors are critical to long-term value. It's nothing special because "considering long-term factors isn't ESG investing; it's investing." [1]

Investors have many possible reasons for choosing to allocate capital to investments that score highly on a range of ESG factors. For example, they believe the investment will outperform because it aligns with their values or because they want to make a positive impact through their decisions.

This report explores ESG data and how we can use it effectively when making investment decisions. We also evaluate the various challenges of ESG ratings and how investors can navigate them to meet their own particular needs.



Investing for good was the first article in this series about investing responsibly. It explored how investors can make a positive impact on society and the environment through their investments.

Please ask your investment manager for a copy or visit www.rathbones.com/knowledge-and-insight/responsible-investment

THE RISE OF RATINGS

The term ESG was first used in the report *Who Cares Wins* by the UN Global Compact, and endorsed by financial institutions, in 2004. The UN Global Compact is an initiative to encourage businesses to adopt sustainable and socially responsible policies, and to report on the implementation of these policies. ESG was introduced to capture relevant, non-financial factors related to companies.

Companies and financial markets rely on a range of interconnected and interdependent stakeholders and systems to operate. Therefore, these factors should be included when assessing company performance. This expands the range of factors evaluated when considering an investment case.

One way of understanding this is to consider an example outside financial markets, such as buying a home. Before the purchase, the buyer would consider its sale price, mortgage rates and monthly repayments, the cost of any necessary improvements, and the expected increase in valuation over time. These would be the generally accepted financial considerations used for the purchase.

However, the buyer would also consider non-financial factors that could affect the value or income generated from this property or whether or not they would want to live there, such as access to transport, local schools and what the neighbours are like. This is sound investment research.

It's unlikely that someone would admit to not accounting for these factors as part of their purchase because it's accepted that they are important to the purchase. The factors that are being considered and the value applied to them would vary depending on whether the buyer is an investor or owner occupier. ESG data works in the same way. It can offer essential information into the value of an investment. It should therefore be considered by every investor. Financial metrics and ESG metrics, when assessed together, give us a clearer, more realistic, and more holistic picture of an investment.

Advancing into the mainstream

The number of investment managers using ESG information in their investment analysis has grown steadily. When the UN Principles for Responsible Investment (UN PRI) was first launched in 2006, it had 65 signatories with $6.5 trillion in assets under management (AUM). By 2021 there were 3,826 signatories with $121.3 trillion in AUM. The UN PRI is a global initiative committed to advancing responsible investment through six aspirational principles (see box on page 7).

At the same time, companies began to report how they managed ESG issues alongside financial performance – and the number doing this kept growing. By 2016 nearly 9,000 companies worldwide were issuing sustainability reports, up from only 20 in the early 1990s.[2]

The rapid acceleration of both corporate reporting of ESG data and its use by investors has been impressive. What drove this significant increase? It's largely down to increased awareness, which has driven expectations higher – and with it corporate policy.[3] Most stakeholder groups – including investors, customers and employees – now demand information on companies' management of ESG issues.

These issues have transcended the specialist corporate governance world, buoyed by public consensus that they are important, and passed into the mainstream. Meanwhile, regulators have stepped in to standardise definitions and reporting. In 2006, there were 60 different ESG reporting and disclosure policies across 19 countries.[3] By 2023, there were 2,463 policies in 133 countries.

The increase in awareness and data availability created a market for ESG specialists to collect and analyse the information and make it readily available to investors in a form they can understand quickly. That has led to the creation of ESG ratings, provided by financial services companies such as MSCI, S&P Global and ISS ESG. Many other smaller, more specialised providers, such as EcoVadis and RepRisk, specifically offer ESG data and analysis. The purpose of an ESG rating is to assess a company's performance on key ESG factors. Typically, a company will receive an overall ESG rating, as well as a rating for each of the three individual factors: environment, social and governance.

The ESG rating industry has grown rapidly over the past decade. The year-on-year growth from 2023 to 2024 for spending on ESG ratings information was 14%.[4] This is on top of already high growth of 31% from 2021 to 2022 and 59% from 2020 to 2021. Spending on ESG data is expected to reach $2.1 billion in 2024, up from $305 million in 2016.

The six UN Principles for Responsible Investment

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

DOES IT PAY TO BE GREEN?

Dr Julian Kölbel is assistant professor of sustainable finance at the University of St. Gallen, School of Finance and Center for Financial Services Innovation. He is also a research affiliate at MIT Sloan, where he is a co-founder of the Aggregate Confusion Project, which aims to improve the quality of ESG measurement and decision making in the financial sector. Dr Kölbel is also a faculty member of the Swiss Finance Institute.

For as long as ESG ratings have existed, people have wondered whether investing in green or socially responsible companies results in higher financial performance. There are thousands of studies on the subject. And yet there is not one simple answer to this interesting question.

It is a difficult question to answer for two reasons. First, there are different ways of measuring ESG factors, and some are hard to assess. Second, there are multiple ways in which ESG factors could affect financial performance. Those effects can work against each other, or apply only temporarily, making it hard to detect them.

Regarding the measurement issue, it is well-documented that different ESG raters offer different ratings assessments for the same company. This is largely because people have different perspectives, depending on what they care about. For example, Tesla could earn an excellent score for its pivotal role in establishing the electric vehicle market. At the same time, the company could have a poor score because of corporate governance. One specialist might care relatively more about its environmental success and less about its governance than another provider – and vice-versa.

When taking a financial perspective, one must consider the impact of these ESG factors on future share prices. It may be that companies with exposure to electric vehicles underperform, and those with strong corporate governance outperform. One metric may predict better returns, while another may be irrelevant or predict negative returns. Therefore, the answer to whether it pays to be "green" always depends on the chosen measure of "green."

Cutting through the noise

Measurement noise is a tricky problem even when it is absolutely clear what one wants to measure. Statistical noise is data that doesn't tell us anything useful – even though it may at first appear to do so. It is not unreasonable to believe that companies with a good culture will outperform in the long run. Employees are motivated, they share information and they support each other to achieve the best outcomes for the whole company.

ESG mispricing means shares with good ESG performance are undervalued because the market underestimates the value inherent in these qualities

But how do you measure a good culture? You can rely on surveys of current and former employees but they can be biased. For example, unhappy employees may be more likely to participate, or clever HR departments may encourage employees to take the survey to increase their company's scores. If so, the survey will not reliably identify companies with a positive culture.

As a result, a strategy of following this data will not yield superior returns, even though the investment thesis is valid. Therefore, a second reason why it is hard to determine whether it pays to be green is that measures of "green" can be noisy.

Putting measurement challenges aside, there are also conceptual issues to consider. ESG factors could predict returns for different reasons. The major candidates are mispricing, momentum and risk. These three reasons can be valid at the same time or only for a certain period, which again makes it challenging to answer conclusively whether it pays to be green.

ESG mispricing means shares with good ESG performance are undervalued because the market underestimates the value inherent in these qualities. Take, for example, a company developing technology that has yet to be widely employed but has the potential to drive down carbon emissions. If this technology drives the company's growth beyond market expectations, an early investment will earn a handsome return.

The same can work in reverse, where investors avoid investing in firms whose business models are becoming obsolete. Of course, mispricing is challenging to discover, since it is unlikely that all stocks with good ESG ratings are mispriced. But sometimes the market gets it wrong and those who see this early get rewarded.

ESG momentum means share prices go up not because the company performs well operationally but because other investors invest in the stock and drive up the price. ESG momentum is necessarily a temporary effect, akin to riding a wave. There are moral investors who prefer to hold stocks with good ESG ratings. As moral investors shift their holdings towards stocks with high ESG ratings, and new moral investors come to the market and allocate to such stocks, this will drive up their value.

An early investment in stocks strong on ESG can therefore earn high returns. Similarly, an investment in stocks transitioning from low to high ESG performance can benefit from the resulting boost to their share price. Note that once the growth of moral investors comes to an end, one must expect lower returns from stocks with good ESG in the future because they are expensive relative to their fundamentals. For ESG momentum, timing is everything.

ESG risk means ESG problems may be correlated with risk. For example, companies with high carbon emissions are potentially exposed to regulatory risks. If these risks are priced in (i.e., no mispricing, as discussed before), you can expect greater returns from those companies. But this is not outperformance. It is simply compensation for the greater risk the investor is taking on. This is similar to high-yield debt, where a greater return compensates for the greater risk of default.

Several papers suggest that climate risks are priced in by the market, although concerns remain about how accurately climate risks are measured. Even if risks are priced in, they may not be fully priced in. Survey evidence suggests that they are not.

Making better decisions

Investing is inherently about using information to make decisions in an ever-changing world. ESG information can help us to understand how things are changing. But to use ESG information successfully, you must understand exactly what is being measured. The multitude of ESG metrics is confusing at first sight, and simply looking for a high ESG score when deciding which companies to invest in is unlikely to deliver extra financial performance. If it were that simple, everyone would do this.

However, a wealth of information exists, and trained eyes can extract a signal from the noise. If armed with a clear thesis on why a particular ESG signal should result in greater financial performance, investors can make better decisions. It makes sense to take ESG information into account from a financial point of view. However, it does not make sense to prioritise ESG information over other information. At the end of the day, ESG information is simply one part of the information set that active investors must consider.

ESG RATING CHALLENGES

Despite the growth in ESG data usage and the clear rationale for incorporating this information into investment research, ESG ratings can tell a confusing story. They can vary substantially between the most popular providers, with consequences for investors.[5] The variations can make it difficult for investors to evaluate a company's ESG performance. They can also make it hard for companies to channel resources into improving ESG performance if they are seeing mixed messaging from the market on what investors value, leaving no clear benefit from an improved ESG rating.

There are legitimate reasons why the ESG rating agencies differ on the ESG performance of individual companies. One is that ratings may have different objectives in their analysis.[6] For example, one agency may base its ESG ratings on how a company impacts people and the environment, such as the ecological harm caused by pollution. Another may base its ratings on financial factors, such as whether pollution caused by the business will impose a financial cost on it. Without sufficient transparency of objectives or methodology, it can be hard for investors to make sense of ESG ratings and whether they suit their purposes.

Explaining the divergence

An analysis of divergences between rating agencies by Berg, Kölbel and Rigobon (2022) found three main sources of it.[5] First, ratings may differ based on their scope: what they choose to include as an ESG factor. Second, ratings may differ because they give different weights to the different components. These two issues, scope and weights, relate to what the rating seeks to measure.

To draw an analogy, you can think of school grades when hiring young graduates. While all schools teach maths, some schools add art classes while others add athletics, which will affect the overall grade average. Some put more weight on languages. Provided you know what you are looking for and what the school values, it is easy to interpret the grades.

There are legitimate reasons why the ESG rating agencies differ on the ESG performance of individual companies

The third and most important reason for divergence between ESG rating agencies is measurement. This means that the measurement of concrete aspects of ESG performance, such as water consumption or labour relations, differs between agencies. Going back to the school analogy, this means different schools would give different grades to the same student in the same subject. This is much more difficult to make sense of, as you would need to dig deep into the 'exam questions', to continue the analogy, that underpin the grades.

Simplifying complexity

At first glance, the great divergence between different agencies' ESG ratings may be infuriating. Some critics might even say it discredits the agencies. However, it also reflects the fact that assessments of ESG issues are affected by underlying objectives and that some ESG qualities are genuinely difficult to measure. But like school grades, ESG ratings have to condense and simplify complex issues into numbers. That is both their appeal and their weakness.

Another concern is that certain ESG rating providers are subject to conflicts of interest: they rate companies' ESG performance while simultaneously offering them consulting services on how to improve their ESG scores.[6] More importantly, some ESG rating providers also use their own ESG ratings to construct ESG indices which are licensed to asset managers as benchmarks for funds.[7] Because of these conflicts of interest, it is important for users of ESG ratings to understand the business model of the ESG rating provider and how they generate income. This topic is under increased focus because of efforts in the EU and UK to regulate ESG ratings providers.

Nevertheless, investors who are clear on the objectives and understand the nuances can still use the information to help them reach their investment objectives.

HOW TO USE ESG RATINGS EFFECTIVELY

ESG ratings can be effective and useful tools if investors understand how to respond to the challenges. An essential first step is being clear on what they will be used for and why. There are broadly three reasons for favouring companies that perform well on a range of ESG factors.[8]

Managing for performance

Investors may gravitate towards companies with strong ESG ratings because they believe they will perform better financially. For instance, such companies could attract customers who care about sustainability and face a lower threat of litigation for unethical conduct. As mentioned earlier, this holds true even if ESG factors are not fully priced in by the market, leaving it undervalued by investors.

A company with strong ESG ratings may also offer less downside risk from major controversies that could be costly – in both fines and reputational damage. It may also suffer less disruption from the transition to a global economy that has considerably fewer carbon emissions. It may be hit less by the physical effects of climate change, which could disrupt business continuity. In most cases, specific pieces of ESG information will inform investment decisions, rather than an overall ESG rating.

Managing for values

Investors may not want to profit from businesses and industries they perceive as unethical. In this instance, financial performance is not the key driver of investment decision-making. An investor's primary focus is aligning their portfolio with their values. Investors may not wish to invest in companies performing poorly on ESG issues as this poor performance may have a negative effect on the reputation of those companies, and by extension their investors' reputations. Such investors view their investment strategies as an extension of their way of life or their organisation's values.[8] Therefore, any reputational damage to companies they invest in affects their reputation.

If investors have this motivation, it makes sense to use an overall ESG rating.

Managing for impact

Investors may wish to divert capital to companies with strong ESG ratings to reward this positive ESG performance and to help these companies grow. Conversely, they may seek to punish companies' poor ESG performance by not investing in them, in the hope that if enough investors do this, it will raise their cost of capital.

This approach can show the market what investors value, but the effect on cost of capital lacks sufficient evidence. You can find out more in our report *Investing for good*.

MAKE OR BUY?

Understanding the challenges of ESG ratings, and being clear in your own mind about what you are hoping to gain from them, can help you determine how best to use either the ratings or the data that underlies them. An investment manager could buy ESG ratings from an ESG rating provider. Alternatively, they could buy ESG information from a variety of ESG data providers – but not the ratings themselves. They could then use this information to construct their own ratings.

There are valid reasons why an investment manager may choose to buy ESG ratings from an agency. The primary reason is efficiency. An investor is not just gaining access to data that is otherwise time-consuming to procure. They are also benefiting from the analysts who check and interpret the information underpinning the rating.

Having a ready-made rating also makes it convenient to compare multiple companies. Moreover, access to the overall rating usually also comes with access to the underlying data, offering the opportunity to dig deeper when needed.

A second reason is reputation. By relying on an independent, third-party rating, the investment manager is buying a label that a company's ESG performance has been externally assessed. Rather than having to explain in much detail how that is done, it can make sense to rely on a rating from a reputable specialist.

Such an approach may be most useful when applying a best-in-class investment approach. Best-in-class investing is when an investor will only invest in companies that meet a defined ESG threshold. This means limiting investment in companies with lower ESG ratings. Provided there is sufficient transparency about the way ratings are decided, relying on an external rating offers a straightforward way to help ensure investors have minimised exposure to companies they rather would not want to be invested in because of ESG concerns.

A blended approach

Alternatively, an investment manager may choose to make their own ESG ratings using data from different ESG providers. This approach requires more in-house resources. But there are two advantages: transparency and control. This is because the investment manager can decide how to work out the rating. This allows them to create a methodology that matches the firm's view of financial impact and performance, meaning which ESG factors the firm views as most important. The investment manager can use the underlying data from the rating agencies and map this against industry standards or frameworks to suit their own investment needs or preferences.

This is generally a good option when an investor is deploying ESG information to try to improve the financial performance of their investments. This strategy of using the most relevant ESG characteristics of a company to paint a more complete picture of the investment case is known as ESG integration. This approach also means that investment managers can work closely with investors to meet their ESG and financial objectives.

It's the difference between buying a cake and making your own. When making a cake you can decide which ingredients go in, and how much, to yield the desired results. You have complete transparency about the process. Buying a cake also makes it possible for you to meet your objective (not arriving at a party empty-handed) – and it saves time as well. But you don't really know how it was made. The key questions you ask yourself when asking which option is best is whether you are any good at baking, and how much time you have.

The great thing about ESG data is that these approaches can complement each other to provide an enhanced offering to investors. Investors may also then choose to add additional layers such as investing in line with their values, screening out any potential investments with poor ESG ratings or particular ESG factors they do not want to invest in. To return to the cake analogy, it's like putting sprinkles on top.

THE RISE OF REGULATION

Venessa Parekh
ESG policy analyst

Financial market regulators have become increasingly aware of the prominence of ESG data and rating providers. ESG ratings provide an efficient way to gather and interpret information. However, different providers have different ways of arriving at their ratings — and the way they do this is not very transparent. Regulators are increasingly aware that investors that are buying ESG ratings may not understand them well.

Different countries' regulators have explored different ways of addressing these concerns. These approaches include:

- giving firms guidance about how to use third-party ESG data and ratings
- supporting efforts by this specialist industry to develop a code of best practice
- proposing the regulation of ESG rating providers.

In Singapore, Hong Kong and the UK, regulators have chosen the second option: they have issued voluntary codes of conduct for ESG rating and data product providers, based on recommendations from the International Organisation of Securities Commissions (IOSCO). These codes aim to establish industry standards for transparency in the way agencies come up with ESG ratings, and in the data sources. They do the same for governance and for managing conflicts of interest that may compromise the reliability and independence of the ESG ratings.

Systems and controls

Progress has been slower in establishing regulatory regimes for ESG rating providers. However, the EU has led the way by agreeing, in February 2024, the ESG Ratings Regulation. It sets an expectation for providers to establish systems and controls to support the robustness, independence and accuracy of their ratings.

Different providers have different ways of arriving at their ratings — and the way they do this is not very transparent

It also requires them to separate their ESG ratings business from other services that they offer, including refraining from offering consulting or insurance to businesses that they rate. In some cases, the rules require providers to adopt measures to manage conflicts of interest. The regulation is expected to apply from mid to late 2025.

The UK Government announced in August that it will introduce a bill to regulate ESG rating agencies. The aim is to improve clarity and trust in them.

The common denominator among these frameworks and codes is that they aim to regulate the provision of ESG data and ratings to third parties. This means ESG ratings established by financial institutions for use internally, which may influence their investment process or be used in conversations with clients, will not be subject to the same degree of rigour or supervision.

THE FUTURE OF ESG RATINGS

ESG ratings look set for more regulation. So too does the mandatory reporting by companies on ESG issues. This is likely to make the ESG information they disclose more standardised.

The ESG rating industry will evolve from focusing on availability of data to analysing the quality of data. Parallel to this, the ESG rating providers' role will shift from collecting data and putting it together to interpreting it. In an ideal world, ESG analysts will become more like financial analysts, largely agreeing on current ESG performance, but taking different views on future performance.

More data and faster processing

Satellite and drone images can provide data that may previously have been hard to measure or report. This could tell, for example, if companies or their supply chains are using child labour in the fields – a social issue. Ben Caldecott from the University of Oxford thinks the ability to use geospatial data – data that shows features, as well as giving their precise location – will become core to the job of financial analysts. This will have significant implications for information markets, risk modelling and management and valuation modelling. It will also help identify investment opportunities.

Advances in artificial intelligence (AI) mean these datasets can be processed almost in real time. Companies and investors will make better management decisions. They can assess environmental impact better as well. AI can also improve the automation and collection of ESG data, leading to more informed and therefore better decision making.

Natural language processing (NLP) can also streamline the analysis of large volumes of unstructured ESG data, allowing ESG specialists to focus on extracting insights and interpreting results. They can use these new technologies to analyse large amounts of text data and recover valuable information that was prohibitively expensive to obtain in the past.

In our *Investing for good* report, we also mentioned the growing demand for data on environmental and social impact. We reasoned that these factors will continue to increase in importance. AI can improve the analysis of this data, not only through satellite imagery but also through predictive analytics.

For example, present data on deforestation is extremely limited. However, through the use of satellite or drone images, environmental monitoring will become faster and more accurate. Companies and investors can also predict the potential effects of one behaviour or practice over another in order to calculate the degree of impact. As more data about the impact that companies have on the environment and people becomes available, it may become easier for investors to identify which metrics suit their objectives, such as financial performance, values or impact.

THE EVOLUTION OF ESG

Interest in ESG data has grown rapidly over the past decade – and the appetite for it will remain strong. ESG data offers an important set of information that is relevant to all investors. Since the term was first used back in 2004 there has been much research into how ESG data can contribute to effective decision making – along with robust debate about how it can and should be used. Over the last few years, this has led to substantial regulation covering the disclosure of ESG issues by companies and the appropriate labelling of investment products by investment managers, such as use of the term 'sustainable investment'. These regulations can support transparency by companies and investment managers to mitigate misleading claims. There is a lot to understand in order to have an informed opinion on ESG.

It's important for investors and investment managers to have a good understanding of ESG data and ESG ratings and how they can be used to meet their financial or personal objectives. Investors and investment managers can use ESG information for three main purposes: to improve performance, values or impact. Knowing the goal is the first step to effectively integrating ESG information into decision making.

ESG ratings can vary, as can the availability of the data used to create them. For this reason, when using a specialist provider, it is important to understand the workings behind each rating from the provider to ensure the way the rating was decided is aligned with the investment manager's objective. Alternatively, investment managers can create their own ESG ratings using individual ESG data to suit their own objectives. Both options are viable, if the investment manager has sufficient knowledge to use the information effectively.

The ESG landscape is constantly evolving. As responsible investors, if we want to make the most of developments in this field, we have to evolve too.

Find out more

We publish regular content that explores the issues covered here and many more subjects.

Please visit us online at www.rathbones.com/knowledge-and-insight/responsible-investment

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