



ESG ratings: art or science?

RBC Emerging Markets Equity Team

A variety of professional data providers construct and sell quantitative metrics of firms' ESG performance. The ratings that result from these have begun to influence the investment decisions of many institutional investors. Despite the increased use of these ratings, studies suggest that there is substantial disagreement across rating agencies about how they assess factors and what ratings they assign to individual firms. This is highly problematic, as without agreement on what constitutes good ESG performance, market participants may be misled.

Therefore, we consider four questions:

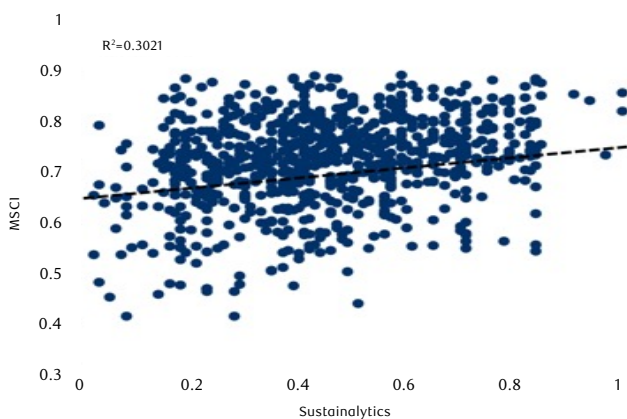
1. Is there a material difference in the ESG ratings of different ESG research providers?
2. What is driving the difference in ESG ratings across different providers?

3. Are there any other patterns or biases that can be found from the analysis of ESG ratings?
4. What is the likely long-term outcome, and what can we do to improve the industry?

Is there a material difference in the ESG ratings of different ESG research providers?

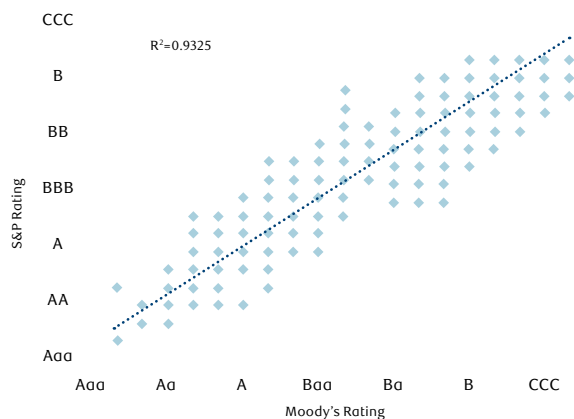
Our analysis confirms that there is a substantial difference between the ESG ratings of research providers. We analysed the correlation between the ESG ratings of the two largest providers, MSCI and Sustainalytics, and also compared these to our own ESG scores. We included all stocks in the MSCI Emerging Markets Index as part of our assessment and found the correlation between the ESG ratings of the two providers to be very weak (some may say negligible) at 0.3 (Exhibit 1). This contrasts with credit ratings, where the correlation coefficient between ratings by S&P and Moody's suggests nearly perfect correlation at 0.93 (Exhibit 2).

Exhibit 1: Limited correlation between ESG ratings providers



Source: RBC Global Asset Management, Sustainalytics, MSCI. Data as at September, 2021.

Exhibit 2: Strong correlation between credit ratings providers



Source: Bloomberg Barclays Index Services Limited. RBC Global Asset Management. Data as at September, 2021. Note: The Moody's ratings have been adjusted for comparison purposes. Axes have been labelled using overall rating groups.

What is driving the difference in ESG ratings across different providers?

There are two main reasons for the discrepancy between ESG ratings providers. One reason can be attributed to the data sets and varying methodologies of ESG ratings providers; the other is more qualitative and philosophical in nature.

We subscribe to several leading ESG ratings providers and have conducted a thorough review of the main discrepancies across our portfolio holdings. For example, for one of our holdings in the Philippines, we found that Provider 1 ranks the company as top quartile on overall ESG performance, while the company is ranked in the bottom quartile by Provider 2. When looking more closely, we found that Provider 2 fails to take into account environmental metrics for the business (focusing solely on social controversies), whereas Provider 1 assigns a 15% weight to environmental metrics with an above-average score for the company. We also found a significant difference in the approach of the two providers to governance. Provider 2 assigns a significantly higher weight to governance factors (50% versus 30% for Provider 1), and a substantially lower rating for the company (bottom 5% versus average rating by Provider 1).

Generally, we find that the methodologies tend to be materially different among providers. This leads to three main sources of disagreement (Exhibit 3):

- **Measurement.** Providers can measure the same ESG attribute with different indicators. For example, human capital management could be assessed on the basis of employee turnover, spending on training, reliance on third party research (Glassdoor scores), or the number of labour cases against the firm. In the same way, promotion of women could be measured by the gender

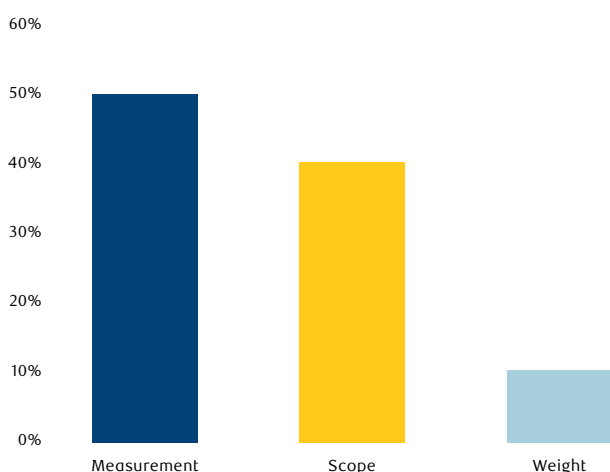
pay gap, the percentage of women on the board, or the percentage of women in the workforce. Of course some indicators tend to be binary (yes/no), and cannot be measured.

- **Scope.** Different providers include different attributes in areas that they consider material in terms of risk exposure for a particular industry or firm. Most providers consider a firm's greenhouse gas (GHG) emissions and water usage when evaluating its environmental record. However, only some will include electromagnetic radiation and waste. One rating agency may include lobbying or bribery while another may not.
- **Weight.** Providers tend to assign varying degrees of importance to attributes. They may value human rights more than lobbying, for example. Or perhaps corporate governance more than GHG emissions. Additionally, the weights of each metric (one of our providers has 1000 metrics!) tend to vary materially.

Beyond the data, there is another consideration which we believe is paramount to the assessment of a company's ESG: ESG ratings are ultimately a matter of judgement. ESG assessment is an art which the ESG ratings providers have attempted to convert into a science. This has led to some confusion. Metrics in the ESG space can be insightful, but must be used with caution. In financial analysis, and especially in ESG investing, the use of judgement is crucial. Metrics are valuable and should be used, but we believe that to rely on ESG ratings alone, without using our own research, analysis and judgement, would not always provide a complete picture.

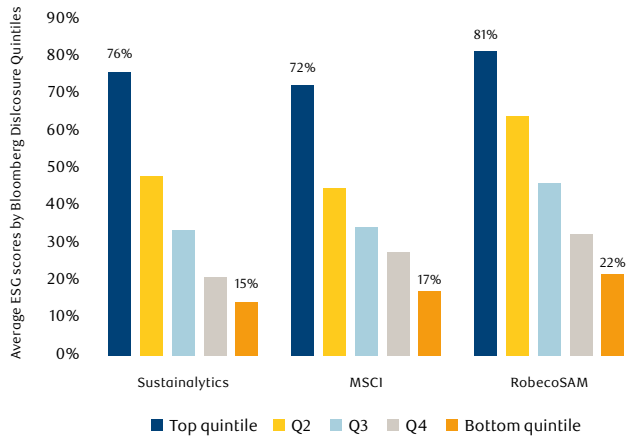
Companies (even within the same industry) report very differently even on the same topic. This therefore requires ESG rating agencies to choose how and what to factor into their assessment. This is a key driver of differences in ESG ratings, and essentially reflects a difference in judgement on how to consume and interpret the data. The choice of which metrics to use, the materiality of each metric, and assignment of relative weights all come down to individual judgement. In addition to this, some ESG areas are just too difficult to capture in a metric. Take the corporate culture of a firm, for example. Corporate culture is one area of ESG that has been attracting increasing attention from institutional investors and rating agencies in recent years. Studies have proven that the best way to understand the corporate culture of a firm is to have an interview with the CEO or founder of a company, and we believe it is hard to find an adequate substitute for dialogue.

Exhibit 3: Key sources of ESG ratings disagreement



Source: Aggregate Confusion: The Divergence of ESG Ratings. MIT. Data as at May, 2021.

Exhibit 4: ESG disclosure vs ESG ratings



RBC Global Asset Management, GS Sustain, MSCI, Sustainalytics, RobecoSAM. Data as at September, 2021.

To a large extent ESG is about transition and how a company is positioned in terms of risks and opportunities presented by that transition. The best fund managers and analysts take a view on what the world will look like in the future. They then assess how a company fits into that future, and what the financial implications will be for that stock. In this respect, the ESG providers are ultimately trying to answer a question that is subjective in nature. This makes their task very different from that of their credit ratings peers, who are all trying to answer the same question: will the issuer pay me back? Unlike credit ratings, ESG ratings largely rely on non-standardised information relating to many different types of risks and opportunities. By contrast, standardised data tries to rate one single type of risk.

Are there any other patterns or biases that can be found from the analysis of ESG ratings?

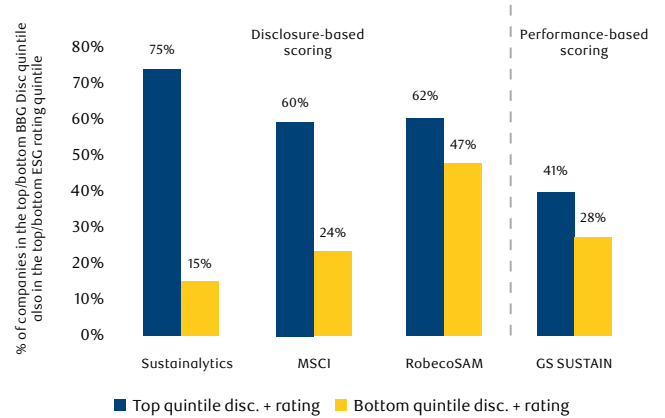
Our analysis uncovered a number of additional trends:

1. Higher ESG ratings correlate with companies that report more. The amount of ESG data that is available for a company is positively correlated with the commercial ESG rating of that company (Exhibit 4). This is true for nearly all of the rating agencies' methodologies, which take a very punitive approach towards companies that do not disclose. There is an argument that low public ESG disclosure should be treated as neutral, rather than penalising companies automatically. There are many companies, particularly smaller firms, that are assigned very poor commercial ESG ratings despite strong ESG performance.

2. Higher ESG disclosure correlates with higher ESG ratings disagreement. Contrary to preconceived ideas, our analysis suggests that ESG disagreement is most pronounced for firms with high levels of ESG disclosure, thereby shedding light on the key drivers of ESG rating discrepancies (Exhibit 4). In our view, this highlights

¹ RBC, GS Sustain, MSCI Sustainalytics, RobecoSAM, September 2021.

Exhibit 5: Ratings based on ESG disclosure vs ESG performance

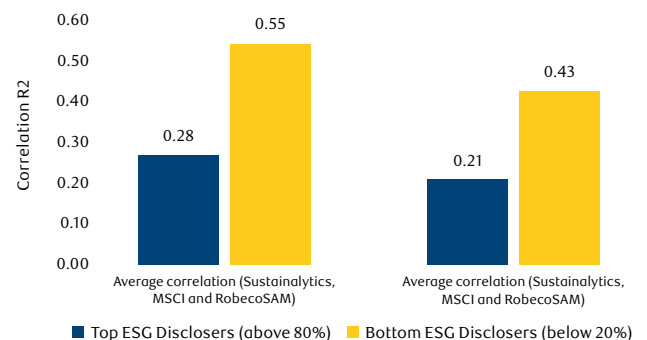


Source: RBC Global Asset Management, GS Sustain, MSCI, Sustainalytics, RobecoSAM. Data as at September, 2021.

the importance of developing independent understanding and judgement of a company. ESG ratings can differ more dramatically with more disclosure because providers rank, measure, and weight the ESG disclosures differently.

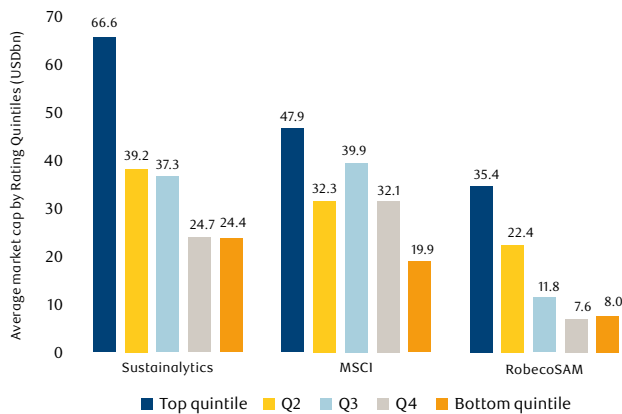
3. High ESG disclosure doesn't always mean high ESG performance. There is evidence to suggest that there may be a disconnect between ESG ratings and actual ESG performance. Many of the best disclosers (based on Bloomberg ESG Disclosure Rank) ranked in the top quintile of ESG ratings across the main ESG ratings providers (Exhibit 5). On average, two-thirds of companies with a high level of disclosure end up in the top quintile in terms of ESG ratings.¹ However, fewer end up in the top quintile when taking an ESG performance (evaluating whether the company delivers on its' ESG targets) based approach (Exhibit 6). The implication for investors is that they should do their homework and examine what the ESG data actually shows. They should also monitor the trends of the data versus the ESG-related targets or policies set by the company, rather than simply 'tick the box'. For corporations, for the time being, it implies that they will get favourable treatment in the capital market if they publish more ESG data.

Exhibit 6: ESG disclosure vs ESG ratings disagreement



Source: RBC Global Asset Management, GS Sustain, MSCI, Sustainalytics, RobecoSAM. Data as at September, 2021.

Exhibit 7: Company size bias – ratings by market cap



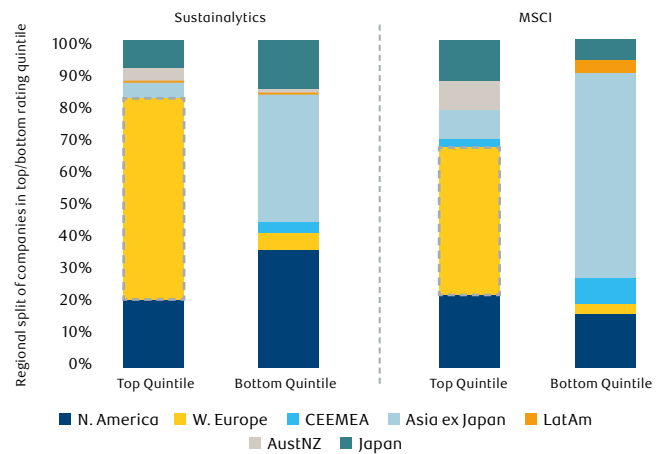
Source: RBC Global Asset Management, Sustainalytics, MSCI. Data as at September, 2021.

4. Geography, industry and size bias. There is a very significant large-cap bias among all ESG ratings providers. Large companies tend to score higher in the ESG ratings than mid-sized and small businesses. Our analysis of ESG ratings showed, for example, that companies with a higher market capitalisation score better on ratings than lower market-cap peers (Exhibit 7). Companies in regions with high reporting requirements, such as Europe, obtain higher sustainability-related ratings compared with companies with less regulatory pressure (Exhibit 8).

What is the likely long-term outcome and what can we do to improve the industry?

What does this all mean for investors? ESG performance is difficult to measure and reasonable people can disagree, just as some analysts will rank a company as ‘buy’ and another as ‘sell.’ However, we can’t just take an ESG rating at face value. We need to understand what

Exhibit 8: Ratings distribution by geography



Source: RBC Global Asset Management, Sustainalytics, MSCI. Data as at September, 2021.

the ESG rating is actually capturing, as different providers define ESG in different ways. Similarly, if there was one unambiguously correct ESG rating, it would be priced into the market. As a result there are, in our view, four broad conclusions on ESG ratings:

1. ESG ratings harmonisation is unlikely. The probability that in the longer term we will have a harmonisation of ESG ratings among the different agencies - like we have now for credit ratings - is very low. There are two reasons: first ESG is, and will continue to be, a matter of judgement; second, if that were to happen, it would undermine the business model of the ESG rating agencies and their perceived added value. There are dozens of ESG ratings providers, and the number continues to grow. Why could we need so many if they were all going to say the same thing? It is in their interests to provide ratings that are different.



2. The importance of ESG ratings is likely to decrease.

We believe investors will use ratings less and less to drive their investment decisions as their knowledge in this area increases. Metrics are valuable and should be used, but to rely on metrics without using our own judgement, experience and analysis fails to provide the complete picture. The ESG conversation is, in our opinion, likely to move away from ratings to, “How can we use all of the available information about a company to decide which has the best risk/return potential?” In other words, we are (as an industry) just getting back into ‘good’ investing.

3. ESG needs to be done top down and bottom up.

We think ESG needs to be done bottom up at the sector and company level, and top down at the thematic and policy level. Bottom up, we think the best way to think about ESG and security selection is through the concept of financial materiality. What are the most financially material ESG issues that matter to that business? Top down, we think it is important to appreciate and go deep on a few themes. In addition, it is very important to follow the regulation on all aspects of ESG finance, and perhaps more importantly, the real economy regulation on climate, human capital etc.

4. Increased regulation will increase disclosure and comparability.

Regulation is going to play an increasingly important role across all areas and participants within ESG. This is not a matter of ‘if’, but rather ‘how’ and ‘when’. A stricter regulatory environment will reduce the risks from greenwashing in the long term. It will also support the development of in-house research and knowledge across fund managers. We started to see the beginning of this in March 2021, when the European Union (EU) introduced the Sustainable Finance Disclosure Regulation. This is a set of EU rules which aim to make the sustainability profile of funds more comparable and better understood by end-investors. Likewise, in December 2020, the financial authorities in France proposed a European regulatory framework for ‘sustainability-related service providers’. The proposal sets out various requirements for ESG rating providers, including transparency on methodologies, management of conflicts of interest, internal control processes, and enhanced dialogue with companies on the subject of ESG ratings. In addition, at the corporate level, we could see a higher degree of standardisation in metrics, thanks to organisations like the Sustainability Accounting Standards Board. If we obtain standard data for certain agreed-upon material issues, then the rating agencies may see their ratings converge somewhat but it is likely that they will still continue to weight things differently. Additionally, there are plenty of business model nuances that will continue to make comparability a challenge.

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