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Understanding ESG Ratings: A Brief Primer From Celent

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The proliferation of investments based on environmental, social and governance (ESG) factors has led to multiple measures of related corporate behavior, which can be problematic for financial advisors serving clients who want to invest in sustainable assets.

How can they assess with confidence that ESG rating of any one company and compare it to the ESG rating of another, or compare one ESG-focused funds to another knowing that the funds, too, use different ESG metrics, of varying quality.

Financial advisors have another incentive to understand and compare ESG ratings. According to Morningstar and Barron's, U.S. funds with high sustainability ratings tend to perform better than funds with lower ratings. In addition, TruValue Labs and Quantopian found that a portfolio of companies in the S&P 500 scoring high on their ESG Insight and ESG Momentum Scores outperformed the benchmark index over a five-year period.

Despite the stronger performance of these companies and funds, there are issues with ESG data. Close to 70% of institutional asset owners surveyed by Morgan Stanley recently said that lack of quality ESG data is one of their biggest challenges when investing according to ESG principles. Nearly 60% reported they did not have access to adequate tools to assess how investments align with their sustainability goals.

"There is no common standard for ESG reporting due to self-reporting by companies and data content providers each having their own ranking system in place," reports Celent, a research and consulting firm focused on financial services technology, in a recent study.

The study reviewed some of the leading data content providers for ESG, and found that some, including Reuters and Morningstar, use a "controversy score" that can offset corporate self-reporting, which allows companies to cherry pick their best data. Advisors can use the information as a guide when assessing even ESG reports from other data providers not included in the Celent report.

Thomson Reuters. A database on more than 7,000 companies across the globe, including 1,000 for whom the data goes back about 15 years or so, based on corporate sustainability reports, annual reports and websites; SEC filings, NGO websites and news sources.

Corporate self-reported data is classified according to 10 prominent themes, including emissions and human rights that are discounted for significant ESG controversies.

The Reuters database is an open platform that can share propriety data and engage with partners such as TruValue Labs, an AI-powered ESG data provider. Its ESG score is based on algorithms and 150 content research analysis and ranges from A to D.

Morningstar. Company-level data is provided by Sustainalytics, 40% of which was acquired by Morningstar last year. Sustainalytics provides the company-based data which measures three factors – preparedness (policies in place), disclosure (relative to regulation and/or global standards) and performance (qualitative and quantitative) – plus a quantitative controversy scored based on scanning thousands of media sources, industry reports and more.

ESG scores range from 0 to 100; controversy scores from 0 to 5, and Sustainalytics then normalizes scores across sectors.

Morningstar then does an asset-weighted rollup of company ESG scores with deductions for holdings with controversies when 50% of a portfolio's assets have corporate ESG scores. It calculates sustainability ratings for over 38,000 managed products including ETFs, mutual funds, SMAs for equity and corporate bonds and collective investment trusts (CITs).

In order for a fund to receive a sustainability rating, at least 10 funds in a particular Morningstar category must have a sustainability score. Fund sustainability ratings range from zero to five globes, with one global indicating the bottom 10% and five globes the top 10%.

Morningstar recently added an asset-weighted carbon risk score for portfolios where 67% of assets have a Sustainalytics carbon risk score. It uses 70 carbon fund-level metrics including low-carbon designation.

FactSet. OpenFacetset allows clients to buy individual data feeds on ESG reporting, including TruValue Labs and Reprisk and soon Quantopian. FactSet also has its own proprietary data feeds having acquired Revere Data in 2013 for supply chain data. Clients can learn if supplier is on a sanctions list.

Engaged Tracking. This London-based firm publishes carbon rankings of the world's largest companies and their supply chains, covering over 4,000 companies and 30,000 securities. The carbon ratings measure Scope 1 (self-reporting by company), Scope 2 (energy emissions) and Scope 3 (everything else such as upstream and downstream activities for oil and gas companies.

Raymond James has created customized strategies selecting 40 stocks from the Europe 300 using Engaged Tracking. The portfolio is rebalanced quarterly and its carbon data is reviewed at least once a year based on Engaged Tracking's annual carbon ratings.

In addition to these ESG ratings described by Celent is a new Carbon Price Risk-Adjusted Index Series recently launched by S&P Dow Jones Indices, which already has a Carbon Scorecard that measures the carbon footprint of major global index benchmarks, an as well as several ESG Indexes.

The S&P Carbon Price Risk-Adjusted Index Series focuses on the potential carbon-related risks for companies by 2030, a year targeted by EU countries, China, Russia and other signatories to the Paris Climate Accord as a deadline for substantially reducing their carbon emissions. The accord, in turn, is focused on limiting the rise in average global temperature to no more than 2 degrees Celsius from pre-industrial levels.

According to S&P Dow Jones Indices report, "$1.3 trillion may be at risk" for S&P 500 companies, or 5.6% of the indexes' market capitalization, by 2030.