

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTING

No Place to Hide Thanks to Morningstar, Bloomberg, MSCI, and Multiple Global Data Providers

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With the global trend of environmental, social, and governance (ESG) adoption firmly entrenched among institutional investors, individual investors are now focusing on ESG or sustainable investment choices. Morningstar is just one of the agencies to rank them for mutual funds in a simple but elegant manner. Shining a bright light on the topic is *Barron's* new annual special report, “The Top Sustainable Funds” (the second edition came out October 9, 2017), which states “the color of outperformance is green.”

It is important to note that different investors have different views on ESG and different ESG research providers have different biases. We have outlined some of the differences in table 1. For example, *Barron's* list changed in 2017 from 2016 in how it ranked funds: In 2016, it ranked the best ESG performers first; in 2017, it ranked 203 funds by their one-year returns, highest to lowest, regardless of style or number of globes. The key to successful ESG investing still lies with the interpretation of this data and squarely on advisors' shoulders.

This article reviews the ESG research and data collection that drives the overall portfolio ESG ratings, including the Morningstar globes, which rely on Sustainalytics research. In fact, Morningstar is completely committed

to Sustainalytics and recently bought 40 percent of the company.¹ It is important to note that each global industry classification standard sector should have different weightings and risks in the decision process.

EXAMPLE: EQUIFAX

For example, it would be a safe bet that 99 percent or more of everyone reading this article and their clients were impacted by the hack of the Equifax databases. MSCI ESG research had rated Equifax a CCC on April 7, 2017, before the announcement of the hack. In fact, the report mentions a previous customer breach of 431,000 employee salary and tax records from Kroger in 2016. It is easy to have an understanding of potential environmental or governance issues, but MSCI calls “Privacy and Data Security” a social issue—and that's the S in ESG.

EXAMPLE: VOLKSWAGEN

ESG ratings also differed for Volkswagen following its “dieselgate” scandal, in which the auto manufacturer subverted emissions tests worldwide. Sustainalytics gave Volkswagen an overall ESG performance score of 61, an average ranking; but in the detailed rankings, Sustainalytics gave Volkswagen #5 on both environmental and governance issues and highlighted “business ethics” as a concern in its third-quarter 2017 report. A #5 is the poorest score in Sustainalytics' 1-5 ranking system,

and the rating group had been dropping Volkswagen's ESG score during the summer of 2015 as the emissions scandal unfolded.

As of July 8, 2016, MSCI ranked Volkswagen's overall ESG as a CCC, which is one of its lowest rankings. And on August 27, 2015, Bloomberg noted that Volkswagen had the weakest governance among autos and posted on Bloomberg Intelligence an article highlighting that Volkswagen “may lack sufficient board independence to consider all investors' interest.”

But the Dow Jones Sustainability Index, which uses RobecoSAM for its ESG ratings, awarded Volkswagen the sustainability prize for the automobiles and components industry group in September 2015. That same month environmental agencies in California, the United States, Germany, France, Italy, Britain, Mexico, and Taiwan all announced investigations into Volkswagen for the emissions violations.

Clearly the Volkswagen rankings varied widely, which is unusual but indicates that ESG research demands due diligence.

ADVISOR DUE DILIGENCE

Advisors, asset managers, and clients need to acknowledge that there is a lack of uniformity in the research ratings or scores from the ESG research providers.

Table
1

ESG DATA PROVIDERS

Agency	Coverage/Research Professionals	Scope
Thomson Reuters (TR)	<ul style="list-style-type: none"> • 6,000+ companies • 150 ESG analysts • Worldwide 	<ul style="list-style-type: none"> • ESG rating compares performance against peers in the Thomson Reuters Business Classification (TRBC) industry group • ESG controversy rating reviewed each fiscal period
Sustainalytics	<ul style="list-style-type: none"> • 6,500+ companies • 170+ ESG analysts • Worldwide • 300+ clients from 22 countries 	<ul style="list-style-type: none"> • Evaluates company ESG factors based on: <ul style="list-style-type: none"> › Preparedness (management of ESG risk) › Disclosure (external and internal reporting) › Performance (for example, carbon intensity disclosure)
MSCI	<ul style="list-style-type: none"> • ESG company coverage • Equity: 6,200 issuers • Fixed Income: 350,000 securities • Funds and ETFs: 23,000 • 150+ ESG analysts • 1,000+ clients worldwide 	<ul style="list-style-type: none"> • Rates companies against peers on 4-8 of the most relevant ESG factors <ul style="list-style-type: none"> › Identify key issues by industry › Measure risk exposure › Measure risk management › Controversy deduction
RobecoSAM	<ul style="list-style-type: none"> • 3,400+ companies • Uses Corporate Sustainability Assessment (CSA) questionnaire • Worldwide • 80-120 questions on questionnaire • Evaluated by RobecoSAM analysts 	<ul style="list-style-type: none"> • CSA questionnaire covers: <ul style="list-style-type: none"> › 6-10 broad ESG criteria (company specific) › 2-10 questions (based on criteria) • Each criterion is worth 100 points and assigned a percentage (%) • Total Sustainability Score is out of 100 based on pre-defined weights for each question or criterion
Morningstar	<ul style="list-style-type: none"> • ESG Mutual Fund Globe ratings • Ratings for 35,000+ global funds • 300 global analysts • 40+ clients from 10 countries • 20+ years of sustainable research experience 	<ul style="list-style-type: none"> • Rating portfolios on ESG performance based on Sustainalytics ESG data Portfolio Sustainability Score = ESG score minus a deduction for controversy
Bloomberg	<ul style="list-style-type: none"> • 10,000+ companies (disclosure score) • Worldwide 	<ul style="list-style-type: none"> • Bloomberg analysts gather data from public sources, Sustainalytics, (MSCI World Index and 1,600 companies), RobecoSAM (2,000 publicly listed companies)

This can lead to variability among the ratings based on data, data sources, or interpretation of the data, in part because data quality is improving and integration of data into decision models varies.

Table 1 features four types of ESG rating agencies. The most common type comprises Thomson Reuters, Sustainalytics, and MSCI. These agencies rate specific companies on their overall ESG performance. A company's particular rating is based on a quantification of ESG risk and how the company manages that risk. Data are pulled from public information, company data, non-government organizations, carbon footprints, and proxy statements. Thomson Reuters,

Sustainalytics, and MSCI, however, provide different ESG ratings because each uses a different methodology.

The second type of rating agency is exemplified by RobecoSAM, which uses an annual questionnaire, the Corporate Sustainability Assessment, to assess and rank a company's sustainability. The collected data are used to provide a report and rating of how sustainable the company is. Company reports are sent out along with rankings against relevant peers within a company's industry.

Morningstar is unique among the rating agencies because it rates portfolios based on their ESG sustainability against other portfolios within a specific Morningstar

Category. This is done by taking Sustainalytics data on different companies and combining the scores into an overall portfolio score based on the company's ESG score within the particular fund. The score of the portfolio is then rated against others within the Morningstar Category. Morningstar also deducts from the overall score for controversies that may decrease a company's profitability.

Finally, Bloomberg is merely a data provider. It provides the consumer with a RobecoSAM rating and a Sustainalytics rating for any security searched. Bloomberg also provides a disclosure score that shows the amount of ESG information disclosed by a particular company against its peers.

Analysis and Outputs	Key Differences	Data Sources
<ul style="list-style-type: none"> Rating from A+ to D- (best to worst) 10 ESG categories, weighting of each based on specific mutual fund Updated every 2 weeks 	<ul style="list-style-type: none"> TR acquired Asset4 to enhance its ESG rating technology Uses TRBC Industry Benchmark for ESG ratings 	<ul style="list-style-type: none"> 400 ESG data points TR ESG analysts Annual reports Nongovernment Organization (NGO) websites Corporate social responsibility (CSR) reports Company websites
<ul style="list-style-type: none"> Sustainalytics ESG experts provide the data and research to create the ratings. 0-100 overall ESG score 0-100 pillar score 1-5 controversy score Industry peer comparison Biweekly updates Annual reports 	<ul style="list-style-type: none"> Company reports Historical three-year trends on reports dating to 2009 Capital IQ, Bloomberg, and Moreover Technologies ESG data 	<ul style="list-style-type: none"> Sustainalytics ESG research analysts Company data NGO information Media data
<ul style="list-style-type: none"> Data produced by MSCI ESG analysts using different data sources. New information reflected on weekly reports. In-depth annual review. Companies invited to participate in a formal data verification process. Companies are ranked from AAA to CCC on ESG performance 	<ul style="list-style-type: none"> Provides individual reports for companies Provides industry reports on ESG landscape for each industry Scores for each company in a particular pillar (E, S, or G) compared to peers 	<ul style="list-style-type: none"> MSCI ESG research analysts News media NGO reports Academic and government data CDP, carbon estimation model Company-reported data
<ul style="list-style-type: none"> Early September: CSA results and Dow Jones Sustainability Index members announced Late January: RobecoSAM Sustainability Yearbook published Early April: Online questionnaire launched End of May: Deadline for CSA submission 	<ul style="list-style-type: none"> Dow Jones Sustainability Index uses CSA data for holdings within the index. Top 10% ESG companies in each industry are put into the DJSI Provides company reports Provides rankings against peers 	<ul style="list-style-type: none"> Corporate Sustainability Assessment questionnaire
<ul style="list-style-type: none"> Morningstar normalized Sustainalytics data to provide the most relevant portfolio data. Morningstar analysts create scores and ratings against peers, offer products based on 45+ ESG metrics. Updated every 2 weeks In-depth annual review 5 globes = highest rating 1 globe = lowest rating 	<ul style="list-style-type: none"> The only rating agency to provide portfolio-specific ESG rankings and data Provides portfolio education products to enhance ESG rating across the fund 	<ul style="list-style-type: none"> Sustainalytics Uses Morningstar Fund Categories for portfolio ratings
<ul style="list-style-type: none"> Disclosure score rating Updated on a rolling basis ESG ratings created by Sustainalytics (updated monthly) and RobecoSAM (updated every six months) 	<ul style="list-style-type: none"> Derives ESG disclosure score of 0-100 based on data collected 	<ul style="list-style-type: none"> Bloomberg ESG analysts 150 data fields across E, S, and G Company and public data, carbon footprint reports, proxy statements

CONCLUSION

More important than deciphering which ESG data source is the best or most relevant is the strong commitment of these major research providers to ESG factors. Data about ESG factors are becoming more public each day, making it hard for anyone to hide.

As such, ESG factors are becoming a major part of the investment discussion for asset managers. Clients want to know what they are investing in and the impacts their investments are making. These demands are forcing asset managers to integrate some form of ESG into their investment processes, and many are deciding to make ESG part of their intensive research. Institutional

investors and the millennial generation are the main drivers of this secular change, and we are only at the beginning of ESG integration. This trend will continue to grow and it is important for wealth managers to catch this wave. The CFA Institute now includes ESG research into its Level 1 and 2 tests. With Morningstar, Bloomberg, MSCI, Thompson Reuters, and others all providing ESG data and daily commentary, we have more than enough information to have our own discussions with peers and clients about ESG.

Transparency on ESG factors is a global issue but most importantly it is an investment issue. ESG rankings can highlight risk and reward opportunities

in a variety of sectors as well as companies in specific sectors. ●

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ENDNOTE

1. See <http://www.sustainalytics.com/press-release/morningstar-acquire-stake-sustainalytics/>.