Who are the ESG rating agencies?

Investors are putting a lot of faith in environmental, social and governance (ESG) ratings. Yet how much do they know about how the ratings are calculated and who produces them? This paper is the first in a series aiming to shed some light on the ESG rating agencies.

Why is it important to know about the ESG rating agencies?

ESG rating agencies are becoming a major force in markets. The managers of one-third of all professionally-run assets globally – equivalent to over $20 trillion – now use ESG data to inform their investment decisions, and most of them rely on ESG rating agencies to supply it. Not only are the ESG raters potentially influencing the returns on an ever-expanding pool of retirement savings, university endowments and other investments, they are also affecting companies’ strategic decisions: some 33% of companies say inquiries from sustainability analysts have shaped their overall business strategy.

The collective influence of the raters is set to grow. Later this year, Morningstar plans to put ESG ratings on retail investment funds, a move that some believe could drive significant fund flows. In addition, alliances are being struck between service providers and ESG raters, impacting on indices, listing requirements, bond ratings and proxy voting. Perhaps the next growth area for ESG vendors will be the credit rating agencies. Standard & Poor’s, Fitch and Moody’s all say they consider elements of ESG and promise more transparency for bondholders soon.

Where do professional investors get ESG data?

<table>
<thead>
<tr>
<th>Source</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Public information</td>
<td>75%</td>
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<tr>
<td>Third party research</td>
<td>66%</td>
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<tr>
<td>Company reports</td>
<td>64%</td>
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<tr>
<td>Direct engagement</td>
<td>50%</td>
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<tr>
<td>Regulatory filings</td>
<td>46%</td>
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<tr>
<td>Other</td>
<td>4%</td>
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ESG data: Well used, but how well understood?

73% of professional investors say they take ESG factors into account
28% say their company offers training on considering ESG issues (another 18% weren’t sure)

Source: CFA Institute, June 2015: Environmental, Social and Governance (ESG) Survey

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2 What kind of businesses are they?

According to the Global Initiative for Sustainability Ratings (GISR), well over 100 organizations produce sustainability research and ratings on companies. They are a varied group, ranging from NGOs focusing on a single issue – such as diversity, customer loyalty or medicine – to global businesses covering more or less the full gamut of ESG.

We estimate that about 10 providers are of primary relevance – that’s significantly more than the number of credit rating agencies most investors would need to pay attention to.

3 What’s their commercial motivation?

With demand for it growing exponentially, ESG data – also termed non-financial data – has become big business. Some of the leading ESG research companies now compete to supply it, including Bloomberg, MSCI, RepRisk, Sustainalytics and Thomson Reuters. There are also several specialist firms, including CDP, Oekom, South Pole Group, Trucost, and VigeoEIRIS.

It’s a fast-evolving and extremely competitive market. Providers are racing to achieve critical mass, with numerous mergers and takeovers in recent years (see table below). Many have also formed partnerships with other ESG data firms to try to grow their businesses and increase their influence.

The consensus view is that the sector will consolidate further, with perhaps only a handful of ESG research and ratings providers eventually dominating. It remains an open question when that might happen, but the ESG leaders are now evident.
4 How do users access ESG data services?

The most common business model is that the ‘user pays,’ though ESG data may be bundled with other information services. This contrasts with a credit rating, where the entity being analyzed typically foots the bill.

Several providers have formed strategic relationships with major data users such as investment managers, consultancies, stock exchanges, governance service providers, and investment research companies, (see more detail below). While these tie-ins may help in embedding sustainability data into an investment process or product, they raise questions about research independence and the appropriateness of relying on a single ESG data provider (see ‘What do people say about them?’).

ESG mergers, acquisitions and partnership examples

Mergers & Acquisitions

12.2015 – Vigeo and Eiris merge to form VigeoEIRIS
09.2015 – Sustainalytics buys ESG Analytics
08.2014 – MSCI buys GMI Ratings
12.2010 – GMI forms from merger of Governance Metrics International, The Corporate Library and Audit Integrity
06.2010 – MSCI buys RiskMetrics
12.2009 – Bloomberg buys New Energy Finance
11.2009 – Thomson Reuters buys Asset 4

ESG Partnerships

12.2015 – Trucost and Beyond Ratings form partnership
12.2015 – Trucost and TruValue Labs team-up
10.2015 – South Pole Group and EarthRate partnership
10.2015 – CDP and South Pole Group launch global water ratings
09.2015 – South Pole Group and Oekom partnership
09.2015 – CAER & South Pole Group announce partnership
09.2015 – EthiFinance and South Pole Group offer carbon footprint analysis
08.2015 – Ecolab and Trucost enhance Water Risk Monetizer
07.2015 – CDP and South Pole Group launch water management benchmark
03.2015 – CDP and RepRisk establish data partnership
10.2014 – RepRisk and GEC form strategic partnership
10.2014 – Vigeo and GovernArt form partnership
03.2014 – FirstCarbon Solutions (FCS) and CDP expand global partnership
01.2014 – Oekom Research and GES form research partnership
06.2013 – CDP and FirstCarbon Solutions form marketing partnership
08.2012 – FirstCarbon Solutions (FCS) and CDP launch scoring partnership
06.2012 – Oekem and GES form initial strategic
06.2012 – CDP and Forest Footprint Disclosure Project merge
5 How do ESG data providers differentiate themselves?

Each ESG data provider has a distinct offering (see next question). In general, though, the dominant mantra for those seeking to gain a competitive edge seems to be ‘the bigger, the better’.

Many providers are attempting to expand their offerings, resulting in a proliferation of ESG data. As one critic put it, “a blizzard of sustainability indicators populat[es] the information marketplace.” vii Another complained, “the endless stream of [sustainability] information makes it difficult for business leaders and investors to know what to do with it all.” viii

A database of ESG ratings products, compiled by GISR ix, gives an idea of the volume of ESG information out there. It contains details on 479x separate ESG ratings, rankings and indices xi, most of which are aimed at investors.

GISR says its ‘Hub’ repository is the first online database of ESG ratings and research. It includes profiles of ESG products and research organizations. See www.ratesustainability.org.

Strategic relationships with major data users (examples)

Investment Consultants
- Mercer
- Callan
- GPIF
- CalSTRS
- Kepler Cheuvreux
- USS Investment Management (USSIM)
- Russell Investments
- SynTao
- Columbia Threadneedle
- Norwegian Government Pension Fund
- BNY Mellon
- City of London Investment Management (CLIM)

Investment Managers
- Morningstar
- Glass Lewis
- Jantzi Social Index + STOXX
- SXI Switzerland Sustainability 25 Index
- Dow Jones Sustainability Index
- SASB
- PRI
- Mission Markets
- Institutional Shareholder Services
- GEC Risk Advisory
- GRI
- South Pole Group + STOXX
- SASB
- Climate Disclosure Standards Board (CDSB) + International Integrated Reporting Council (IIRC)

Services / Other
- Euronext
- Climate Bonds Standards Board
- PRI

Source: SICM

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6 How do their services compare?

We could write a book about this one because ESG data providers differ significantly. In essence, there are four dimensions to think about:

Coverage: What companies, sectors and regions do they analyze?
Scope: Which aspects of sustainability do they monitor?
Data sources: Where do they get their data? For example, some providers primarily use information supplied by companies, others scour media sources, even blogs.
Analysis and output: How do they process the raw data, and how is their analysis updated and presented?

The challenge for investors is that no two ESG providers are identical.

7 What do people say about them?

ESG data providers clearly have many satisfied customers, hence the rapid growth in use of their services. But a number of criticisms persist; these are the four relevant to investors:

Not so see-through
A common complaint is that ESG data providers aren’t transparent enough. The providers argue that their proprietary research methods are commercially valuable and need to be kept secret. Critics counter that investors are left with an “incomplete understanding of how companies are performing along many or all dimensions of sustainability.” Sometimes it isn’t clear why a company might be rated highly for sustainability by one ESG firm, but poorly by another.

Horses for courses
Although some providers claim to offer a comprehensive service, many users disagree. We find that most are stronger in some areas of sustainability analysis than others. Consequently, the answer to “which provider should I use?” is: “It depends what you want to use their data for.” Investment managers and consultancies that have opted to work with just one provider must be clear on the strengths and weaknesses of the single provider.

Broken series
The wave of mergers and partnerships among ESG data providers means that some have changed the way they calculate certain sustainability scores. The harshest critics say this makes the data unusable. We don’t think that’s true; but, when conducting analysis, it’s crucial to adapt for any breaks in a time series.

Quality concerns
Some critics have accused ESG providers of using data sources of questionable quality. One researcher says: “Too many raters [rely] on others to ensure quality (e.g. trusting media or NGO reports or asking companies to review draft reports).” Perhaps quality standards for ESG ratings will be necessary.
What are the lessons for investors?

In our view, none of the above criticisms negates the value of incorporating ESG data into an investment process. Moreover, the proliferation of sustainability raters and ratings has created a wealth of potentially useful information.

What the concerns do highlight is that it’s important to be smart about using ESG ratings and research, including understanding the strengths and limitations of the organizations supplying them. After all, when you’re looking after someone else’s money, we think it’s obligatory to do more than kick the tires on a data source. It’s what you might call responsible investing.

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Endnotes

i  Global Sustainable Investment Alliance, 2015: ‘Global Sustainable Investment Review 2014’. With growth of ESG assets of about 60% between 2012 and 2014, the current figure is likely to be much higher.

ii  CFA Institute, 2015: ‘ESG issues in investing: Investors debunk the myths’

iii  Oekom research, 2013: ‘The impact of SRI’

iv  Financial Times, January 17, 2016: ‘Morningstar ethical rating could cost funds billions’

v  See GISR: www.ratesustainability.org

vi  SustainAbility, July 2011: ‘Rate the Raters Phase 4: The Necessary Future of Ratings’

vii  The Guardian, August 7, 2013: ‘Swamped by sustainability indicators that fail to drive transformation’

viii  Greenbiz, April 2, 2015: ‘Could sustainability ‘survey fatigue’ launch a $1 billion industry?’

ix  www.ratesustainability.org

x  As at February 2016

xi  Greenbiz, April 2, 2015: ‘Could sustainability ‘survey fatigue’ launch a $1 billion industry?’

xii  Global Initiative for Sustainability Ratings

xiii Global Corporate Governance Forum, 2012: ‘Redefining Value: The Future of Corporate Sustainability Ratings’

xiv SustainAbility, February 2011: ‘Rate the Raters Phase 3: Uncovering Best Practices’

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