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Looking Beyond Third-Party ESG Ratings

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What Are ESG Ratings?

Over the last decade, sustainability has become an increasingly important consideration for investors. Most public corporations are now evaluated on their environmental, social and governance (ESG) performance by numerous third-party agencies including MSCI, ISS, Sustainalytics and Refinitiv. These ESG ratings offer a quick assessment of a company's sustainability profile, similar to what Moody's and S&P provide for creditworthiness. These ratings are often based on hundreds of environmental, social and governance data points, such as, for example, whether a company has an ethical supply chain policy or has reduced its carbon emissions over time.

Many investors use third-party ESG ratings in their investment analysis. For example, MSCI has stated that 46 of the top 50 asset managers in the world utilize its ratings. Some investment products, such as sustainable index funds, rely entirely on third-party ratings. As the assets managed in ESG-linked strategies continue to grow, ESG ratings will become more and more influential in determining how capital is allocated.

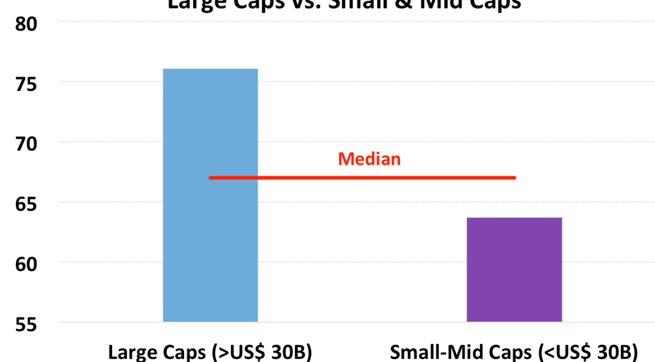
Issues with ESG Ratings

Though they serve a valuable role, there are some issues with third-party ESG ratings that investors should be aware of.

First, most scoring systems depend heavily on companies' disclosures of their environmental and social impact initiatives. Generally, corporations that report more ESG information receive better scores while companies that disclose less data receive worse scores. Large companies tend to have ample budget to produce detailed sustainability reports that check all the required disclosure boxes, thereby position themselves in a positive light. On the other hand, smaller companies are less likely to have the resources to be able to produce extensive sustainability reports. Consequently, third-party ESG ratings have a clear bias against small and mid-cap companies (see Exhibit 1).

Another issue is that third-party ESG ratings are inherently backward looking. They are calculated from historic data and tend to be generated only once a year by the rating agencies. Therefore, if a company's sustainability practices improve or deteriorate mid-year, the impact will not be reflected until the following year's rating. Consequently, third-party ESG data may not always be a reliable source of information.

Exhibit 1: Median ESG Rating from Refinitiv
Large Caps vs. Small & Mid Caps



Note: Based on companies in the MSCI World Index, Overall ESG Scores, which range from 0-100

Cidel's Approach

At Cidel, we integrate the in-depth analysis of ESG factors into our investment decision-making process to enhance long-term, risk-adjusted returns. Our approach identifies a company's material ESG risks and incorporates the takeaways into our valuation. We seek to minimize the likelihood of investing in companies that will suffer significant share price collapses due to major negative ESG events (i.e. ecological disaster, customer data breach or labour disruption)

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Cidel looks at a company's ESG rating from the third-party provider Refinitiv to quickly flag possible risk areas, but this is only our first step. We do not believe that a company with a poor ESG rating always has high ESG risks, and vice versa. Our second step is to apply a proprietary ESG framework to determine a company's most at-risk areas, which can vary greatly by industry. For example, the most important risks for a gold mining company might be environmental impact and employee safety, while for a social media business, it might be data privacy. As a next step, Cidel discusses identified, material ESG risks with the company's management team to develop a deeper understanding of their potential impacts. Management discussions generate particularly useful insights for small and mid-cap companies lacking readily available ESG information. Finally, we determine if the ESG risks warrant an adjustment to our valuation, such as a higher required rate of return.

A good illustration of the value of our approach is the case of Mid-America Apartment Communities (MAA), a holding in Cidel's Global Equity portfolio. The company is a mid-cap $15 billion real estate investment trust. Owning and operating apartments in the U.S., Mid-America receives below-average ESG ratings from most third-party agencies. The primary reason for its poor scores is that the company does not produce a fancy sustainability report with detailed ESG disclosures. While we prefer more disclosure, a lack of disclosure alone does not justify a high-risk rating. Our analysis suggested that Mid-America's most important potential ESG risks were energy, water and waste usage. After further examination, we detected no significant issues in these areas and determined the company's ESG risk level to be low. In addition, when we engaged with management, we uncovered a number of positive factors that were not being captured by the third-party rating agencies. For example, Mid-America's board recently formed an ESG committee to lead a company wide sustainability strategy. Since 2012, the company's water conservation efforts have reduced water usage at its properties by nearly 100 million gallons. Furthermore, Mid-America intends to start reporting carbon emissions data and publicly disclosing its environmental impact improvement targets in 2020. As a result, the company's third-party ESG scores will likely improve next year.

In summary, investors who rely solely on third-party ESG ratings may get a misleading picture of a company's risk exposure and miss out on attractive investment opportunities. Cidel believes that an ESG approach that goes beyond third-party ratings improves returns for our clients over the long term.

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