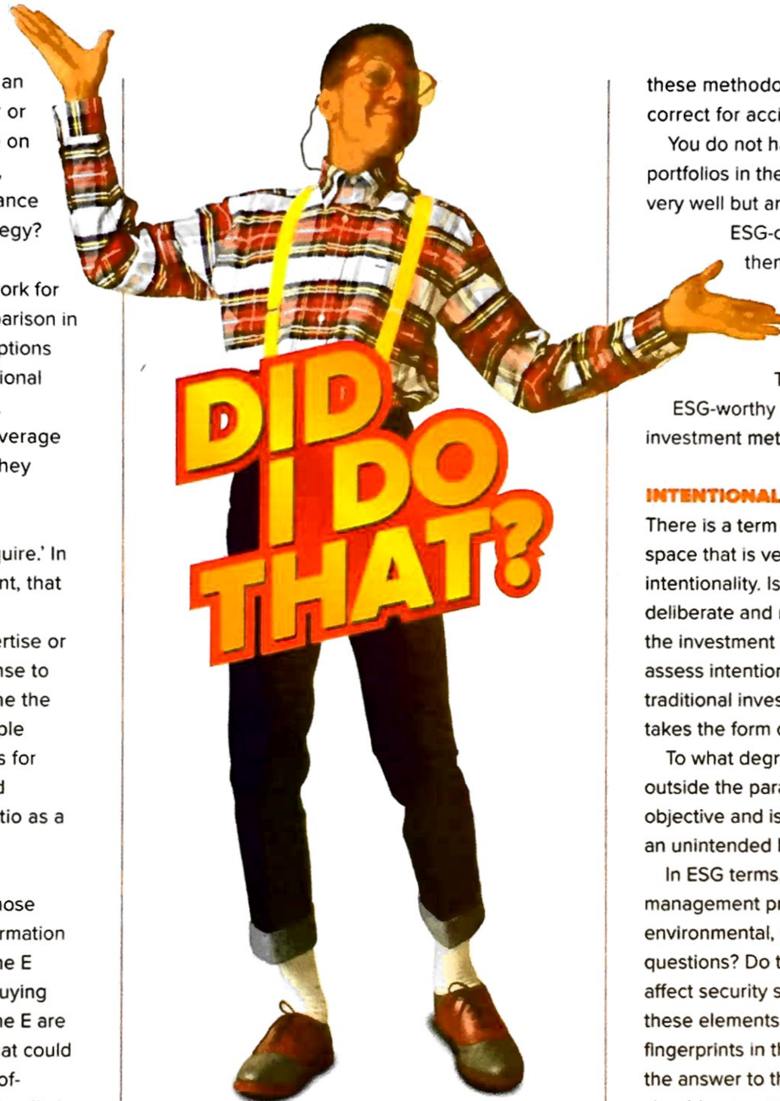
SUSTAINABLE STRATEGIES



ESG RATINGS AND THE IMPORTANCE OF INTENTIONALITY

In a resource-strained environment, weighing up ESG merits can be easier said than done. In this issue, our resident ESG consultant urges investors to consider manager aims

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On what basis does an analyst, an advisor or an investor decide on the environmental, social and governance (ESG) merits of an investment strategy?

In my last article, I suggested a research and due diligence framework for these strategies that requires comparison in the broad universe of investment options and against the same suite of traditional quantitative and qualitative metrics.

I left off saying '...overlay that coverage with robust analysis to be certain they approach ESG with the level of thoughtfulness and authenticity in sustainability terms that clients require.' In a resource-constrained environment, that is easier to say than to execute.

If there is not enough time, expertise or data available, it always makes sense to look for third parties who have done the work already. We also look for simple measures that can serve as proxies for more complex attributes: a low and declining price-to-earnings (P/E) ratio as a signal of value, for instance.

But, whether we do the analysis ourselves or farm it out to others, those analytic proxies carry very little information without context. Is the P falling or the E rising? Either could signal a value buying opportunity. But what if the P and the E are falling, just not at the same rate? That could simply be a signal that a going-out-of-business sale starts soon. The wall to climb gets even higher when proxies cannot be purely quantitative. A lot of simplifying assumptions have to be made to get to a simple ratio, score, rating or ranking.

LEVEL THE PLAYING FIELD

The marketplace has advanced and we now have some shortcuts available for ESG analysis. Tools, databases and methodologies are now here that can characterize the 'ESG-ness' of a fund or separate account in more comfortable and familiar terms – a letter or numeric grade, a symbol, or a ranking.

In principle, that analyst, advisor or investor does not have to be an expert. A uniform process has been applied that compares and scores strategies on a level playing field. The danger though is that these methodologies do not do enough to correct for accidental outcomes.

You do not have to look far to find portfolios in these databases that score very well but are not defined as being ESG-centric by the managers themselves. There is no stated part of the investment objective or process that is geared to these factors. That the portfolio looks ESG-worthy is spurious. 'Oops' is not an investment methodology.

INTENTIONAL IMPACT

There is a term from the impact investing space that is very useful in this situation – intentionality. Is the impact described a deliberate and measurable consequence of the investment commitment? We actually assess intentionality all the time in traditional investment analysis but it usually takes the form of style purity analysis.

To what degree does the portfolio range outside the parameters of the stated objective and is this a calculated decision or an unintended by-product?

In ESG terms, do elements of the portfolio management process specifically address environmental, societal and ethical questions? Do these elements intentionally affect security selection and risk taking? Do these elements yield persistent, quantifiable fingerprints in the final portfolio over time? If the answer to these questions is 'no', then it should not matter how many stars, checks or planets a strategy gets. There is no intention, no certainty that the portfolio you are measuring will continue to be ESG-like over time. A traditional portfolio right now could be low-carbon simply because oil and coal have been poor investments for the last several years. If a client bought the portfolio for its small carbon footprint, imagine the dismay when momentum drives the fund to increase its oil position.

I propose that the true analytic value in these scores is the opposite of what is expected. The real insight is where a strategy is documented as intentionally ESG-oriented and yet scores poorly. Is there a disconnect between the process and the portfolio? Is this a methodology issue with the analysis or an indicator that the investment process itself is flawed?