"WHO WILL GUARD THE GUARDS?" THE DANGER OF TAKING ESG DATA AT FACE VALUE

BORDER TO COAST
PENSIONS PARTNERSHIP

The integration of environmental, social and governance ('ESG') factors can help deliver improved investment outcomes. But while ESG ratings agencies are an increasingly key part of the Responsible Investment ecosystem, caution is needed in applying their data. Will Ballard, our Head of Equities, discusses the associated benefits and challenges of using them.

Across the UK and Europe there is a growing regulatory drive to try and put rules and structure around Responsible Investing. There is no doubt that this is the right journey for us to be on. Scandals surrounding "greenwashing" (the act of overstating your green credentials) undermines credibility and has the potential to take the wind out of an investment category that should help with tackling climate change as well as other environmental and social ills.

At Border to Coast we do not label our equity funds as Green or Sustainable. We do however fully integrate Responsible Investment (RI) into our investment process. We have clear net zero targets, are signatories of the UN Principles for Responsible Investment and take our commitments seriously.

Now prove it.

We can roll out a near un-ending list of policies, procedures and commitments, as well as concrete examples of how we have undertaken our duties of stewardship. From our commitment and engagement on modern slavery, our engagement on fossil fuels, to our work on a Just Transition. This is not enough. Rightly, there is a desire to see and understand how these are embodied in the way we run our funds.

After a lengthy beauty parade, we determined that MSCI were the best independent counterpart to help provide this evidence. Not only do they provide high quality analysis of the ESG risks faced by our investments, but they also attempt to provide systematic and comparable ratings.

> *"MSCI provides a rating for a company going from AAA down to a CCC. This is similar to the credit ratings agencies in their assessment of the credit worthiness of an institution or instrument."*

These ratings have the added benefit that our investments' ESG credentials can now be measured against a representative market index or against absolute standards. This can now provide tangible evidence of the integration of Responsible Investment throughout the investment process.

The benefits are clear and tangible. The problems are less obvious but must still be approached with transparency. They do not undermine the use of these services. They are a huge improvement on anything that has been historically available. They do however show how much more work still needs to be done.

MSCI provides a rating for a company going from AAA down to a CCC. This is similar to the credit ratings agencies in their assessment of the credit worthiness of an institution or instrument. Analysing the data provided by MSCI shows a correlation between company size and company rating. The bigger the company, the better the rating.

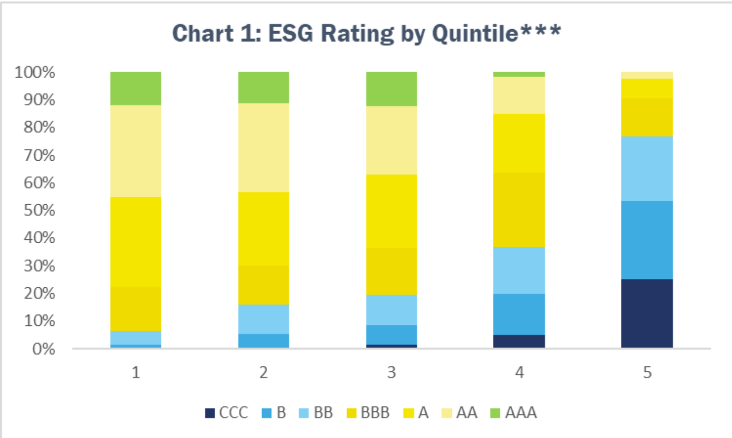


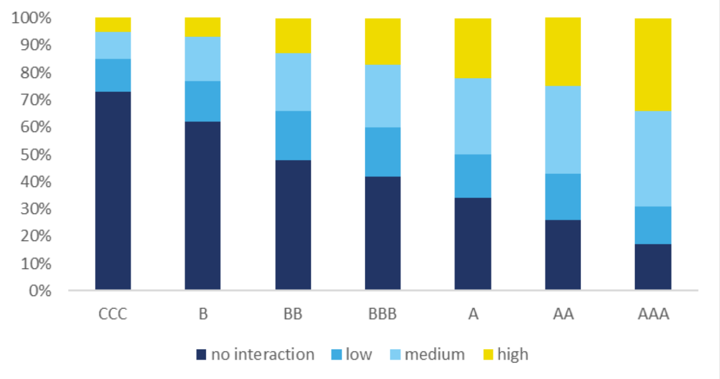
Chart 1 takes the FTSE All Countries World and then divides into five equal buckets ordered by market cap. The largest companies are quintile 1 and the smallest are quintile 5. There is only 1 CCC rated company in quintile 1 currently. Smaller companies having lower ESG standards could be credible. We could speculate their lack of scale leads them to cut corners or de-emphasise their ESG commitments. Perhaps the larger the company, the better its structure to cope with and police compliance?

The size of the skew in the data is such that you would be forgiven for leaping to conclusions and suggesting that the key determinant for a high ESG rating is simply your market cap.

MSCI has a very clear process when it comes to collating data to assess a company's ESG standards and provide a rating. Thousands of different data points are collected across 35 key issues. These come from a wide range of publicly available sources ranging from corporate disclosures to alternative sources such as government and non-governmental agencies.

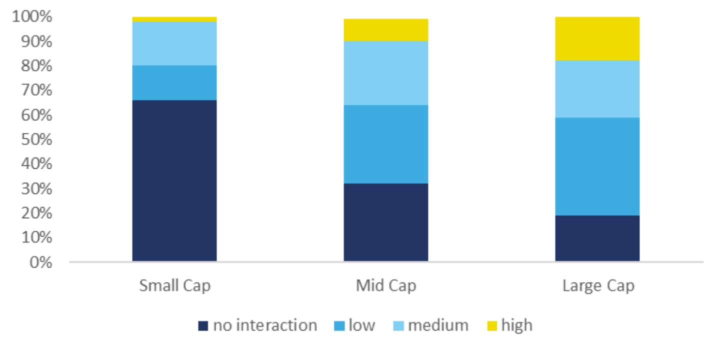
MSCI also has strict guidelines on its interactions with the companies it rates to ensure impartiality. They are therefore not allowed to provide advisory or consultancy services to the companies to help them improve their ratings. This brings us to our second observation. There is a clear linkage between interaction with MSCI by a company and its rating. Chart 2 shows a clear increase in interactions with MSCI and a better rating.

Chart 2: Frequency of interaction by ESG Rating*



We can and should dig into this further. MSCI provide excellent disclosure and so it is possible to dig further into this issue. We can subdivide interaction by company size. Chart 3 does exactly this and shows that the bigger the company, the more interaction they will have with MSCI.

Chart 3: Frequency of interaction by Company Size**



> ***"What is clear is that the demands placed on companies for disclosure around ESG metrics are changing and growing rapidly. It takes significant resources to remain on top of the regulation and disclosure requirements let alone the softer non-regulatory based disclosures."***

Conversely, the smaller the company, the fewer interactions it will have with MSCI and the lower its end rating will be.

There are two clear questions that spring from this analysis. The first, what causes this skew in MSCI's ESG ratings. The second, what does this mean for the assessment of our portfolio's integration of responsible investment.

The causes are hard to pinpoint and push us into the realms of speculation. What is clear is that the demands placed on companies for disclosure around ESG metrics are changing and growing rapidly. It takes significant resources to remain on top of the regulation and disclosure requirements let alone the softer non-regulatory based disclosures.

The importance of interaction with MSCI is not a sign of malfeasance but merely an indication of the scale of the demand placed on companies. MSCI may be looking at 35 key areas but that can be broken down into over 1000 data points on ESG policies, programs and performance. The smaller the company, the smaller the resources that can be marshalled to ensure full disclosure of each and every data point needed. The answer is not to lower our standards but to acknowledge this issue and help in the education process.

When it comes to the assessment of our integration of responsible investment the key again is to acknowledge these issues and be aware of and adjust for the weaknesses within the data. We should set absolute targets and standards for our investments but engage with them directly and understand how, where and why they are falling short.

There are strong parallels with the development of the credit ratings agencies. Moody's, S&P and Fitch, all have a long track record. S&P was founded in 1860, Moody's in 1909, and Fitch, the newest of the bunch, is a mere 100 years old. Despite a century of experience, following every crisis there are still cries that their standards were too lax or they are exposed to conflicts of interest. They still fulfil an essential role, providing an assessment of the credit worthiness of a wide variety of instruments.

They do not provide a guarantee, just an assessment, and still we overlay our own credit analysis, instrument selection and portfolio construction on top.

ESG ratings agencies do not have a century of experience. It's a new area, it's a nuanced area, there is no black and white default. There is also much less history to learn from. The term "ESG" was only coined in 2004 by the United Nations in their paper "Who cares wins" which set in place the foundations for the responsible investing practices we have seen adopted and embedded across the asset management industry. MSCI have one of the longest track records, but even that only stretches back 40 years and is based on their acquisitions of companies such as GMI ratings which they acquired in 2014.

The nature and structure of what we are demanding of companies and what is being demanded of us is changing and growing at a breakneck pace. For us all to be able to meet and evidence our ESG commitments the ESG ratings agencies are the best tool we have, but they are imperfect and provide only part of the picture. To fully understand how we integrated responsible investment, looking at the ratings of companies we invest in will not give us the full story. The rest will only come from going back to our policies, processes, commitments, and examples.

Will Ballard, Head of Equities

Sources:

*MSCI Global ESG Issuer Interaction Snapshot Oct 2022; Interaction frequency defined as: Low 1 to 2, Med 3 to 9 and High more than 10 interactions over a 2 year period.

**MSCI Global ESG Issuer Interaction Snapshot Oct 2022

***Bloomberg & MSCI ESG Manager ratings for FTSE All countries world as at 28th February 2023

Important information