ESG RATINGS: A CALL FOR GREATER TRANSPARENCY AND PRECISION

THE PRACTICE MAKES PERFECT

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In 2006, the UN's 'Principles for Responsible Investment' report raised the notion of incorporating an evaluation of a company's Environmental, Social, and Governance (ESG) practices as part of its overall financial evaluation. In response, 63 investment companies signed on to adopt ESG, and by 2019, there were close to 2500 signatories collectively representing over $80 trillion in Assets Under Management (AUM). By 2022, major institutional investors demanded that the companies they invested in commit to ESG principles. However, not all stakeholders are in agreement as to the extent to which sustainability should play a role in determining value. We will examine the current state of ESG adoption, the various calls for greater transparency, and other issues surrounding this element of financial reporting.

ESG Metrics and Financial Reporting

For centuries, investors have looked at the proverbial 'bottom line' in deciding whether to invest in any particular company or venture. As noted above, it was only recently that other non-financial factors came to be part of the analysis before going forward with an investment. Although not traditionally part of mandatory financial reporting, ESG metrics are nevertheless being disclosed in annual reports or in sustainability reports. Those metrics are now quantified by way of best practices standards developed by such ESG institutions as the Global Reporting Initiative (GRI), the Task Force on Climate-related Financial Disclosures (TCFD), and the Sustainability Accounting Standards Board (SASB), among others.

What Is Covered Under ESG?

While a true taxonomy of ESG factors is still being developed, sustainability reporting standards cover environmental impact as to climate change and carbon emissions, biodiversity, air and water pollution, energy efficiency, and waste management. Social impact reporting includes labor standards—including health and safety of workers, human rights, community relations, and even data protection and privacy. Corporate governance is scrutinized as to board composition, executive compensation, lobbying activity, political contributions, and how the audit committee is structured. However, none of these categories are deemed to be exhaustive as to what a company can include in its ESG reporting.

How ESG is Measured

But ESG performance can be tracked and measured using the company's own data; however, because of inconsistencies in the quality of such reporting, the evaluation of true comparative ESG performance can be challenging. Performance related to important ESG practices, such as decarbonization, workforce diversity, and how materials are sourced according to ethical supply chains, are all metrics that can be quantified and reported if the proper tools and methods are employed to keep track of and analyze such data. The controversy arises, however, when trying to determine just how that compliance—or non-compliance—affects investment value.

In determining how to measure the relative value of a given ESG metric, investors largely rely on three scoring criteria:
(1) peers managing comparable portfolios;
(2) a commonly accepted benchmark index; or
(3) the investors' own history, rather than just the company data itself.

"WE AIM TO DEMONSTRATE THAT THE BEST OPPORTUNITIES LIE NOT AT THE EXTREMES OF ESG RHETORIC, BUT AT THE HEART OF SUSTAINABILITY SUBSTANCE."

— Katherine Collins, Head of Sustainable Investing, Putnam Investments

The risk tolerance of an investor for a particular portfolio, the composition of the stakeholders, and management's fiduciary obligations to an investment fund all play a part in assessing what the raw ESG data means for value as to the particular investor since the world of investors is of course not homogenous.

Transparency and Shareholder Activism

Shareholder activist groups are increasingly putting pressure on companies to further ESG objectives, as demonstrated by the record number of proxy proposals put forth in 2021 related to ESG. As one example, in November 2021, Microsoft shareholders gave a 78% vote of approval to the demand that sexual harassment claims be transparently addressed through independent investigations and reporting.

At the same time, many companies are coming to realize that merely providing ESG data reporting may not be enough to satisfy investors, and therefore they are enhancing ESG transparency by way of not just annual reports but also in their regulatory financial filings as well. This is based on the recognition that broader non-financial disclosures are an important consideration for investors when evaluating company performance and future growth. Given the extent of investor activism, companies that don't advance their ESG transparency risk losing favor with investors or falling behind those competitors who do.

Last May, for example, electric car manufacturer Tesla was surprisingly removed from the S&P 500 ESG Index. Although one might expect that an EV manufacturer would lead the list of ESG-compliant companies—over such remaining index companies as ExxonMobil and Amazon, whose business model relies heavily on extensive consumption of transportation energy resources—the index cited a lack of a low-carbon strategy as well as business conduct, and allegations of racism and poor working conditions at one particular Tesla plant, as justifications for the removal.

Is ESG Overly Ambitious?

Industry expert Katherine Collins has observed that “Any practitioner of sustainable investing is accustomed to operating in an environment that is simultaneously “too much” and “not enough” – including constant assertions that the field is both overly ambitious and woefully deficient.” As part of her investment analysis, depending on the strategy or portfolio in question, she might integrate ESG issues or considerations into her research and/or investment decision-making. She views analysis of ESG issues as part of good investing because those issues, like the more traditional areas of investment analysis, such as market position, growth prospects, and business strategy, also have the potential to impact risk and returns.

Eliminating ‘Greenwashing’

At the World Economic Forum in Davos, Bank of America CEO Brian Moynihan stated that efforts to produce a set of official global standards on ESG issues were vital in order to “align capitalism with what society wants from it.” What ESG needs, according to Mr. Moynihan, is a reboot through the creation of common standards for corporate disclosures. Such standardization would resolve the debate over what sustainability actually means and would address accusations of ‘greenwashing’ by companies attempting to boost their ESG ratings and standing.

At the end of the day, it is clear that the consideration of ESG factors will continue to play an increasingly large part in investor decision-making. The only issue is: how can we make those factors truly transparent?

Executive Summary

1. The Issue

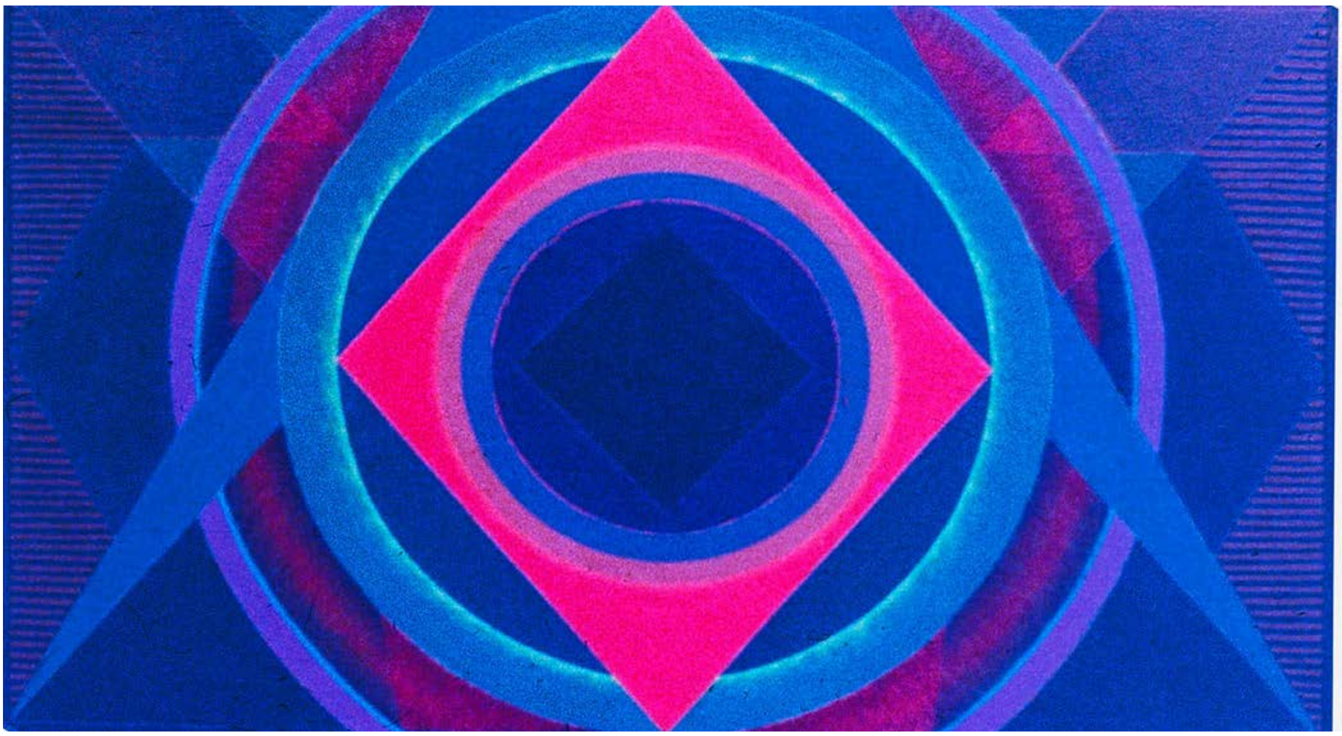
What is the role that ESG plays in determining the value of a company?

2. The Gravamen

ESG factors are today being almost universally analyzed by investors alongside traditional financial evaluation.

3. The Path Forward

Standards for ESG sustainability must be established in order for all companies to participate in the same playing field and for the sake of real transparency as to what the reported ESG data means.



Action Items:

1 Sustainability Goals:

The practitioner is directed to the UN's 2017 Sustainable Development Goals in order to get a benchmark as to what a company's ESG goals should be.

2 Which ESG Factors to Choose?

ESG encompasses so many different aspects of 'sustainability' that it is not likely for one company to be able to receive high scores in all data points. Therefore, if the nature of a company is such that its biodiversity score may be challenged, it can nevertheless excel in other ESG performances.

3 ESG Standards:

ESG standards are not yet universalized. However, there are numerous institutional resources available that can analyze your company's ESG performance, help you to tweak it, and properly report it.

4 Portfolio Specific:

Different investments call for different ESG considerations, and that, along with investor tolerance for ESG variables and fiduciary obligations, must be weighed accordingly.

Further Readings

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After receiving his Juris Doctor degree from The John Marshall Law School in Chicago, Mr. Brochin served as an Administrative Law Judge with the Illinois Department of Labor for six years where he presided over cases dealing with job separation issues and matters pertaining to contested Unemployment Insurance claims. He also co-wrote the agency's administrative rules, and periodically served as a 'ghost writer' for Board of Review decisions. Following that position, he was Director of Development for a Chicago-area non-profit college where he was responsible for High Net Worth donations to the institution. For the next eighteen years he practiced as a solo practitioner attorney with an emphasis in the fields of Real Estate law and Commercial Contracts transactions, and was an agent for several national title insurance agencies.

In 2003 he was recruited to head up a U.S. title insurance research office in Israel, a position he held for four years, and between 2007-2017 he participated in litigation support for several high-profile cases. He has taught Business Law as a faculty member of the Jerusalem College of Technology, and has authored a wide variety of legal White Papers and timely legal articles as a professional legal content writer for GPL clients. Separate from his legal writing, he has co-authored academic articles on Middle East security topics that have been published in peer-reviewed publications.

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