

# The ESG Data Challenge

## The Importance of Data Quality in ESG Investing

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- **Data quality is crucial in the world of investment management, and especially so in the area of environmental, social and governance (ESG) investing, where lack of mandatory and consistent reporting of non-financial information by companies makes it challenging for investors to make decisions based on that information.**
- **Most ESG data providers employ their own proprietary methodologies, and ESG scores can differ significantly across providers.**
- **ESG data should be transparent, align with our ESG beliefs, and incorporate our stewardship insights on companies. To achieve this, we have built our own data architecture. We partner with best-in-class data sources to create ESG scores that leverage a transparent materiality map created by the Sustainability Accounting Standards Board (SASB). This platform is used for investment solutions and reporting across asset classes.**

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### **ESG Data Standards and Reporting**

Successful investing is heavily reliant on the quality of data inputs, something that holds particularly true in ESG investing. Demands from investors and others have driven significant improvements in the level of corporate disclosure of ESG performance data, but disclosures are neither comprehensive nor comparable across firms. This makes investment decision-making based on such information a challenge.

The absence of standardized ESG reporting has implications for asset owners and their investment managers. Understanding companies' performance on ESG issues is important for investors seeking to mitigate risk, identify drivers of long-term performance, or invest according to their preferences.

We support market infrastructure initiatives to standardize reporting — in particular the SASB. SASB is an independent not-for-profit organization that has developed a set of standards to support companies in identifying and disclosing financially material sustainability information usable by investors. Their standard-setting framework follows a multi-year process that encompasses evidence-based research followed by consultation and engagement with investors and other industry experts. The result is a materiality map that ranks sustainability issues across 77 industries in 10 sectors, and offers companies a clear disclosure framework that aligns with investors’ needs. Academic research indicates that investments in companies that score highly when using the SASB materiality map outperform those that score poorly, or that score high on non-material issues.<sup>1</sup>

## Bridging the Gap — ESG Data Providers

ESG data providers play an important role in gathering, assessing and scoring companies on their ESG credentials. These companies have helped to nurture the growth of ESG investments and present asset owners and managers an alternative to conducting such extensive diligence themselves. But there are important considerations for investors to be aware of when selecting ESG data providers.

There are numerous ESG data providers in the market, including well-known providers with global coverage such as ISS, Refinitiv, V.E, MSCI, TruValue Labs, and RepRisk, as well as specialized data providers such as S&P Trucost (providing carbon, climate, sector revenue and fossil fuel reserves data) and GRESB (sustainability performance in real estate).

### Differences in Data Collection and Scoring Methodologies

ESG data providers generally develop their own sourcing process and research methodologies; as a result, the rating for a single company can vary widely across different providers. As part of an 18-month due diligence process in which we looked at more than 30 providers, we examined the cross-sectional correlations for four leading data providers’ ESG scores, using the MSCI World Index as the coverage universe. As illustrated in Figure 1, the relatively low correlation of ESG scores generated by MSCI and Sustainalytics, meaning that their ratings of companies are only consistent for about half of that universe.

Figure 1  
**ESG Scores Are Different  
Across Providers**  
Cross Sectional Correlation  
for Constituents of the MSCI  
World Index, June 30, 2017.  
Representation by Country.  
Based on Latest Available Data.

	<b>Sustainalytics</b>	<b>MSCI</b>	<b>RobecoSAM</b>	<b>Bloomberg ESG</b>
<b>Sustainalytics</b>	1	0.53	0.76	0.66
<b>MSCI</b>		1	0.48	0.47
<b>RobecoSAM</b>			1	0.68
<b>Bloomberg ESG</b>				1

Moreover, the range of data providers with different ESG methodologies presents an immediate difficulty for investors. In choosing a particular provider, they are in effect aligning themselves with that firm’s ESG investment philosophy. Additionally the choice is complicated by the desire among providers to keep a proprietary hold on their methodology, meaning that asset owners are taking on board the perspectives of an ESG data provider without necessarily having a full understanding of how they arrived at those perspectives.

Determining the variances between data providers and how best to account for them can be challenging and requires careful examination of their underlying approaches. Some common points of difference between providers include:

**Data Acquisition and Estimation.** In the course of our research we found discernable differences among ESG data providers on raw data sourcing and acquisition methods. ESG data providers combine data from companies using traditional sourcing techniques with statistical models that attempt to estimate data for unreported companies — based on similar industry and company characteristics. Once again, this means that investors are incorporating judgment calls by the provider into their investment processes.

**Materiality.** As part of a proprietary solution, ESG data providers typically make their own determination on the issue of materiality. An ESG score for a company that is simply an amalgam of scores on both material and immaterial issues does not provide the type of transparency and relevance that asset owners require. Some ESG data can reflect a strong signal for performance by one company but not for another because of the relative importance of that issue in their business.

The academic research behind the SASB materiality framework underscores the importance of the choice of a materiality framework by data providers.<sup>2</sup> Alongside the low correlation of ESG scores provided by ESG providers, differences by provider in how materiality is defined and unveiled adds to the difficulty asset owners and managers have in selecting an ‘off-the-shelf’ provider.

**Aggregation and Weighting.** Each ESG data provider has developed a method to aggregate and weight particular ESG factors for its summary scores. However, without knowing the aggregation and weighting methodology, users of this data are buying a subjective point of view rather than a product that provides full transparency of the method.

Case Study: MSCI versus Sustainalytics

Consider the challenge facing investors by comparing two of the leading ESG providers in the market. Both MSCI and Sustainalytics are widely used across the asset management industry and each of them offers global ESG product suites — including ESG ratings and carbon products. But as Figure 2 illustrates, there are distinct differences in the way the two firms handle ESG data challenges, ranging from how they define materiality to the number of metrics used.

Figure 2  
**Comparison of MSCI and Sustainalytics Approaches to ESG Scores**

	<b>MSCI</b>	<b>Sustainalytics</b>
<b>Materiality</b>	Proprietary Definition of Materiality	International Financial Reporting Standards (IFRS) Definition of Materiality
<b>Normalization</b>	Key Issue Weighted Average by Global Industry Classification System Sub-Industry	Key Issue Weighted Average by 42 Peer Groups
<b>Weighting</b>	Key Issue Weights (proprietary model)	Key Issue Weights (proprietary model)
<b>Aggregation</b>	37 Metrics	60–80 Metrics

For illustration purposes only.

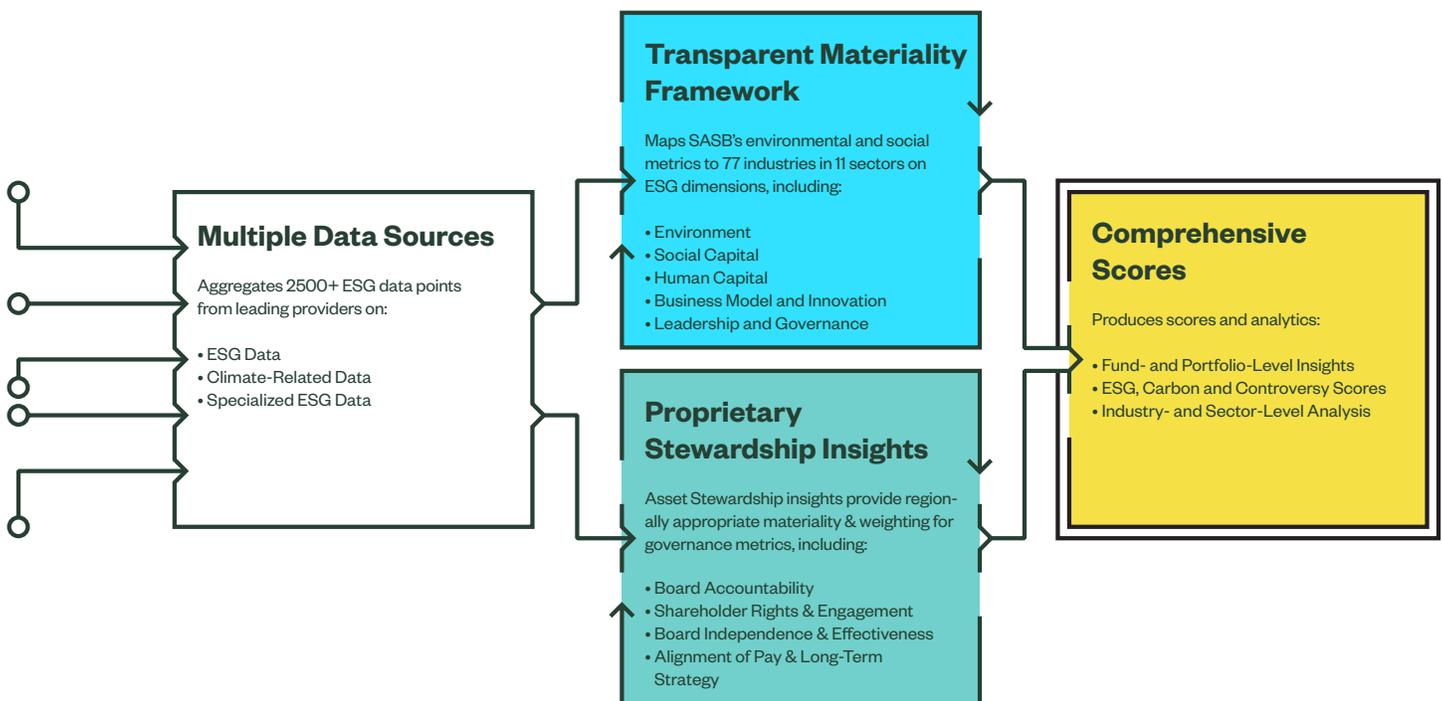
## ESG Scoring at State Street Global Advisors

At State Street Global Advisors, we have made ESG a priority in our research agenda. We believe that the data that supports our products should align closely with our perspectives. Our approach to ESG is fully transparent and is guided by our conviction that responsibly-managed companies deliver stronger, more sustainable long-term results. This means incorporating high-quality ESG inputs into our investment process and delivering a transparent solution for our clients. Our asset stewardship efforts highlight our belief that asset managers can and should drive greater disclosure in investor-relevant data that companies provide using a standardized and consistent framework. This creates a positive cycle that allows for more thorough information inputs into investment decision-making.

The State Street Global Advisors ESG data architecture leverages multiple data sources, and draws on our systematic investment management expertise to offer deeper insights and stronger solutions to our clients. We have incorporated the 'materiality map' developed by SASB into our transparent framework because of their consultative approach and the strong academic evidence that supports the implementation of such standards.<sup>3</sup> By aligning to the SASB guidelines, we support and facilitate the development of market infrastructure to make material ESG data available to investors.

Our approach is enriched by assessments from our Asset Stewardship team. Their active engagement with companies allows us to leverage their expertise to map hundreds of governance metrics and assign custom weightings for each metric across six global regions.

This data architecture is a powerful investment tool and delivers transparent ESG scores that enable the creation of fund- and portfolio-level insights for assets managed by State Street Global Advisors.



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Clients may be able to reap the benefits of the State Street Global Advisors approach through a suite of products that offers exposure to equity and fixed income markets.

We hope this look into the many considerations for evaluating ESG data providers supplies you with ideas to leverage when considering ESG investment decisions. As you move forward, you may wish to use the sample resources described below. As always, we invite you to contact your State Street Global Advisors Relationship Manager or access our ESG website at [ssga.com/esg](http://ssga.com/esg) to learn more about these resources and our ESG capabilities.

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## State Street Global Advisors Resources

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### Understanding & Comparing ESG Terminology

A practical framework for identifying the ESG Strategy that is right for you.

### Next Generation ESG for Better Alpha

A tailored approach to ESG metrics for active equity strategies.

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### Harnessing ESG as an Alpha Source in Active Quantitative Equity

Insights into leveraging ESG factors to increase portfolio returns.

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## Endnotes

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1 Mozaffar Khan, George Serafeim and Aaron Yoon, Corporate Sustainability: First Evidence on Materiality (November 9, 2016).

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2 Khan, Serafeim and Yoon.

3 Khan, Serafeim et al. "Corporate Sustainability: First Evidence of Materiality." Harvard Business Review, 2016.

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ID374240-2392452.61.GBL.RTL 0121  
Exp. Date: 01/31/2022