Article
ESG

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The ESG Data Challenge

- **Quality data about companies' Environmental, Social and Governance (ESG) practices is critical for effective investment analysis.**
- **The lack of standardization and transparency in ESG reporting and scoring presents major challenges for investors.**
- **Third-party ESG data providers play an important role, but there are limitations with this data — especially in terms of differing methodologies that lead to variance in scores — which asset owners should understand.**
- **Moreover, there is a lack of market infrastructure to give companies insights into how they are evaluated with respect to ESG scoring.**
- **To improve the quality of the ESG data we use to make investment decisions for our clients, State Street has built a scoring system that uses data from multiple best-in-class providers, leverages Sustainability Accounting Standards Board's (SASB) transparent materiality framework and incorporates our stewardship insights.**
- **We outline the considerations that asset owners should incorporate into their evaluation of ESG data providers.**

Headwinds to ESG Data Quality

Quality data is the lifeblood of investment analysis. While "quality" can be defined in several ways, most investors agree that consistency and comparability in the availability of data across companies are essential elements of an effective data set.

Unfortunately, the current landscape provides headwinds to achieving those elements of quality when it comes to data about a company's ESG practices. Governments around the world don't require companies to report on most ESG data. Companies are left to determine for themselves which ESG factors are material to their business performance and what information to disclose to investors.

Asset owners and their investment managers seek solutions to the challenges posed by a lack of consistent, comparable, and material information. Investors increasingly view material ESG factors as being critical drivers of a company's ability to generate sustainable long-term performance. In turn, ESG data has increasing importance for investors' ability to allocate capital most effectively.

ESG Data Providers — Contributions and Considerations

ESG data providers play an important role in the investment process by gathering and assessing information about companies' ESG practices and then scoring those companies accordingly. The development of these ratings systems has helped to nurture the growth of ESG investing by giving asset owners and managers an alternative to conducting such extensive diligence themselves.

As of 2016, there were more than 125 ESG data providers, according to The Global Initiative for Sustainability Ratings. These include well-known providers with global coverage such as Bloomberg, FTSE, MSCI, Sustainalytics, Thomson Reuters, and Vigeo EIRIS, as well as specialized data providers such as S&P's Trucost (providing carbon and "brown revenue" data), GRESB (sustainability performance in real estate) and ISS (corporate governance, climate, and responsible investing solutions).

Despite the valuable contributions these data providers have made in advancing ESG investing globally, it's important for asset owners and managers to understand the inherent limitations of this data, as well as the challenges of relying on any one provider.

Differences in Data Collection and Methodologies

Lack of standardization and transparency in providers' data collection and scoring methodologies pose key challenges for investors.

ESG data providers generally develop their own sourcing, research, and scoring methodologies. As a result, the rating for a single company can vary widely across different providers. We recently conducted research to quantify the degree to which this lack of standardization leads to variance among the ESG scores used by investors. (See "A Blueprint for Integrating ESG Into Equity Portfolios ," by Bender, Bridges, et al.)[1]

As part of an 18-month due diligence process in which we looked at more than 30 data providers, we examined the cross-sectional correlations for four leading data providers' ESG scores, using the MSCI World Index as the coverage universe. MSCI and Sustainalytics are two of the most widely used ESG data providers. But, as shown in Figure 1, our research determined a correlation of only 0.53 among their scores, meaning that their ratings of companies are only consistent for about half of the coverage universe.

Figure 1
ESG Scores are Different Across Providers
(Cross Sectional Correlation for Constituents of the MSCI World Index, June 30, 2017)

	Sustainalytics	MSCI	RobecoSAM	Bloomberg ESG
Sustainalytics	1	0.53	0.76	0.66
MSCI		1	0.48	0.47
RobecoSAM			1	0.68
Bloomberg ESG				1

These differing methodologies have implications for investors. In choosing a particular provider, investors are, in effect, aligning themselves with that company's ESG investment philosophy in terms of data acquisition, materiality, and aggregation and weighting.

This choice is complicated by the lack of transparency into those methodologies. Most data providers treat their methodologies as proprietary information. By relying on an ESG data provider's score, asset owners are taking on the perspectives of that provider without a full understanding of how the provider arrived at those conclusions.

Assessing the Differences

Given the lack of consistency among ESG scores, it's helpful to understand the factors that are leading to this variance. In our research, three primary points of difference among the methodologies and approaches used by ESG data providers were identified:

Materiality. A critical part of any ESG scoring is determining which factors are material to a company's financial performance; the importance of materiality has been supported by academic research.[2] As part of the proprietary nature of their solutions, ESG data providers typically make their own determinations on materiality issues — and don't provide full transparency into how these determinations are made. These differences in how materiality is defined and unveiled add to the difficulty asset owners and managers face in selecting an ESG data provider.

Data Acquisition and Estimation. We found discernable differences in how ESG data providers source and acquire raw data. In addition to using traditional sourcing techniques to gather data that is disclosed by the company or is otherwise publicly available, ESG data providers use statistical models to create estimates for unreported data. These models are based on averages and trends from what the data provider views as similar companies and industry benchmarks. This is an example of how investors are incorporating judgement calls by the data provider into their investment processes.

Aggregation and Weighting. Each ESG data provider has developed a method to aggregate and weight particular ESG factors for its summary scores. Again, these are proprietary judgments made by each provider.

Case Study: MSCI versus Sustainalytics

Examining the different methodologies used by two of the leading ESG data providers highlights the challenge investors face when selecting a provider. 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 climate-focused products. But, as Figure 2 illustrates, there are distinct differences in the way the two companies collect and analyze ESG data.

Figure 2
Comparison of MSCI and Sustainalytics Approaches to ESG Scores

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

ESG Scoring at State Street: Our Goals and Approach

At State Street, we believe that ESG factors are directly linked to a company's ability to generate sustainable long term performance. As fiduciaries, we have a duty to rigorously analyze all financial and nonfinancial factors that can affect a company's performance, and we believe that ESG factors can be used to mitigate risk and identify potential alpha signals.

To address the gaps in the current market infrastructure, we are building our own scoring system, known as R-Factor. This scoring system will address the data challenges that we've articulated above.

Our approach to ESG data and scoring is guided by three goals:

- Bring **greater transparency** to materiality considerations that drive ESG scores
- Develop ESG scores that are based on **frameworks supported by a large number of investors**
- Promote **market infrastructure** that both integrates stewardship into ESG scoring and incentivizes greater corporate disclosure of investor-relevant ESG information

We invite you to contact your State Street Relationship Manager to learn more about R-Factor and our broader ESG capabilities.

State Street Global Advisors ESG Resources

Understanding & Comparing ESG Terminology
A practical framework for identifying the ESG long-term strategy that is right for you.

Next Generation ESG for Better Alpha
A tailored approach to ESG metrics for active equity strategies.

Harnessing ESG as an Alpha Source in Active Quantitative Equity
Insights into leveraging ESG factors to increase portfolio returns.

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Endnotes

1 Bender, Bridges, et al. "A Blueprint for Integrating ESG into Equity Portfolios." Journal of Investment Management Volume 16 No. 1, 2018.

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

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The returns on a portfolio of securities which exclude companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities which include such companies. A portfolio's ESG criteria may result in the portfolio investing in industry sectors or securities which underperform the market as a whole.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

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