ESG

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The ESG Data Challenge
The Importance of Data Quality in ESG Investing

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- **We believe 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 and focus on material criteria. 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.**

ESG Data Standards and Reporting

We believe 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. We believe 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, 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 11 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.[1]

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 ongoing, multi-year due diligence process in which we have so far looked at more than 70 providers, we examined the cross-sectional correlations for five 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, December 30, 2022. Representation by Country. Based on Latest Available Data.

	R-FACTOR (%)	ISS (%)	Moody's V.E. (%)	MSCI (%)	Sustainalytics (%)
R-FACTOR	100	70.35	77.83	44.89	20.24
ISS	70.35	100	61.28	45.19	37
Moody's V.E.	77.83	61.28	100	44.06	17.97
MSCI (%)	44.89	45.19	44.06	100	20.9
Sustainalytics	20.24	37	17.97	20.9	100

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, in our view. 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.

Assessing the Differences

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. We believe 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.[2] 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

	MSCI	Sustainalytics
Materiality	Proprietary definition of materiality	Material ESG Issues are characterized by having a significant effect on the enterprise value of a typical company within a given subindustry and its presence/absence in financial reporting and how that influences the investor
Normalization	Score is normalized relative to ESG Rating Industry Peers	Score is rooted in beta indicators and signals which is then normalized via the subindustry correction factor
Weighting	Weighted Average of individual environmental and social key issue scores and then the governance score	3 different scoring schemes; cluster E, S, and G scores are then compiled and weighted with a beta factor based on subindustry scores
Aggregation	35 Key Issues (106 key metrics)	20 MEIS; 40 thematic risk groups

For illustration purposes only.

ESG Scoring at State Street Global Advisors

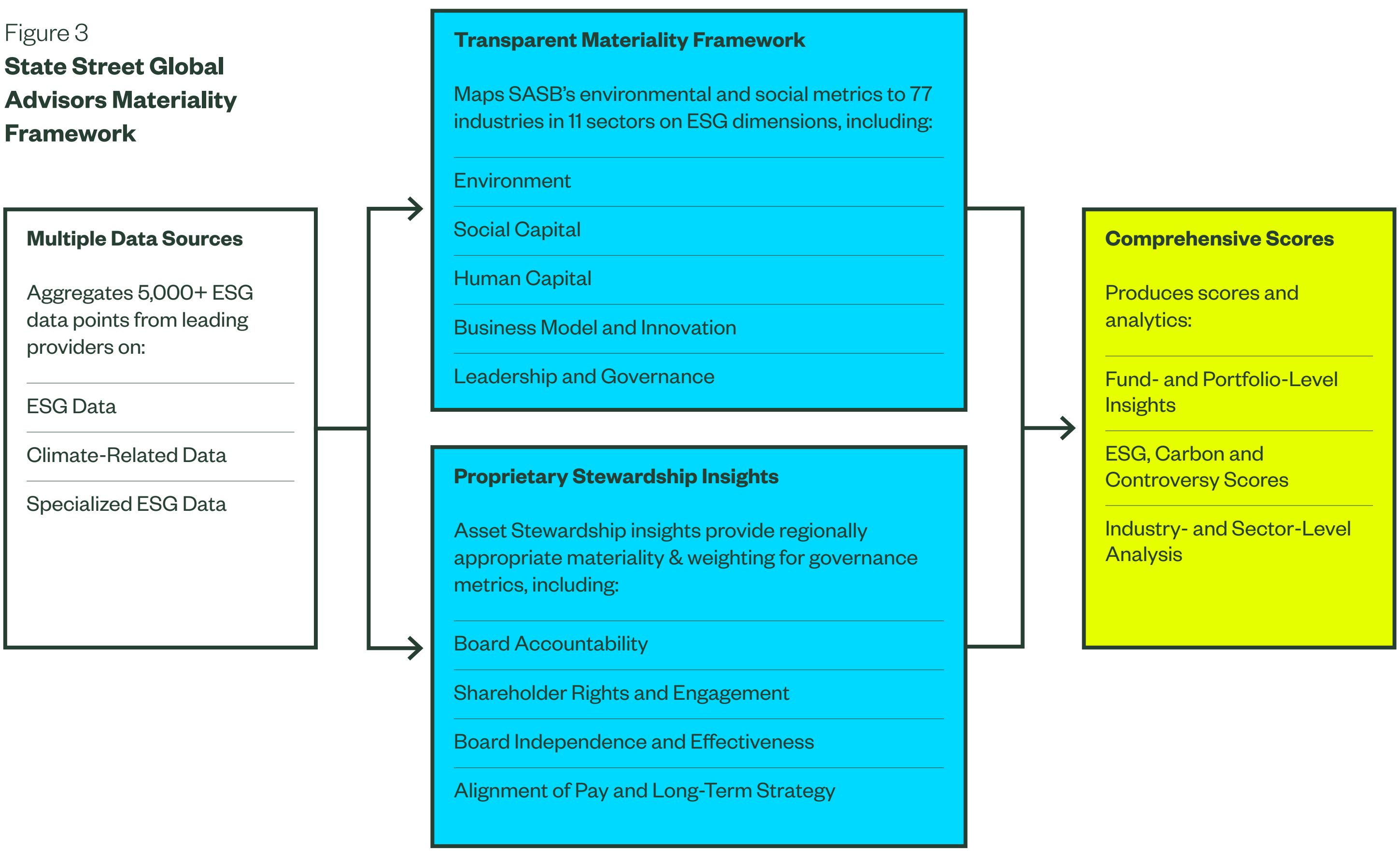
At State Street Global Advisors, we believe that the data that supports our products should align closely with our perspectives. Our approach to ESG is fully transparent and is guided by our conviction that material sustainability considerations, including environmental and social (E&S) issues, can present risks and/or opportunities that impact long-term value creation. Consequently, we are committed to integrating ESG metrics into our investment processes where appropriate and where we are making active investment decisions in managing a portfolio and delivering a trasparent solution for our clients. Our asset stewardship efforts highlight our belief that asset managers can and should drive greater disclosure in material investor-relevant data that companies provide using a standardized and consistent framework. We believe 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.[3] 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.

Figure 3
State Street Global Advisors Materiality Framework



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 to learn more about these resources and our ESG capabilities.

Endnotes

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

2 Khan, Serafeim and Yoon.

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

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