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ESG ratings: What are those all about?

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The rise in sustainable investing has invariably brought with it a plethora of data and information, along with a lot of media attention. Much of the data and information about companies used in sustainable investing has historically been self-reported, voluntary, backward looking, non-standardized, and, therefore, inconsistent over time and from one company to the next.

In the 2000s, a cottage industry emerged to help make sense of the growing mountain of data by supplying subscribers with raw data, screens (algorithms designed to exclude selected securities based on predefined criteria), and alerts (instant communications that apprise subscribers of changes to predetermined criteria). Providers each developed their own approach to analyzing and synthesizing the data into scores or ratings, intended to simplify subscribers' assimilation and use of the vast information. Unfortunately, however, even the best of intentions can lead to unwelcome results. In the case of ESG data vendors, it was the ratings more so than the underlying data that has caused frustration and confusion for investors and companies alike.

Consolidating list of ratings and data providers

Over the years, the ESG data and ratings industry has consolidated into several major providers:

- MSCI
- Sustainalytics (owned by Morningstar)
- Refinitiv (owned by Thomson Reuters)
- ISS ESG
- S&P Global
- Bloomberg

And a few key specialist data providers:

- CDP
- Trucost
- RepRisk

According to a 2022 ESG manager survey by management consultancy Opimas, four of the major providers account for nearly 70% market share—with MSCI at approximately 31%, ISS ESG at 17%, and Sustainalytics and S&P Global each at 10%. This consolidation combined with the surging interest in sustainable investing has given these vendors an increasingly important role in the investment landscape. Even so, a basic internet search reveals in excess of 100 different ESG data vendors in the market today (versus three primary credit-rating agencies).

Expanding list of index funds

Meanwhile, the growth of passive investing has deeply entrenched ratings into the sustainable investing landscape. According to the Index Industry Association, there are more than 50,000 ESG indexes available to investors across asset classes globally.[1] A single ratings provider, MSCI, has more than 1,500 such indexes, many of which leverage its ratings for constituent selection. In the U.S., 30% of sustainable funds, and 40% of the assets in them, are passive strategies.[2]

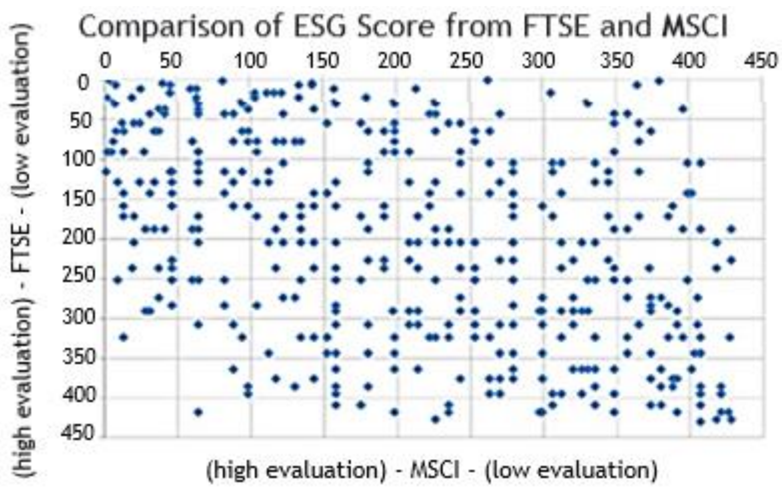
Providers may:

- Use more or less data to assess a topic.
- Use different data points or indicators to assess a topic.
- Use different ways to measure the same data.
- Use different methods to translate qualitative insights into quantitative data.
- Have different views on which issues are material for a given company or sector.
- Put different weights on factors across companies.

Alphabet soup: Lots of data, lots of funds, few standards

Unfortunately, the state of ESG ratings is only modestly better today than it was five or even 10 years ago. While there is now more data to inform these ratings, that doesn't necessarily mean that investors have made much headway in their understanding of how ratings are determined. Meanwhile, the level of investor interest in and demand for ESG information has risen. In many cases, transparency about data sources, calculation methods, and aggregation approaches remains elusive (see Exhibit 1).

Exhibit 1: Making sense of ESG-related ratings is challenging



FTSE/MSCI data as of 12/31/2018. Based on 1,173 overlapping scores. For illustrative purposes only.

An effort to make sense of the data and ratings led to seminal work by Florian Berg, Julian Kolbel, and Roberto Rigobon at MIT Sloan called *Aggregate Confusion: The Divergence of ESG Ratings* (originally published in August 2019 and updated in April 2022). They concluded from their research that the primary differences between ESG rating providers were related to measurement (56%), scope (38%), and weight (6%).

For investors wanting to incorporate ESG considerations into their investment process but unable to independently acquire, process, or synthesize the large volume of ESG data available, the default has been to use ratings provided by vendors. According to the International Organization of Securities Commissions (IOSCO), ESG ratings can be defined as the broad spectrum of ratings, rankings, and scorings that serve the assessment of an entity, an instrument, or an issuer's exposure to ESG risks and/or opportunities. Unlike credit ratings, with their high degree of consistency and correlation across vendors such as Moody's and S&P, ESG ratings are low-to-modestly correlated (see Exhibit 2)—leaving users to question the efficacy of ESG ratings, how to choose between them, and how to apply them.

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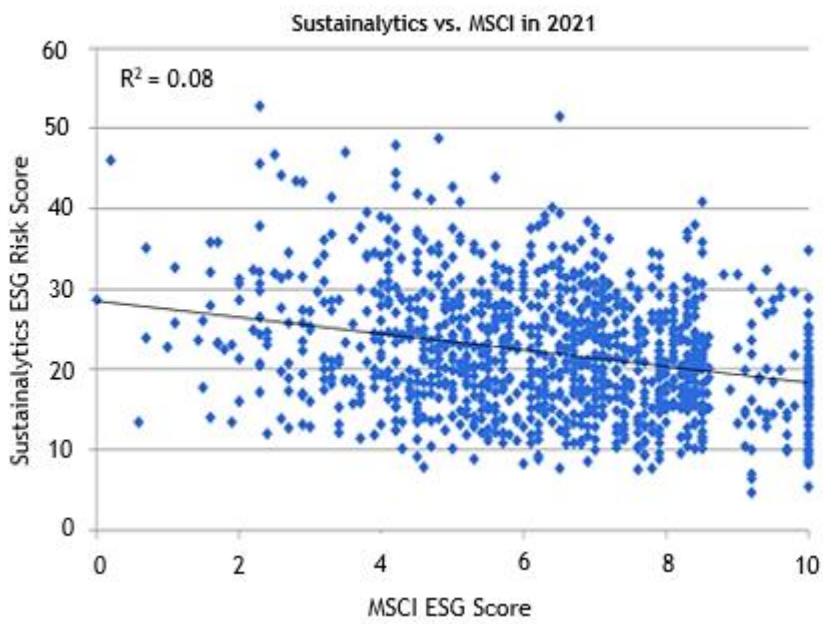
[1] https://www.indexindustry.org/sixth-annual-index-industry-association-benchmark-survey-reveals-continuing-record-breaking-esg-growth-multi-asset-expansion-by-index-providers-globally%ef%bf%bc/
[2] https://www.morningstar.com/lp/sustainable-funds-landscape-report

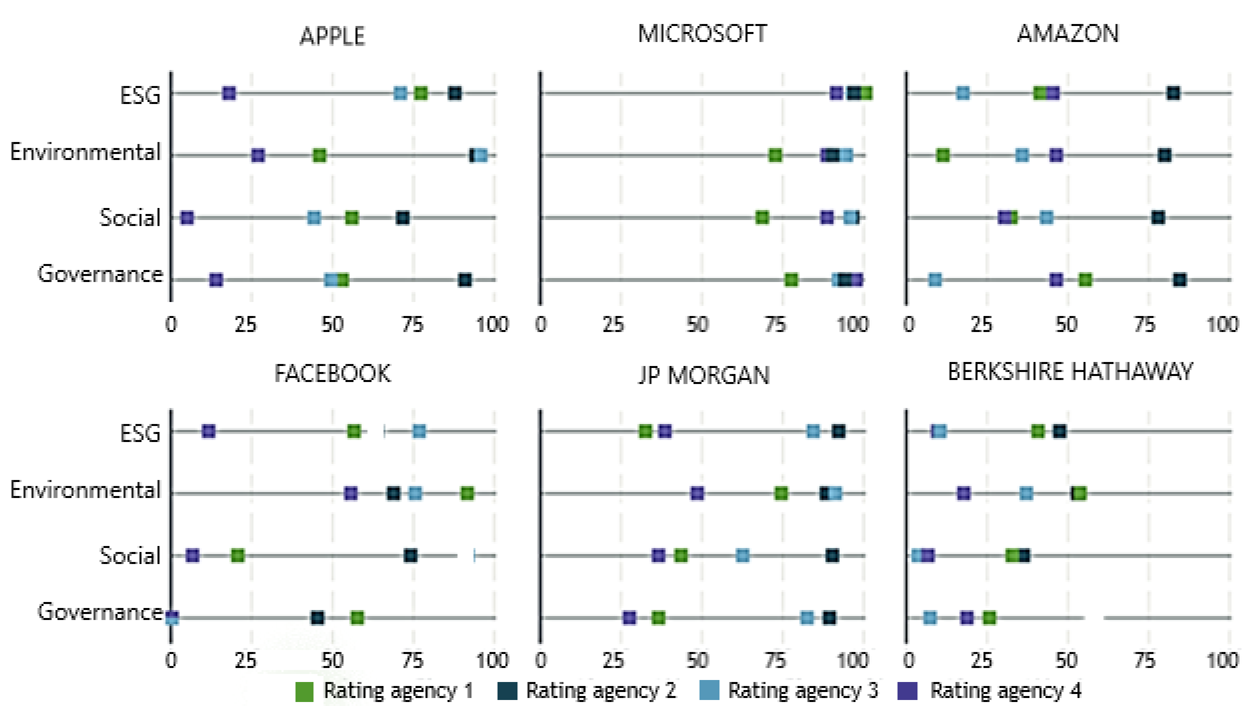
Exhibit 2: Low correlation



Source: CSRHub, S&P 1200 equities, SEI. Data as of 12/31/2021

Exhibit 3 provides a more granular example of rating divergences at the company level using FTSE Russell (FTSE) data (while FTSE does not have a market share position as large as Moody's or S&P, FTSE is a major, well-known provider).

Exhibit 3: Same companies, different ratings



Source: Legg Mason Asset Management Australia, MSCI, Sustainalytics, Refinitiv, Robeco. As of February 2019.

What is an ESG Rating?

Contrary to what many likely believe, an ESG rating is NOT an appraisal of a company's effect on the world—nor is it a measure of the stakeholders' non-financial concerns (such as proxy voting or shareholder engagement).

ESG ratings are an assessment of how well a company manages the risks and opportunities associated with environmental, social, and governance issues.

They serve to help investors recognize and manage exposures to ESG-related risks by aggregating and summarizing more granular information and insights. Given that all investment strategies are exposed to such risks, ESG ratings can be an important risk-management tool for any investor.

ESG ratings are based on data that must be sourced and measured.

By "data," we mean information about companies that is both granular (such as total carbon emissions, recordable injury rates, or board of directors' gender composition) as well as qualitative (such as talent-development programs or community relations).

Next, the vendors must determine the relevance and materiality of each data set. They may deem social factors as more relevant for assessing software companies, for example, and information about carbon emissions as more important to the assessment of oil and gas companies.

Finally, before deriving a company's final ESG rating (whether absolute or normalized relative to peers), the vendors must weigh everything (for instance, MSCI applies up to six key indicators to a given industry) and rank/score the degree to which a company manages risks and opportunities associated with ESG issues (relative to other companies within its industry or across industries).

Why do ESG ratings and ESG data matter?

Making investment decisions based on a vendor's ESG ratings requires adopting that vendor's view of what, how, and how much to measure different types of ESG data. In many cases, doing so offers efficiency and comparability across strategies and managers—such as the case in passive investing. However, it remains important to understand the distinction between ESG ratings and the data from which they are derived.

Exhibit 4 provides a summary of how major vendors source data inputs, while Exhibit 5 summarizes the nature of the ratings that these vendors assign.

Exhibit 4: The inputs behind the ratings

Provider	ESG Staff	Inputs					Peer Group	Ranking Scale	
		Company Disclosures	Company Questionnaire	Third-Party Data	Company Feedback	Treatment of Missing Disclosures		High ESG	Low ESG
MSCI	350+	✓	-	Media, NGO, Academic, Regulatory/ Government, CDP	✓	EC study suggests estimates used	Industry peers	AAA	CCC
ISS	500+	✓	-	Media, NGO, Academic, Regulatory / Government	✓	5%-10% data inputs are estimated. Rating penalized if can't make assumptions.	Industry peers	A+	D-
Sustainalytics	500+	✓	-	Media, NGO, CDP	✓	Ratings penalized	Cross-industry	10	40
S&P CSA	500+	✓	✓	RepRisk	✓	Rating penalized for non-disclosure to CSA questionnaire	Industry peers	100	0
Refinitive	350	✓	-	Media, NGO	-	Rating penalized, EC study suggests estimates used	Industry peers	0	100
Bloomberg	N/A	✓	-	-	-	Rating penalized (score reflects disclosures)	Cross-industry	100	0
Moody's V.E.	400+	✓	-	Media, CDP	✓	EC study suggests estimates used	Industry peers	100	0

Source: J.P. Morgan (as of 9/2022), based on public disclosures and the EC. Bloomberg refers to Bloomberg's ESG Disclosure Score.

How do vendors source data? ESG data may come directly from a company, from regulatory filings, or from news stories—as long as the vendor can assure that the source is reliable.

How do vendors measure data? First, they must establish what they are measuring with the data—perhaps, for example, a company's degree of exposure to financially relevant risks, its level of disclosure, or is ability to address risks or opportunities. Then, the vendors must establish both the method of assessing the data (qualitative, sampled, time-weighted, level, trend, or rate of change) and how the information will be aggregated into factors—groups of data that share similar facets associated with a given area.

Exhibit 5: The nature of the ratings

Sustainalytics' Company ESG Risk Rating measures a company's exposure to, and management of, industry-specific and financially material ESG risks. The score ranges from 0 to 100, with 100 indicating the highest severity of ESG risk (the worst performance). Sustainalytics explains that corporate sustainability depends on "accurate, independent data to evaluate and improve a company's ESG performance" and that the ESG risk rating "measures the degree to which a company's economic value is at risk driven by ESG factors" (Sustainalytics, 2021).

Refinitiv's ESG score measures a company's relative ESG performance. The score ranges from 0 to 100, with 100 indicating top performance. The score accounts for industry materiality and company size biases, helping investors assess the risks and opportunities by companies' performance on ESG factors, in a way that is "designed to help you make sound, sustainable investment decisions" (Refinitiv, 2021).

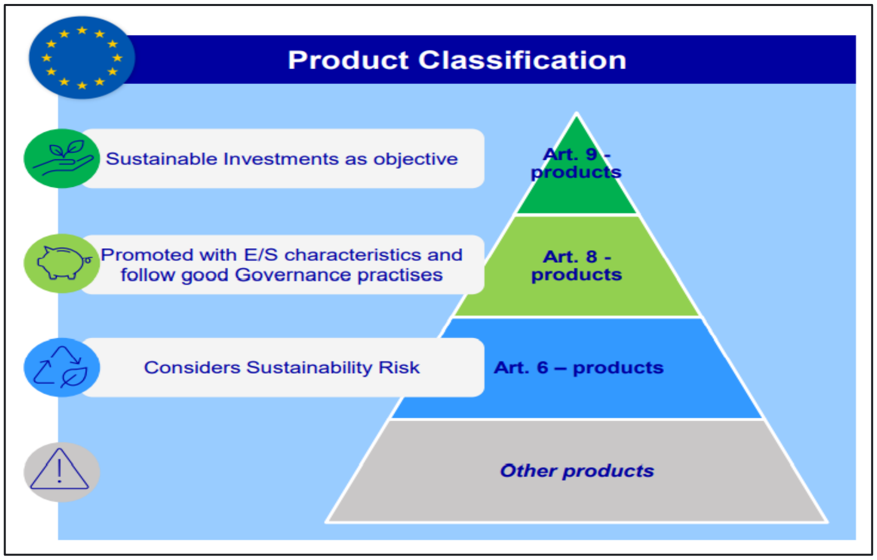
S&P's ESG score is built on the Corporate Sustainability Assessment (CSA), which was formerly called RobecoSAM CSA. This annual evaluation of companies' sustainability practices focuses on industry-specific and financially material sustainability criteria. It ranges from 0 to 100, with 100 indicating the best performance. The score comprises the financial and societal impacts of ESG factors, and it can be used "as KPI for sustainability-linked financing or to build thematic portfolios" (S&P, 2021).

MSCI's ESG rating is designed to measure how resilient a company is to long-term, industry material ESG risks. The score ranges from AAA to CCC, with AAA and AA signaling leaders, B and CCC identifying laggards, and those in the A to BB range being average. MSCI explains that its ESG ratings aim to provide "institutional investors with a more robust ESG integration tool designed to support ESG risk mitigation and long term value creation" (MSCI, 2021).

ESG ratings are also applied to investment funds—based on the companies owned. As such, vendors assign ratings at the company level first, particularly public corporations (vendors also have ESG rating methodologies for sovereign and quasi-governmental entities, albeit with altered criteria). Along with growing investor interest in "sustainable" funds, data providers have seen new opportunities in aggregating that information at the portfolio level. In most cases, portfolio ratings are simply a weighted average of the underlying securities, with the occasional bonus or penalty for manager intent. These product-level ratings aim to provide asset owners with a snapshot of ESG metrics for their investments.

Measures of ESG risk and opportunity aren't the only ESG "ratings" in the marketplace today. Adding confusion to the ESG-rating potpourri was the implementation of the European Sustainable Finance Disclosure Regulation (SFDR) in March 2021. The regulation was designed to make it easier for investors to distinguish and compare sustainable investment strategies available within the EU. SFDR aims to help investors by providing more transparency about the degree to which financial products consider environmental and/or social characteristics, invest in sustainable investments, or have sustainable objectives. The directive specifies three product classifications, as shown in Exhibit 6.

Exhibit 6: EU legal directive adds to the alphabet soup



Source: Nordea

As well intentioned as the EU regulation was meant to be, the fund classifications have been used as another form of ESG "rating" (self-assigned by fund management organizations, no less) rather than as a disclosure standard for which the regulation was designed. The classifications assigned by SFDR were never meant to substitute investor due diligence in assessing a fund manager's ESG and sustainability process, which is far more wide reaching and meaningful than just a disclosure standard. Further muddling things, regulators in the U.K. and U.S. are expected to release their own ESG fund classification schemes.

ESG ratings, notwithstanding their shortcomings, can still be of use to investors—albeit with appropriate caveats in terms of why, how, and when to use them. Ultimately, since there is no universal definition of what constitutes an ESG stock or fund, any use of ESG data or ratings comes down to an alignment of beliefs and expectations. In seeking such alignment, is there a more inclusive or comprehensive way for asset owners and financial intermediaries to assess the ESG credentials of their investments? We think SEI's approach sheds some light toward that.

SEI's approach

Underpinning SEI's investment solutions is our well-established foundation of manager research and selection, which includes a proprietary ESG scoring system. Every firm and investment strategy that is subject to SEI's comprehensive manager-research assessment undergoes an ESG due diligence review and receives a score of either Strong, Moderate, Limited, or Weak.

Unlike data vendors, our approach is more holistic and drives from the top-down (examining a manager's espoused and evidenced actions) rather than the bottom-up (looking at holdings to infer a manager's approach). Our ratings assess a firm's cultural and organizational commitment to ESG and sustainable investing, from its ESG practices and policies as an entity to its allocation of resources to support the firm's ESG commitment. At the individual investment strategy level, we get into the practical details of how ESG risks and opportunities are assessed and integrated into the investment decision-making process, their impact and influence on buy/sell/sizing of securities, and the level of activity and focus accorded to stewardship (the level and nature of a fund's engagement with investee companies).

For the concerns noted above, we don't rely much, if at all, on third-party ratings. This places the onus on qualitatively assessing commitment and action, resulting in detailed discussions with managers to evidence how they put ESG practices into action in both their investment and stewardship processes. We look for specific examples to support a manager's words, and evaluate the quality of those examples. Manager transparency, therefore, is critical. Like any qualitative analysis, it is subjective. In order to minimize biases, we created criteria to define our qualitative assessment—providing transparency and consistency in guiding our final ratings, which are always subject to an analyst's final judgment.

By combining firm and investment strategy ratings, we think our ratings provide a more comprehensive and complimentary picture of a manager's ESG commitment and execution than a simple weighted average of security-level ratings. Exhibit 7 summarizes the key differences between SEI's ratings approach and that of typical third-party vendors.

Exhibit 7: SEI's approach

	SEI	Typical Third-Party Provider
Primary Approach	Largely Qualitative	Quantitative
Assessment Level	Manager	Security
Data Challenges	Some	Some
View on ESG Commitment	✓	x
View on Resourcing	✓	x
View of Stewardship Practices	✓	x
Analysis of Engagement & Investment Case Studies	✓	x
View on Reporting	✓	x
Security-Level Integration	✓	✓

Source: SEI

To put this into context, we looked at our ratings across a subset of managers that have MSCI and Morningstar ratings as well as SFDR designations. The data in Exhibit 8 details the various ratings these strategies carry (anonymized, as we don't publish our ratings). While the majority of strategies achieved our minimum threshold of Moderate/Moderate (based on SEI on firm/strategy ratings) to be considered for an SEI-sponsored Article 8 fund, several of these strategies received "less-than-competitive" ratings from MSCI and/or Morningstar. This underscores, once again, the importance of investors paying close attention to how ratings were constructed, what drove the ratings, and how closely the ratings align with their own beliefs and ESG framework.

Exhibit 8: Different frameworks result in different ratings

Strategy	Asset Class	SEI Firm Rating[1]	SEI Strategy Rating[1]	MSCI Fund Rating[2]	Morningstar Fund Rating[3]	SFDR Designation
Fund #1	Equity	Strong	Strong	AA	5	A8
Fund #2	Equity	Moderate	Moderate	AAA	2	A8
Fund #3	Equity	Moderate	Strong	AAA	3	A8
Fund #4	Equity	Strong	Strong	AA	5	A8
Fund #5	Equity	Strong	Strong	AA	4	A8
Fund #6	Equity	Moderate	Moderate	AA	3	A8
Fund #7	Equity	Strong	Strong	AA	5	A8
Fund #8	Equity	Limited	Limited	A	4	A8
Fund #9	Equity	Moderate	Moderate	A	2	A8
Fund #10	Equity	Moderate	Moderate	A	4	A8
Fund #11	Equity	Strong	Strong	A	4	A8
Fund #12	Equity	Strong	Strong	A	5	A9
Fund #14	Equity	Strong	Strong	A	4	A9
Fund #15	Fixed	Moderate	Moderate	AAA	3	A8
Strategy #16	Fixed	Strong	Moderate	AA	3	A8
Strategy #17	Fixed	Strong	Moderate	A	3	A8
Strategy #18	Fixed	Moderate	Limited	A	2	A8
Strategy #19	Fixed	Strong	Strong	BB	3	A8
Strategy #20	Fixed	Moderate	Strong	B	2	A9

Source: SEI, MSCI, Morningstar. Data as of December 31, 2022.[1]SEI rating scale: Strong, Moderate, Limited, Weak. Strong is best [2]MSCI rating scale: AAA, AA, A, BBB, BB, B, CCC. AAA is best. [3]Morningstar rating scale: 5 Globes, 4 Globes, 3 Globes, 2 Globes, 1 Globe. 5 Globes is best.

Disclosure and transparency matter

Media and investor focus on and questioning of ESG ratings isn't about to go away any time soon. Perhaps some of the confusion will dissipate as more uniform collection and reporting standards come into effect (slowly), but what ESG and sustainable investing "means" to investors is not likely to be resolved with "better" ratings or a single score. While almost all investments are exposed to ESG risks and stewardship opportunities, how and what investors choose to do about that exposure will vary based on personal beliefs, objectives, and values. As such, when selecting sustainable investments, it remains critical to choose managers and strategies with well-articulated ESG philosophies and approaches, and can support their claims with evidenced decision-making.

To that end, disclosure and transparency are of paramount importance to investors as they provide the key to making informed decisions in the multi-dimensional and nuanced area of ESG ratings. At SEI, that openness (through our manager engagement program) has helped our clients and managers move forward with confidence on their journeys. We believe our transparency has fostered a greater understanding of our ratings methods—elevating trust among clients in our assessments and nurturing a deeper appreciation among managers of how we assess their ESG processes. To learn more or engage, please contact your SEI relationship manager.

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