Finding Insights in the Flood of ESG Data

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As more institutional investors understand that consideration of environmental, social and governance factors does not mean sacrificing returns, asset managers have found that incorporating ESG factors into their investment process can reveal opportunities that aren't detected through traditional fundamental analysis. These trends have led investors to seek more information on ESG factors, and to meet this demand, companies are providing greater amounts of data around sustainability, governance and economic, environmental and social impact. Amid this flood of data, discerning signal from noise becomes critical for investors. As much, if not most, of the data around ESG remains nonstandardized, applying a responsible investment approach can be a major challenge for asset managers.

Pensions & Investments spoke with Columbia Threadneedle Investments' Malcolm (Mac) Ryerse, lead analyst (U.S.) of responsible investment, and Kirk Moore, global head of research, to discuss the wealth of ESG data now available and how their firm's portfolio managers and analysts use the information to enhance and strengthen their fundamental analysis processes.

|Pensions & Investments| ***Why are ESG conversations between asset owners and investment managers occurring more frequently than, say, five years ago?***

|Malcolm Ryerse| Investors are thinking more deeply about nonfinancial risks, and that conversation has been propelled by better data, both quantitative and qualitative. Here is a simple statistic: In rough terms, if you go back to 2011 and look at S&P 500 companies, about 20% of them produced a corporate sustainability report, which is one of the primary means by which issuers deliver ESG data; today, in that same population, the number is around 85%. So we have seen this explosion in ESG data. In addition, the fact that many academic and practitioner studies have shown the efficacy of including nonfinancial information in the total investment mix has driven an awakening among the investor community.

|P&I| ***As an investment manager, how is Columbia Threadneedle addressing that explosion of data?***

|Ryerse| We have found that clients want us to put our own thumbprint on the analysis of ESG data and not delegate or outsource that work. One of the important ways we have addressed this demand is by creating proprietary responsible investment ratings to complement our fundamental and quantitative research. We realized a proprietary tool was essential because we found that there was little predictive value in the ratings of third-party providers as they relate to investment returns. As a firm we are committed to employing advanced analytics, and so it was a natural evolution to harness the power of our data-science capabilities to bring shape to the growing volume of ESG data. When we began to look at the ESG data sets through our own lens, we could see strong investment signals in terms of future performance that we were not seeing from third-party data. That became very compelling.

|Kirk Moore| These nonfinancial factors align with how we fundamentally approach companies in general. At the heart of our ESG approach is a recognition that these factors ultimately can turn into financial risks, whether it is because of bad governance, bad stewardship or other risk factors.

|P&I| ***What are the key metrics that you developed?***

|Ryerse| The ratings system we have developed has two components. The first one is called the ESG Materiality Model, and it is built on the framework that was developed by the Sustainability Accounting Standards Board. The SASB model relies heavily on environmental and social factors, incorporating unique characteristics on an industry-by-industry basis. To complement this, we developed a Financial Stewardship Model with our internal quantitative equity research team that serves as a proxy for financial prudence. In tandem, we believe that these two components help us assess the quality and performance of thousands of companies in 77 distinct industries. Our ratings schema works on a scale of one to five, where a one-rated company indicates high-quality and a five-rated company is low-quality.

|P&I| ***Can you talk a bit more about the forward-looking aspect of your approach?***

|Moore| One of the things that we discovered when looking at third-party ratings systems was a limited ability for them to inform a forward-looking view. The ratings that were publicly available, while good, were descriptive but did not make industry-level distinctions.

|Ryerse| We could see some methodologies that were predicated on a values-based approach rather than an evidentiary or a data-driven approach. We found very low correlations between headline ratings from third-party firms with respect to future market performance. Our desire as a firm was to develop tools that could be additive as well as signal future investment performance. This means identifying the ESG factors that might become most financially material on an industry-by-industry basis.

|P&I| ***Can you give an example of a financially material factor that is not found in financial statements?***

|Ryerse| If you look at the consumer beverages industry, water management has been shown to be a financially material ESG factor that is not directly captured in the financial statements of firms in that space. It is reflected in cost of goods sold, but there are a whole host of other factors that more fully describe how efficiently a firm is managing its water usage. Water management is one of the six ESG factors that we identified as being the most financially material to companies within the consumer beverages industry. We think that it is critically important to put this information in front of portfolio managers and analysts alongside other components of fundamental research as they assess firms.

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> **– Mac Ryerse**

Employing our tools and enhanced analytics, we can show how companies compare to peers within their industry, as well as present an absolute evaluation.

|P&I| ***How do Columbia Threadneedle portfolio managers and analysts use this information?***

|Ryerse| There are three basic components to our dashboard system. The first is a company look-up tool that allows investment personnel to input the name or ticker of a company and, on one dashboard, see our proprietary RI ratings alongside contextual, qualitative ESG information. This dashboard displays our RI ratings and the breakout of the underlying models that roll up into those ratings — on water management, for example. The dashboard will reflect the issues that are potentially financially material to a company based on its industry and will have the specific scores for how the company is performing in each of those dimensions alongside industry averages. This information is presented alongside research ratings from our fundamental equity and credit analysts so that we have our firm's collective view on a company in one location. We also include third-party information as a reference point.

The second tool is a screening tool. We have almost 8,000 companies in our screening tool, and up to 800 different ESG data points for each company. This utility allows a portfolio manager to screen by universe, industry, domicile or any ESG factor. They can slice and dice prospective or current investments as part of their ongoing portfolio and risk management assessments.

The third tool is a portfolio analytics system where we can take a specific portfolio and its benchmark, and analyze it based on a top-down view of its nonfinancial characteristics. For instance, what is the aggregate RI rating score for a given portfolio relative to its benchmark? Where are the hot spots? Are there lower-rated firms that are concentrated in one sector or industry? We can even toggle to see what that same portfolio and benchmark would look like viewed through the lens of any one of the third-party raters as well.

|P&I| ***How much weight does a rating hold within the overall investment process?***

|Ryerse| When we speak with clients, we are very clear that the ratings by themselves should not be taken as an absolute signal to include or exclude a company in a portfolio. The ratings are another important data point for managers to consider — akin and additive to the fundamental equity or credit research that they evaluate.

|Moore| As Mac noted, the ESG ratings themselves are not the end product. They are intended to start a conversation between analysts, portfolio managers and, based on our approach, the companies. These can be long-term issues, and our approach allows us to identify the prospect for change.

> *"The ESG ratings ... are intended to start a conversation between analysts, portfolio managers and, based on our approach, the companies." – **Kirk Moore***

|P&I| ***How do you think about companies with lower ratings? Are they considered toxic, so to speak?***

|Ryerse| Our challenge is to do a deeper dive in these cases to understand the rating. We may produce a deep-dive research piece on the ESG characteristics of that company or we may engage company management around a data gap that our model detects. We want to understand how the company is thinking about these risks and what they are doing to manage or mitigate them. Periodically, we will get a "deer-in-the-headlights" look with a reply along the lines of, "Gosh, we have not thought about that," which is telling. More often, what we hear is, "Sure, we have recognized that risk and here is what we are doing." That result may give us a new investment insight.

I should also point out that in many third-party systems, there is a bias against firms where disclosure is lacking — with the presumption that the company is mismanaging or hiding something, or simply not paying attention. As a result, we see that there are higher-rated firms in those regions with higher disclosure requirements. U.S. firms tend to rate lower than their peers in Europe, the Middle East and Africa, for example. In our ratings, where we see low disclosure, or in very rare cases no disclosure, there is no inherent bias applied to the rating; instead, it becomes an important opportunity to engage company management.

|P&I| ***What have been some of the challenges around implementation?***

|Ryerse| Data integrity and data gaps. But as I mentioned, we see both the flood of data and the data gaps as opportunities rather than problems. We know that we need to continue to seek better ESG data disclosure from firms and to look for the appropriate data sets that we can map to our models so that we can develop actionable insights. Our portfolio managers and research analysts now have additional data that they can use to their advantage to make better and sharper investment decisions.

|P&I| ***Much of the academic work on ESG to date has been focused on equities. Are you able to leverage your ESG ratings on the credit side?***

|Ryerse| Studies from practitioners and academics have established the value of considering ESG factors in connection with equities. In fixed income, we are starting to see evidence from practitioners on correlations between nonfinancial factors and credit spreads and total return. We believe there is opportunity in that space, and as a firm we hope to be at the forefront of research on this subject. That is coming, but it is an area where more work can be done.

|P&I| ***How have clients embraced the work your firm has done developing and implementing this approach?***

|Ryerse| We find that regionally there are differences in the expectations of asset managers. Europeans have generally been faster to adopt ESG principles, and the discussions tend to begin by focusing on values — tell me how you think about gambling, tobacco, alcohol, weapons, etc. — before they turn to investment performance. In the U.S., the discussions are different. While there are some investors who will come to the table thinking about values, they are generally more data-driven, they are more pragmatic, and our approach is a good fit with market demands.

Our goal is to create a more holistic picture of each investment opportunity and to do that systematically. That approach has been well-received by clients and prospects in the U.S. who are already thinking about ESG. Certainly, investment performance is critical; it will always be a top factor. We think we can enhance returns by systematically taking ESG risk factors into account when making investment decisions. That is a message that is resonating well with investors. ■

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