Santander Asset Management | Where evolution meets tradition

Global CIO Office | ARTICLE 3

ESG Ratings

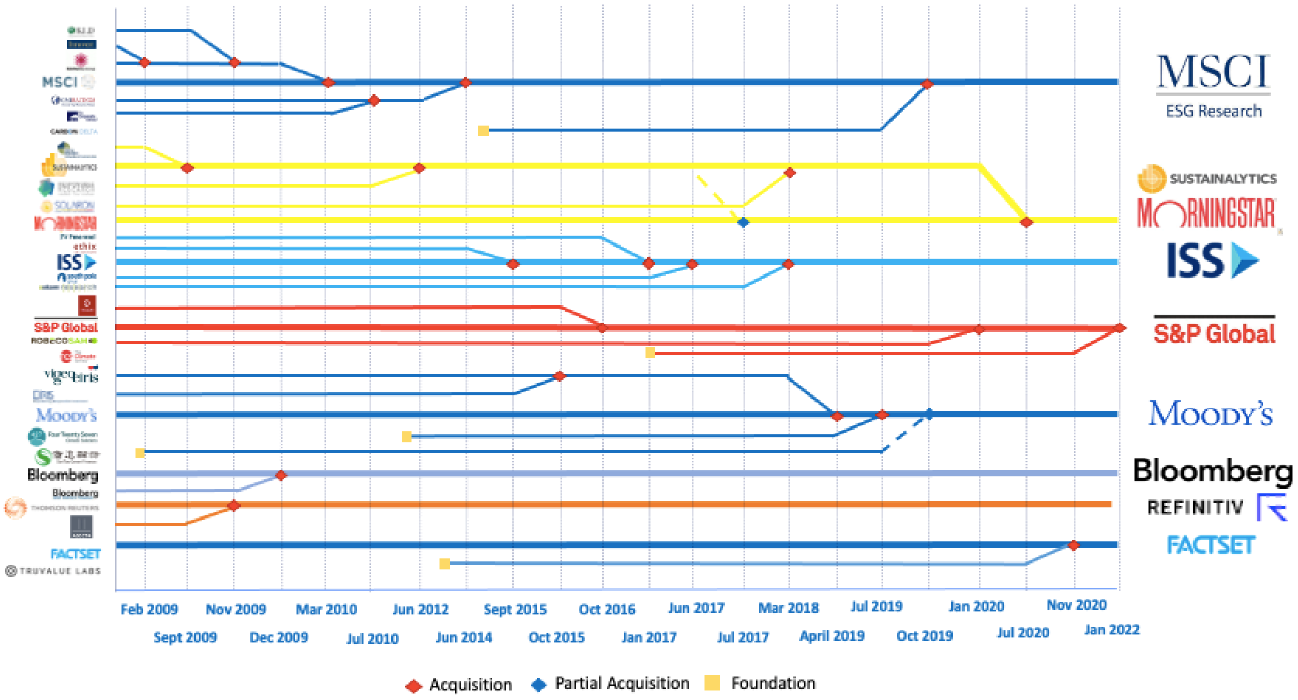
Fabrizio Ferraro

Professor and Head of the Strategic Management Department at IESE Business School. He received his PhD in Management from Stanford University. His current research explores the emergence of responsible and impact investing in the financial sector.

The Evolution of the ESG data industry has closely followed the responsible investing space evolution. As the industry mainstreamed and became global, the traditional dominant providers of financial information either scooped up independent players or launched their in-house initiative. Today, most of the leading providers of ESG data are part of one of them. Indeed, the first provider of ESG data, KLD in Boston, was founded by a group of SRI investors (Peter Kinder, Steve Lydenberg, and Amy Domini, thus KLD) to collect data for their SRI investment Fund.

ESG Data Providers (M&A)

Source: Author



ESG scores matter for investors who rely on ESG data providers to aggregate all the relevant information on a firm's ESG performance and translate it into metrics that can be more easily compared across firms, industries, and geographies.

ESG ratings are also the core infrastructure on which ESG indexes are built. They can thus have a quasi-mechanical effect on flows of investments as ESG indexes rebalance their holdings. ESG ratings are integrated as well in mutual funds sustainability ratings. For instance, Sustainalytics ESG ratings are used to construct the Morningstar mutual fund sustainability ratings. Researchers have shown that fund flows react strongly to these ratings.

Thus, it should be no surprise that ESG ratings matter, even when they change by mistake! When Sustainalytics inverted the scale in their ESG ratings, investors bought stocks they misconceived as ESG upgraded and sold the ones they thought were being downgraded. In terms of returns, a one standard deviation decline in the ESG rating translated into a 1.12% decrease in the monthly four-factor abnormal return. Interestingly Institutional Investors and ESG funds, who are more likely to "handle" ESG ratings with care, did not change their holdings.

Another recent study made for tantalizing headlines in the news, as they showed that ESG ratings from the five top providers (MSCI, Sustainalytics, Moody's, S&P Global, Refinitiv) were not highly correlated with an average ESG correlation of 0.54. Furthermore, they show that different raters measure the performance of the same firm in the same category differently.

Correlations between ESG Ratings, 2017

Source: Author, based on Berg, Koelbel, and Rigobon (2019)

SA: Sustainalytics RE: Refinitiv MO: Moody's ESG MS: MSCI SP: S&P Global

	SA MO	SA SP	SA RE	SA MS	MO SP	MO RE	MO MS	SP RE	SP MS	RE MS	Average
ESG	0.77	0.65	0.53	0.53	0.62	0.60	0.49	0.42	0.40	0.37	0.54
E	0.70	0.66	0.59	0.33	0.69	0.60	0.35	0.61	0.26	0.19	0.50
S	0.67	0.57	0.52	0.29	0.62	0.60	0.27	0.55	0.27	0.28	0.46
G	0.55	0.48	0.36	0.34	0.70	0.70	0.43	0.68	0.38	0.34	0.50

Given the divergence, it is crucial to understand how much this ESG disagreement matters. Another study answers this question by showing that an increase in ESG disagreement from 25th to 75th percentile leads to higher volatility (0.03-0.04%), higher market-adjusted returns (0.08-0.1%), decreasing likelihood to issue equity (0.2-1.1%), increasing likelihood to raise debt (0-2.2%), and higher cash holdings (1.4-5.1%). However, this effect is different for ESG laggards than ESG leaders, as firms in the top 25th percentile of ESG performance have 25-23% lower rating disagreement than those in the bottom 75th percentile.

Will more disclosure help? As regulation increases corporations' disclosure requirements, it is reasonable to expect that ratings will converge more. The evidence so far suggests that it might not happen, as there will always be multiple ways to interpret the information disclosed. Indeed, the same study reports that if ESG Disclosure increases from the 25th to the 75th percentile, it can exacerbate its ESG Rating Disagreement by 22-31%.

Taken together, the studies we have seen so far suggest that despite their flaws, ESG ratings are already driving trading decisions and fund flows, so corporations and investors should carefully follow the work of ESG providers to identify potential pitfalls and suggest fixes. Investors should not rely on one provider and should become familiar with all the main ones (as some might be better suited to specific investment needs). At the same time, it is probably unlikely that ESG ratings will ever converge as credit ratings do, as ultimately, users might want to use these ratings for different needs. A better analogy would be analyst forecasts, where it is common to have some disagreement, and the disagreement can be informative for investors. Finally, only in the last five years many new players have entered the space, bringing a new wave of ESG data sources to the table. This data, mostly constructed by using AI/ML techniques with real-time data sources (news, satellite, etc.), is only started to be used in practice, and research should explore how it can help the ESG investment process.

To Learn More

- Berg, F., Kölbel, J. F., & Rigobon, R. (2019). Aggregate Confusion: The Divergence of ESG Ratings. MIT Sloan School of Management. SSRN Publication.

Available at: Read more

- Christensen, D. M., Serakeim, G., & Sikochi, S. (2022). Why is Corporate Virtuein the Eye of the Beholder? The Case of ESG Ratings. The Accounting Review, 97(1), 147-175. Read more

Available at: Read more

- Pelizzon, L., Rzeznik, A., & Weiss-Hanley, K. (2021). The Salience of ESG Ratings for Stock Pricing: Evidence from (Potentially) Confused Investors. Center for Economic Policy Research – Discussion Paper No. DP16334. Read more

Available at: Read more

- Hartzmark, S. M., & Sussman, A. B. (2019). Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows. The Journal of Finance, 74(6), 2789-2837. Read more

Available at: Read more

Other Interesting Resources:

- Berg, F., Fabisik, K., & Sautner, Z. (2021). Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings. European Corporate Governance Institute – Finance Working Paper 708/2020 Read more

Available at: Read more