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The limitations of ratings and avoiding the green bubble

Louis Larere • original

Finding a **common language** is one of the greatest challenges facing the responsible investing revolution. While advisers and asset allocators are embracing the importance of non-financial analysis, there is prevailing confusion regarding the **new lexicon around green investing**.

As we await the **EU Taxonomy Regulation's clear framework for labelling sustainable financial products**, due to become law by the end of 2020, we believe investors should be aware of the limitations of ratings and heed the wisdom behind avoiding overvalued 'green' stocks.

Our main focus is to differentiate environmental, social & corporate governance (ESG) integration from sustainable investing. **We define ESG as a set of metrics that help us to understand a company's non-financial performance across the acronym's three dimensions**, allowing us to rank the company against an industry or peer group as opposed to Sustainable investing, which specifically target companies having a positive societal impact.

The limitations of ESG ratings

ESG factors do not help form an opinion of an industry's impact on the world, but rather function as a guide to how a company is improving its impact on all stakeholders – whether local communities, employees or shareholders. It is important to understand **how ESG ratings are attributed**. While the corporate governance dimension metrics – voting rights, board independence, number of women in management, etc. – are easily compared across industries, this is not true of the environmental and social metrics. Comparing an asset-heavy, labour-intensive car maker's social or environmental performance to a software designer's is challenging.

This is why ESG rating providers, understandably, only conduct company comparisons and rankings within specific industries. For instance, they would only assess Valeo, the French auto supplier, against similar businesses, such as Continental in Germany, Aptiv in the US or Denso in Japan. Rating agencies give each metric a different weight depending on the industry. This is straightforward for clearly defined sectors such as auto suppliers, but less so for diversified holding companies with businesses from a range of industries.

We are convinced proper ESG due diligence leads to a better understanding of risks and opportunities but are wary of looking only at ratings for two reasons.

Low correlation among ratings

Firstly, **ESG ratings providers tend to disagree**. They find it far harder to agree on specific rules relating to CO2 emissions and employee training hours, for instance, than their peers the credit rating agencies do for leverage and liquidity. Consequently, **ESG research firms' ratings for the same company are lowly correlated, at just 61 per cent** – ranging from 40-70 per cent – according to recent research by MIT Sloan Business School. For context, the comparable number for credit ratings is 99 per cent.

> 53 per cent of the discrepancy comes from the fact that the rating agencies are measuring the same categories differently, and 47 per cent of the discrepancy stems from aggregating common data using different rules.

Take Tesla, for example. Some ESG ratings agencies judge it poorly because of weak governance, poor labour conditions or unconventional related-party transactions – like the acquisition of loss-making and highly-levered SolarCity. Meanwhile, others rate it highly as the only pure electric car maker, with a low environmental impact when competitors still depend heavily on gas or diesel powertrains.

Secondly, we find the peer group approach of ESG ratings providers misleading. **Making comparisons only within a specific industry can obfuscate the impact a company has on the world.** For instance, MSCI ESG Rating awards ratings of AAA, AA and A respectively to oil producer Galp Energia, weapons manufacturer BAE Systems and betting operator William Hill.

Yet MSCI gives healthcare conglomerate Fresenius a rating of just BBB, placing it in the bottom half of the healthcare sector due to a corruption case and a poor employee management track record. Remember, Fresenius is a business fully aligned with the UN's sustainable development goals, according to Vigeo Eiris, another ESG rating agency.

To confirm our intuition about the potential for ESG ratings to confuse, we built a hypothetical portfolio including all the companies we exclude from our socially responsible investment (SRI) strategy – oil and gas companies, tobacco, alcohol, those with severe controversies, etc. The result? The hypothetical portfolio was rated AA by MSCI, making it a leader in ESG terms and similar to our sustainable portfolio.

Finding true sustainable alpha

It seems pretty clear true **sustainability and high ESG ratings are two very different things** – you can be a bad corporate citizen in a sustainable industry and vice versa.

At Zadig, we describe our SRI philosophy as '*sustainability at a reasonable price*'. The word **sustainability** is important, as our primary goal is to invest in companies that are either significantly addressing sustainable themes or are going through a transition phase towards being more sustainable businesses. While we like today's '**green leaders**', we think investors have a role in pushing companies to become more sustainable.

Indeed, we believe improving companies offer the most attractive opportunities – both in terms of impact on society and returns for investors. A good example is **Stora Enso**, the Finnish provider of renewable solutions in paper and packaging. Just 15 years ago, it used to make more than 70% of its earnings from paper manufacturing, a business that is far from sustainable. Today, half of the company's value lies in its forests that absorb about three million tons of CO_2 per year, a number that is growing with the forests. Stora Enso also makes fibre-based packaging, which is much less CO_2 intensive and easier to recycle than plastic and glass alternatives, as well as wood products that are replacing concrete and steel in construction.

This philosophy does not mean ESG analysis is not crucial in our process. On the contrary, ESG is an integral part of stock picking across all funds at Zadig. A company with controversial practices and no sign of improving is unlikely to end up in any of our portfolios.

But as the whole market is now turning to ESG and SRI for profitable investment ideas, there is a tendency for investors to concentrate solely on a handful of today's leaders. Instead, **Zadig is looking ahead for companies making radical improvements.** By doing so, we are differentiating our portfolios from competitors' and avoiding the perils of the green rush.

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