Measuring the Immeasurable

Scoring ESG Factors

Investors need a comprehensive understanding of key metrics of ESG factors in a portfolio.

Evaluating ESG in a Passive Portfolio

ESG factors are used in public market portfolios in a variety of ways, with some active managers using ESG factors as an integrated part of their fundamental approach to investing. These investors posit that a focus on companies with better ESG practices, in addition to good financial characteristics, will potentially lead to better risk management or may result in alpha generation. In passive portfolios, investors can choose to use ESG factors to better align a portfolio with their values, for example by emphasizing certain characteristics (e.g., companies with better human rights practices, or a higher “S” score), or de-emphasizing certain characteristics (e.g., companies with lower carbon emissions, or a higher “E” score). As opposed to active managers, which generally look for financially material ways to integrate ESG factors into their investing process, passive investors are generally looking for financially immaterial ways to integrate ESG factors.

When analyzing the ESG score of any passive portfolio, an investor must first identify the key qualities or metrics that
he or she wishes to emphasize. While many data providers offer a single ESG score for an individual security, which is a composite of many different individual factors, using such composite metrics to evaluate either a holding or a whole portfolio implicitly assumes a common set of ESG values across investors. What is socially responsible to one investor, however, may not be to another. With databases containing hundreds of different ESG indicators reflecting various corporate attributes, a focused approach to both understanding—and then utilizing—ESG data can be highly valuable. Given the multitude of ESG indicators, investors have looked to outside sources for guidance in sharpening their perspective. For example, many institutional investors have placed a high degree of focus on the levels of greenhouse gas emissions represented in their investment portfolios, in the wake of industry initiatives such as the Montreal Pledge and the United Nations Environment Program Finance Initiative (UNEP FI), as well as popular movements such as fossil fuel divestment protests.

In addition to determining which ESG factors to focus on, investors need to determine how to measure the relative value of a given ESG metric. Three main approaches exist, as investors may compare their ESG score to: (i) peers managing comparable portfolios; (ii) a common benchmark index; or (iii) the investors’ own history. The appropriateness of each approach depends on an investor’s particular situation including, for example, the risk profile of the portfolio, the composition of stakeholders, and any fiduciary obligations.

**Common ESG Characteristics for Investors**

ESG is a broad topic, and while fossil fuel-related issues are one of the most common considerations, a variety of other metrics exists across ESG. Other environmental metrics of interest include water usage, renewable energy programs and the existence of a specific environmental policy program. Conventional social and governance criteria include corporate diversity policies, racial and gender diversification among executives and/or the corporate board, as well as explicit human rights and child labor policies, where applicable.

It is important to note that both active and passive investors can score the resulting ESG factors of an investment portfolio to determine how the resultant portfolio aligns with his or her values; outcomes-based ESG measurements—a portfolio “report card”—is not reserved for purely passive portfolios.

**Implications for ESG Portfolio Construction**

As with any investment strategy, investors must first determine their risk and return targets. In an ESG-aware passive portfolio, questions of risk tolerance are critical, as higher levels of concentration and/or tracking error may result from the use of certain ESG metrics to negatively screen or proactively tilt a portfolio. For example, a strategy that sought to own companies sourcing renewable energy would likely be relatively concentrated, whereas a strategy focused on low carbon emissions could consider that metric without sacrificing the option to achieve greater diversification. Additionally, a significant amount of ESG data on companies are self-reported, which leads to meaningful gaps in data availability; some ESG factors are not widely reported enough to sufficiently cover the universe of investable companies in a more diversified approach. For example, while 64% of S&P 500 companies report their carbon emissions, only 12% report the percentage of their energy consumption derived from renewable sources.

Another consideration in the design of an ESG portfolio is whether to eliminate specific sectors or to emphasize
identifying the best companies within each sector. Some sectors, such as energy, are prone to low overall ESG scores, while others such as technology, may have higher overall scores due to the nature of the underlying business models. An inter-sector approach, which removes low-scoring ESG sectors from the portfolio, ensures exclusion; however, it may lead to additional tracking error from the benchmark. An intra-sector approach, which seeks to select the best ESG companies within each sector, retains exposure to top ESG companies within inherently challenging ESG sectors. An intermediate approach is also possible, whereby a few low-scoring sub-industries, such as coal mining, are eliminated, while the remaining portfolio is constructed using an intra-sector model.

As data availability, technology and sophisticated risk management techniques have advanced, it has become increasingly possible for investors to utilize ESG factors to better align their portfolios with their values, while being sensitive to issues of concentration, tracking error and risk.

1. Passive investment: An investment strategy that is tied to a specific index or benchmark, resulting in limited buying and selling actions
2. Sustainalytics
3. CDP: Bloomberg.