Making ESG data work for you

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The need for ESG data

A fundamental shift is occurring in the investment ecosystem, centered on the growing importance of ESG-related factors in investment strategies. Investors increasingly consider ESG matters when allocating funds, asset managers are setting strategies in alignment with ESG-focused mandates and companies are reconsidering how to represent these factors in their corporate behavior and reporting. Throughout the investment lifecycle, market participants must think about the risks – and opportunities – that arise from climate change, gender-equality concerns, human rights protections and a host of other issues.

For companies to be able make the right disclosures – and for investors to be able to make the right decisions – there is a great need for accurate, thorough and comparable data. The lack of tangible or traditionally well-understood metrics only adds to the challenges of creating and sharing this data.

This white paper looks at some of the important ways investors and companies are sourcing and using ESG-related data and offers insight into how the current landscape is evolving. To do so, we've connected with Parnassus Investments to capture the investor's view, and with Bloomberg to understand the perspective of a data provider.

The investor's view

Iyassu Essayas, Director of ESG Research at Parnassus Investments

How do you use ESG-related data in terms of investment decisions?

Here at Parnassus the ESG data we collect and assess is really important to our investment process. To give you a basic idea of how that process works, the analysts – we call them the fundamental team – will generate an idea and they'll [look to] get a portfolio manager's sponsorship to see whether there's any interest in owning the stock. Once he or she has a portfolio manager's sponsorship, the analyst will activate the ESG team to work side by side with him or her to ferret out value drivers in the stock.

The real value-add in having the ESG team look at the company is getting a holistic view of what we are going to be investing in. We'll cover a number of what we call ESG factors: environment, community, customer, workplace and governance. Within those factors are key issues we will pay attention to and weight depending on which industry and sector the company is in. At the end of the day, we'll provide a recommendation on whether the company meets our ESG criteria.

In order for us to provide that recommendation, we need data, so we'll look at a whole host of sources – either from the company itself or ESG research providers – and we'll aggregate, process and analyze it to provide our recommendation. The data providers are very helpful for discovery of facts and circumstances but they can't apply a value judgment. Therefore, our ESG team will recommend whether a stock might be suitable for our investors and then the chief investment officer makes the final call.

The process doesn't stop there. We continuously monitor that company to ensure we are capturing all the significant ESG positives and negatives that may happen. [We'll] also put the company through a formal annual review, which is essentially the initial process, to make sure we didn't miss anything.

The value in using ESG data is that it gives a different perspective on companies that a traditional asset manager may not be paying attention to because it's not included in, say, the Form 10K or proxy filing. ESG can unearth some hidden risks and opportunities for portfolio managers.

How do gender-equality considerations at issuers factor into your investment decisions?

Our research, and the research of others, shows that the inclusion and promotion of women is positively correlated with good company performance. Therefore, we examine how much of the company comprises women, with special attention to management/ executive ranks and board members.

To better understand the specific impact, we review policies and programs companies have to help develop women throughout their stay at the company. You can look at gender pay issues, to see whether they are being hit with a gender-pay shareholder resolution, or whether there are women in the organization who are writing open letters about how they are being treated with regard to pay and promotion. You can also look to see whether there are media reports of controversies involving women, specifically how they are treated in the workplace.

Overall, what you want to see is that women have the same opportunities as men to develop their talent, reach senior executive levels, even reach the board, and that both genders are treated fairly. We find companies that do these things often have more thoughtful decision-making, better recruitment and retention and improved morale and engagement. All these items improve the bottom line.

How do you use ESG-related data in determining your engagement strategy?

No company is perfect but, when major issues arise, we will often attempt to engage the company to see whether we can help to remedy the problem. We are finding more and more that companies are willing to engage with us because we're all focused on improving enterprise value or retaining the value already created. There are many issues that could cause us to seek engagement: supply chain problems, environmental improvement opportunities (such as stronger recycling or renewable energy problems) and workplace issues such as the gender pay topic.

We want to have good follow-through ourselves so we limit our pursuits. In our case, a targeted engagement program has ideally not more than five companies. Once identified, we will reach out to them to let them know that we intend to open dialogue in the year ahead. This is intended to address key ESG risks and opportunities, and hopefully start the process to reach a resolution (ie, the company takes action on the items raised).

From an ESG perspective, what would you like to see more of in terms of companies' disclosures?

Comparability. That's the big issue in the responsible investing space. Back in 2011 about 20 percent of the S&P 500 published some type of sustainability reporting; by the end of 2018 that was about 86 percent. There's a lot of ESG data out there but a lot of it isn't comparable. And if you want to assess a company's performance relative to its peers, you need data to be comparable.

Organizations like the Sustainability Accounting Standards Board (SASB) are creating standards so that companies can report in a comparable way. We encourage our companies to start reporting more on sustainability issues that affect their performance, that are material to the company, and SASB is one of the organizations we point them toward.

One of the difficulties of dealing with ESG-related issues is that they often entail intangible factors. How do you make sure you're getting the best data?

We talk to the companies themselves. They don't usually try to give investors misinformation. But you do have to verify, so you have to structure your ESG questions to get the right ESG data from the company and make sure you follow up with it to [confirm] the data is accurate.

To what extent do you look at ESG-related data in terms of opportunities as opposed to risk management?

On the risk side, you want to be prepared for issues that may pop up and affect the company's stock price. There are hidden risks you want your portfolio manager to be aware of that are not being captured in the traditional Form 10K or proxy, and so on.

There are sensitivities a good ESG analyst will have depending on what sector or industry the portfolio manager wants to invest in. A good example would be healthcare, where you have large pharmaceutical companies that may have recalls or off-label sales and marketing controversies that are not captured in the traditional reporting sense. A good ESG analyst will be sensitive to those and look at whether these are idiosyncratic issues or reveal a systemic problem with the company itself.

On the opportunity side, we think there are some ESG themes portfolio managers should be aware of, such as the workplace. We have the Parnassus Endeavor Fund, which focuses on companies that offer great places to work. The theory is that good places to work lead to happier employees who are more productive. We renew the study from time to time on a basket of 'good companies' as defined by outside parties and it is nearly always the case that these companies outperform a broader market index.

The data provider's view

Patricia Torres, head of sustainable finance solutions at Bloomberg

In which subject areas are you seeing growth in investor demand for ESG-related data?

The area where we've seen the fastest growth is ESG integration, especially in Europe. ESG integration refers to combining third-party ESG data and research insights with internal analysis and corporate engagement as part of normal company analysis and selection.

We've continued to see an increase in active and passive managers incorporating material ESG data into their investment process in order to enhance risk-adjusted returns. One company taking ESG into account in this area is Aviva UK Life. It shared its view of ESG as a central pillar of risk and return analysis in a recent interview with Bloomberg. According to Aviva chief investment officer Ashish Dafria: 'We're past concerns that we're compromising on returns by factoring in ESG. It's the right way to manage money going forward.'

What are some of the key data points people are interested in?

Information on greenhouse gas (GHG) emissions is an important data point for investors to understand how their portfolios are contributing to a lower-carbon economy. Investors want to understand not only how companies' GHG emissions data compares with peers', but also what the number will be in the future. Companies that set GHG reduction and energy-efficiency targets do so because they believe setting and meeting the targets will improve their bottom line, reduce costs and drive innovation. As an example, Burberry Group has set targets to cut GHG emissions in its bid to become carbon-neutral in operational energy use by 2022.

Investors are also looking for diversity at the companies in which they invest. The most downloaded ESG data on the Bloomberg Terminal is information on board independence and female representation in the workforce, in management positions and on the board. Companies that do not disclose these data points are missing an opportunity to distinguish themselves from competitors.

Are there any trends you are seeing in terms of the data itself?

There is growing demand among investors for mandatory and standardized ESG reporting in order to drive the availability and transparency of data. Currently, ESG reporting is voluntary and traditionally has been self-selective, resulting in companies picking the ESG data points on which they wish to report.

In the absence of regulatory requirements, industry groups are leading the way in providing guidelines for disclosures. SASB provides a framework that is sector-specific and uniquely tied to financial materiality. The Task Force on Climate-related Financial Disclosures provides a voluntary reporting framework for reporting consistent and comparable climate-related financial information, furthering internal and external analysis on how an organization can respond to and mitigate climate risks.

How does investors' demand for ESG-related data change as they consider industry, size of company, geography and other factors?

Bigger companies – with more resources to collect and report ESG data – tend to disclose more, leading to a perception that they will have a higher disclosure score. Investors want more insight into small and mid-cap companies, which means smaller firms must work harder on proactive engagement with investors to provide transparency.

Among sectors, we see resource-intensive companies in utilities and materials making a conscious effort to improve disclosures and metrics in terms of social and governance factors, perhaps to offset their perceived impacts on the environment.

In emerging markets, availability of ESG data generally trails that of developed markets, due to lenient regulatory regimes, lower exposure to global investors and less mature models of corporate governance. That said, there is a growing effort to promote better ESG disclosure as a way to attract local and international investors to emerging markets.

Which teams within issuers do you see as producing – or managing the production of – ESG-related disclosures?

Historically, a sustainability or CSR group siloed within an organization would have produced these reports independently. Now, in recognition of the financial materiality of ESG, sustainability teams are becoming more connected to investor relations teams and the CFO's office.

How are issuers using their own and peers' ESG-related data?

For the most part, issuers are using ESG-related data to communicate to investors. In October 2019, 30 companies in the S&P 500 mentioned the term ESG in their earnings call. Issuers are also using this data internally. We talk to a lot of corporate sustainability teams and IR teams that use the Bloomberg Terminal to compare themselves with their peers.

What would you recommend an issuer prioritize to satisfy the needs of investors?

Issuers can conduct an internal materiality assessment to identify the specific ESG factors material to the industry in which their company operates, and then evaluate their performance vis-a-vis their peers. Using this data to focus on improvements can help with increasing operational efficiency, attracting cheaper funding and building a long-term shareholder base.

About Parnassus

Parnassus is a fundamental, bottom-up investment firm that was founded in 1984 based on the belief that a well-managed responsible investment strategy could outperform traditional approaches. To build wealth responsibly for its clients, the Parnassus investment team selects businesses it believes have increasingly relevant products or services, sustainable competitive advantages and quality management teams for the firm's high-conviction portfolios. Every investment must meet rigorous fundamental and ESG criteria.

About Bloomberg

As a trusted leader in market data, Bloomberg brings transparency to financial markets by creating an ecosystem of ESG data, tools and solutions, enabling clients to make informed decisions, minimize risk and identify opportunities.