AbelNoser

ESG Portfolio Monitoring – A Best Practice for All Sides

Harnessing Consensus Ratings and Portfolio-level Reporting to Monitor Manager Investment Practices

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Introduction

The integration of environmental, social, and governance ("ESG") considerations into investment programs is a topic where numerous industry participants passionately disagree. Many asset owners, particularly in the US, believe ESG considerations potentially violate fiduciary duties to maximize portfolio returns (by limiting the investable universe) and may also erode local economies if investments in certain industries are banned.

At the same time, many other asset owners care deeply about the merits of ESG and feel it should be widely adopted within their fund's investment programs. However, these funds often struggle to quantify the degree to which their managers are actively integrating ESG ideals, and desire a better understanding of the social, environmental, and governance construct of their portfolios.

Regardless of a fund's position on ESG, most asset owners lack transparency and have limited tools to track whether fund assets are being invested consistently with their priorities.

In this regard, a primary obstacle they face is that almost all ESG-related data consists of raw metrics. Consequently, both asset owners and managers must have the internal resources to collect and aggregate the data, as well as sufficient internal subject-matter expertise to consume the raw data and assess whether follow up is warranted. A further constraint, for asset owners in particular, is that current ESG due diligence on fund managers is typically limited to soliciting feedback *directly from those managers* with no means of independently assessing and verifying the efficacy of the responses.

A potential solution to these challenges is the use of ESG ratings. ESG ratings are intended to assess how well each company is addressing its respective ESG risks. In theory, practitioners can utilize these ratings when building and/or exercising oversight of investment portfolios. Unfortunately, as discussed in greater detail below, the firms that provide ESG ratings often yield very different rating assessments on the same company. This lack of consensus has historically limited the value of using any single rating provider and undermines investor confidence in the validity of their assessments.

Happily, recent industry developments offer quantitative solutions that now enable practitioners to develop prudent investment decisions and oversight policies based on those ratings.

This article is divided into four sections. The first section summarizes the growth of ESG and evolution of an ESG regulatory framework, including more recent resistance to what some view as imprudent ESG-activism. The second section describes the historical challenges of measuring and monitoring ESG data and the new quantitative solutions to these problems. The third section reviews the various positions and policies that asset owners hold with respect to ESG oversight. The final section describes key insights and benefits associated with ratings-based quantitative ESG oversight.

Background on ESG Initiatives

For many institutional investors, ESG-related initiatives are ultimately about managing risk. As noted by the Organization for Economic Co-operation and Development (OECD), a poor environmental record may make a firm vulnerable to legal or regulatory fines/sanctions; socially, mistreatment of workers and dissatisfied employees may lead to higher absenteeism, lower productivity, and weaker client servicing/relationships; and weak corporate governance may incentivize and/or enable unethical behaviors related to pay, accounting irregularities, and even fraud.[1] For these reasons and more, ESG advocates believe that identifying and addressing material ESG-related issues germane to a corporation is a quintessential exercise in risk management – for the management of that company, for investment managers thinking about holding that security in their portfolio, and for asset owners concerned whether the manager is acting in accordance with fund policies.

In this regard, the centrality of ESG to these investors is borne out by the rapid integration and growth of ESG-oriented retail and institutional investing. According to the US SIF Foundation, in January 2020 there were 384 investment managers and 530 institutional asset owners who had incorporated ESG principles into their investment policies.[2] Further, Morningstar Inc. recently reported that the number of US sustainable open-end funds and ETFs reached 534 in 2021, almost double the number as of 2020.[3] The AUM of those funds exceeded $350 billion, a 35% increase over 2020. Similarly, the number of signatories to the UN's Principles for Responsible Investment has grown from about 250 in 2006 to almost 4,700 by the end of 2021, including around 700 asset owners. Collectively, these signatories represent approximately $121.3 trillion in assets.[4] Globally, the reported sustainable investment assets under management now represents about 36% of all assets under management.[5]

This growth is buoyed by strong regulatory tailwinds. Regulatory authorities around the world are enacting ever greater rules and regulations governing the conduct and standards surrounding ESG. The intent of these regulations ranges from aspirational to enhanced transparency to prescriptive and promises to continue into the foreseeable future.

Specifically, as of mid-2021 there were 195 mandatory regulatory ESG initiatives in the implementation phase around the globe, including 80 that financial institutions will need to implement by 2024.[6] Further, in March

[1] OECD, ESG Investing: Practices, Progress, and Challenges, (2020)
[2] US SIF Foundation, Report on US Sustainable and Impact Investing Trends, 2020
[3] Morningstar Manager Research, Sustainable Fund US Landscape Report 2021: Another year of broken records, (Jan 31, 2022).
[4] PRI Signatory Update, (Oct-Dec 2021)
[5] Global Sustainable Investment Alliance, Global Sustainable Investment Review, 2020. It should also be noted that the European and Australian definitions of "sustainable investing" have recently been tightened, and the AUM figures listed in the report would be significantly higher if the US standards for characterizing AUM were used.
[6] Some key mandatory ESG initiatives currently in effect include (in chronological order): PRI (2006 UN's "Principles for Responsible Investing") established a framework for integrating responsible investing within a manager's decision-making process (over 4,000 manager and asset owner signatories); NFRD (2014 EU regulation, Non-Financial Reporting Directive", effective March 2018) was intended to increase the quantity, and improve the quality, of annual ESG reporting from ~6,000 publicly traded corporations; SDGs (2015 UN "Sustainable Development Goals") established social, environmental, and economic goals for 2030; TCFD (2017 Financial Stability Board promulgated the "Task Force on Climate-related Financial Disclosures"), which is charged with developing better standardized climate-related financial

2021 the SEC established a 22-person “Climate and ESG Task Force” to review the efficacy and legitimacy of managers that label their strategies as “ESG-related” (to counter greenwashing), and indicated that ESG would be one of their major areas of regulatory focus in 2022. The SEC also stated that manager practices surrounding ESG would be one of the top two areas they would scrutinize in 2022 (crypto currency was the other). This has been borne out by several fines, sanctions, and investigations levied against institutions who the SEC viewed as misrepresenting their ESG-related efforts.[7]

Outside of the US, in July 2021 the UK’s Financial Conduct Authority (FCA) issued a letter to the investment management industry describing their expectations regarding the design, delivery, and disclosure of ESG and sustainable investment funds. The letter included several examples of managers who had not met the FCA’s standards. These included:

- A passive fund with an ESG label but incorporated only a few ESG exclusion screens in its portfolio construction, and who tracked an index that was not ESG-focused
- A fund who made questionable claims that they invested in companies with a positive environmental impact
- Several funds who claimed they were “sustainable” funds, but whose top ten holdings included high-carbon emission energy companies

In issuing its letter, the FCA stressed that it would challenge managers to ensure that new or repurposed funds met their guiding principles and regulatory requirements.

Given these trends, it’s easy to understand why many industry practitioners argue that ESG analysis has a potential role in every stage of a manager’s investment cycle: asset allocation, investment universes, portfolio construction, investment selection, risk management, regulatory/client reporting, and client oversight. This view was echoed by research firm Aite-Novarica in its 2021 industry-wide study of ESG practices which suggested that ESG analytics would shortly begin migrating from manager research teams onto front office screens (e.g., core trading, portfolio management, and risk systems).[8]

At the same time, many other practitioners, particularly in the United States, feel the application of ESG principles in the context of investment decision-making introduces its own suite of risks. These risks include

disclosures from issuers, and builds upon the initial standards set by the NFRD; SFDR (2019 EU regulation “Sustainable Finance Disclosure Regulation,” effective March 2021) governs sustainability-related disclosures in financial services. It strives to improve the clarity of each investment strategy’s sustainability characteristics, by bucketing products into three categories: ESG Integrated (Article 6)– Investment strategies that consider ESG issues as an additional investment screen, ESG Binding (Article 8) – Investment strategies that over-weight portfolio holdings with good ESG scores, and ESG Positive Impact (Article 9) – Investment strategies that are designed to generate both strong returns and impact ESG in a positive manner; and the EU Taxonomy (late-2019 EU regulation, effective 2020) – is intended to provide a standardized classification system through which various institutions can uniformly list their “sustainable” economic activities. The UK and other non-EU jurisdictions have also indicated they would be developing similar taxonomies in collaboration/reference to the EU’s standards.

[7] Institutions recently fined, sanctioned or investigated by regulators for ESG misrepresentations include: BNY Mellon in May 2022 (fined $1.5 million), DWS in May 2022, Goldman Sachs in June 2022, and KLM in July 2022.

[8] Aite-Novarica, ESG Data, Ratings, and Analytics: View from The Buy-Side, (December 2021)

potentially violating fiduciary duties to maximize returns (by limiting the investable universe) and the erosion of local economies by banning investments in certain sectors/industries. Such concerns are exacerbated by fears that ESG principles might inadvertently creep into their investment programs notwithstanding fund policies to the contrary.

In a widely publicized letter sent to Blackrock Inc. on August 4, 2022, nineteen state Attorneys General articulated these concerns in detail.[9] Additionally, numerous states and municipalities have acted legislatively to push back on the notion that ESG is compatible with prudent fiduciary standards, particularly in the investment of public funds. These legislative initiatives tend to follow one of two approaches:

- Prohibitions on government agencies from doing business with financial institutions that boycott or discriminate against companies in certain industries[10]; and/or
- Prohibitions on government agencies from investing in strategies that consider ESG factors for any purpose other than maximizing returns.[11]

As of mid-September 2022, twenty-five anti-ESG bills have either been enacted or introduced across eighteen states. The scope of these bills span firearms, fossil fuels, energy, mining, production agriculture, commercial timber, and ESG in general.[12] Most recently, the Texas State Comptroller issued a list of ten financial companies disqualified from certain state business as a result of those firms boycotting energy companies.[13] According to the law firm Morgan Lewis, as of mid-September 2022, twenty-five states have either signed the August 4th letter to Blackrock, and/or proposed/enacted anti-ESG legislation.[14]

Ultimately, irrespective of a fund's policy direction, if for no other reason than compliance, it's becoming increasingly important that asset owners develop an informed position on ESG and have the oversight tools necessary for ensuring compliance with their chosen investment policy.

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[9] Letter from M. Brnovich, S. Marshall, C. Carr, T. Rokita, D. Cameron, L. Fitch, D. Peterson, L. Rutledge, L. Wasden, D. Schmidt, J. Landry, E. Schmitt, A. Knudsen, J. O'Connor, K. Paxton, D. Yost, A. Wilson, and S. Reyes to Blackrock Inc. CEO L. Fink (August 4, 2022) (discussing Blackrock's ESG-related activities).

[10] Texas SB 19 (enacted June 2021) for example, prohibits Texas government entities from contracting with a firm unless that firm attests in writing that they don't discriminate against firearms companies or trade associations. Texas SB 13 (enacted May 2021) further prohibits Texas government entities from contracting with a firm unless that firm attests in writing that they don't discriminate against energy companies. Similarly, Kentucky S.B. 205 (enacted April 2022), for example, requires Kentucky government entities to divest from all financial institutions that boycott energy companies.

[11] For example, the Florida State Board of Administration, following the July 2022 announcement by Governor DeSantis of his intent to introduce similar legislation, adopted a resolution on August 22, 2022, that barred the fund from including ESG factors in its investments.

[12] Goldberg, Dial, Mann, The State of Anti-ESG State Legislation, Morgan Lewis Blog Post (September 12, 2022).

[13] Glenn Hegar, List of Financial Companies that Boycott Energy Companies, Texas Comproller's Office (August 24, 2022). At the time of publication, the list consisted of Blackrock, BNP Paribas, Credit Suisse, Danske Bank, Jupiter Fund Management, Nordea Bank, Schroders, Svenska Handelsbanken, Swedbank, and UBS.

[14] Goldberg, Dial, Mann, The State of Anti-ESG State Legislation, Morgan Lewis Blog Post (September 12, 2022). The states are: Alabama, Arizona, Arkansas, Florida, Georgia, Indiana, Idaho, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Montana, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Virginia, West Virginia, and Wyoming.

Historical Challenges to ESG Oversight

Clearly both ESG advocates and opponents would benefit from greater ESG transparency and oversight of their respective investment programs. However, as noted earlier, almost all ESG-related data presently consists of raw metrics pertaining to each company reviewed. Consequently, regardless of one's views about ESG, practitioners wishing to incorporate (or exclude) ESG principles within their investment programs must be prepared to commit significant time and fiscal resources to collect, analyze, and evaluate that data.

For asset owners, an additional challenge in monitoring manager ESG practices is that their oversight is currently limited primarily to qualitative surveys administered to their managers.[15] The asset owner is thereby dependent on the self-reported manager feedback. And excepting the questions pertaining to the manager's internal policies, the manager feedback on their portfolio holdings is company specific. Consequently, the asset owner must distill that information into a meaningful portfolio-level assessment. This can be cost prohibitive for many asset owners.

The one exception to the consumption of raw data and absence of independent manager oversight is ESG ratings. ESG ratings purport to measure and rank the degree to which each company held in (or traded from) a portfolio that is managing its respective ESG risks. To this end, several vendors offer services that assess company compatibility with ESG-related matters - and then publish ESG ratings based on those assessments.

Unfortunately, because of the disparate and inconsistent nature of company disclosures, each ESG ratings provider, by definition, must make important decisions about which data sources to use, how to weight various factors, and then apply its own ethical judgements and algorithms to the key considerations associated with each respective industry. Not surprisingly, these firms often yield very different rating assessments. In fact, it's not uncommon for a company to be rated very highly by one ratings provider while simultaneously rated very poorly by another.

For example, a 2021 study conducted at MIT found that while the correlation of bond rating agencies Moody's and S&P was 0.92, the correlation of ESG rating agencies ranged from only 0.38 to 0.71.[16] Similarly, a 2018 study of the top 100 US companies rated by 14 different ESG rating firms (conducted by the ESG research and rating firm OWL ESG), found that only 12 companies were represented on all 14 lists. In addition, when measuring those 12 companies by rank, there was an average dispersion of 25 ranks.[17] The study observed that these inconsistencies were a function of three key causes:

Different ESG Factors
Each ESG rating firm, based on their diverse backgrounds and focus, utilized what they considered to be the most relevant ESG factors for each respective industry and sector. In the study, there was only

[15] The UN administered Principles for Responsible Investment offer several technical guides defining best practices for the monitoring of managers by asset owners and consultants (e.g., PRI, Investment Manager Monitoring Guide (2020); and PRI, Investment Consultants and ESG: An Asset Owner Guide (2019)). The PRI, Investment Manager Monitoring Guide (2020) in particular, provides a 13-page questionnaire template, to be administered by the asset owner to all their managers. However, the key premise of the PRI's suggested approach is that the managers' self-reported responses would, *"provide the foundation of the [asset owner's] monitoring process… and are key to reviewing and assessing the quality of the manager activities…."*

[16] Berg, Koelbel, Pavlova, Rigobon, ESG Confusion and Stock Returns: Tackling the Problem of Noise, Nov. 19, 2021

[17] *OWL ESG Methodology*, page 1 (2018)

about a 50% overlap between the factors that any two rating firms viewed as material (in producing their ESG scores for any given company).

Different Weighting of ESG Factors
Based on each firm's particular expertise and knowledge, even when the firms identified similar ESG factors, they weighted those factors differently in their algorithms. Further, the firms also combined and calibrated those ESG factors differently. These subjective weighting choices obviously compounded the divergences between each company's ESG scores and ranks.

Different Data Sources
Without a single consolidated data source, as a practical matter, each rating vendor gathered data from a variety of news outlets, non-governmental organizations (NGOs), research firms, and other sources. Some data sources were, of course, used by multiple vendors, but in many instances each vendor relied on unique and different sources as well. Further, even when the data sources were the same, the rating firms often looked at different time periods. It followed that, even had the algorithms been the same (which as noted above, they were not), by inserting this differing data into their models, the rating firms inevitably produced different results.

It's important to recognize that these ESG rating deficiencies are inherent symptoms of the industry. Unless and until disclosures and weighting factors become uniform (whether by common practice or regulatory fiat), rating providers will always need to make choices. And where there is choice, there is subjectivity.

As a practical matter, this lack of consensus acts as a brake on the wider oversight of ESG practices and presents a significant challenge for practitioners hoping to develop policies and investment decisions based on those ratings. While some managers have dedicated ESG teams numbering 30, 40 or more FTEs, many managers (particularly in the US) do not yet systematically incorporate ESG factors at all. Similarly, only a handful of US-domiciled asset owners have dedicated ESG teams. The vast majority do not.

Bottom-line, for investment practitioners hoping to use ESG ratings to manage portfolios, or monitor those firms that do, such a wide range of ratings can be disconcerting. Each of those ESG rating agencies likely spent years studying ESG in general, examining which ESG factors had a material impact on each industry and sector, and optimizing their algorithms. They had good reasons for why they chose which ESG factors to use in their ratings processes. And yet, despite this expertise and effort, the discrepancies in their industry models nevertheless exist. Rhetorically speaking, practitioners may be forgiven for asking how they can rely on ESG ratings when there's such a wide divergence of opinion even among the experts.

Happily, the application of artificial intelligence and machine learning to the consumption of ESG data has provided a solution to this problem. Essentially, a few ESG rating providers have begun leveraging technology in a manner that consumes ESG data from multiple rating vendors (as well as numerous other sources) and optimizes that data to reduce the inherent subjectivity between any two rating providers. In effect this approach creates a "consensus ESG rating."

Consensus ESG ratings necessarily incorporate significantly more data than any single rating vendor. And by applying robust statistical analysis to normalize and weight all the data inputs, the consensus ESG ratings represent an intellectually-sound solution to the above noted practical obstacles for investors who might otherwise be inclined toward including (or excluding) ESG ideals within their investment criteria.

For example, one firm that has taken this approach is OWL ESG. OWL ESG consumes data from over 500 sources, among them 14 different ESG rating and research firms (both generalists and specialists), news & media outlets, NGOs, government databases, unions, activist groups, and other various public sources. In aggregate, OWL ESG collects over 100 million data points each quarter and rates each company on approximately twice as many industry-specific ESG factors as any single provider.

The goal in constructing these consensus ratings is to leverage the collective efforts, knowledge, and expertise of all the rating vendors, while at the same time managing the subjective choices as to which ESG factors are important to which industries. Based upon the consensus data, OWL ESG for example, identifies 12 themes which they characterize as key performance indicators (KPIs). The 12 KPIs, collectively, are based on thousands of ESG data elements that are combined into over a hundred subthemes (which often have different variations depending on the industry). Table 1 below details the 12 KPIs.

Table 1

Environmental	Social		Governance
	Employer	Citizenship	
Pollution Prevention	Compensation & Satisfaction	Community & Charity	Board Effectiveness
Environmental Transparency	Diversity & Rights	Human Rights	Management Ethics
Resource Efficiency	Education & Work Conditions	Sustainability Integration	Disclosure & Accountability

The net result is an enormous consensus-driven database of normalized ESG (and KPI) ratings for every company analyzed. The database is then mined to generate relevant peer comparisons and rankings (based on geographic regions, and within each region, the company's sector, sub-sector, and industry). The establishment of relevant peer group universes enables investment practitioners to quickly identify, with greater confidence than ever before, how companies compare to their peers across all ESG pillars.

In this regard, once constructed, the consensus rating approach enjoys a number of advantages over the use of any single ESG rating firm.

Significantly greater inputs: The consensus rating approach, by definition, consumes multiples of data more than any single rating vendor. This enables far more robust assessments.

Reduced subjectivity: The consensus rating approach essentially leverages the "wisdom of the crowd" theory, by which the derived ratings reflect a weighted score based on the number of ESG rating providers that view each respective E, S, and G metric as relevant for a given industry. The resulting statistical optimization reduces bias and error and generates a consensus viewpoint for every company covered. Accordingly, consensus ESG ratings represent a more quantitative statistical optimization of the marketplace's broad consensus.

Significantly more coverage: Because the consensus rating approach processes data from so many different sources on so many different companies, it has significantly broader coverage than any single rating provider (often more than two or three times as much coverage). On a stand-alone basis, even major rating providers may rate as few as only 9,000 companies globally. In contrast, the aggregate data collected under the consensus approach enables the rating of over 30,000 companies. The comprehensiveness of this coverage can be particularly attractive for asset owners who desire the ability to assess all their managers' holdings.

Monthly frequent scoring: Similarly, because more data is consumed, specific data that warrants a change in rating is uncovered quicker. This enables ESG ratings to be updated monthly instead of annually, leading to more dynamic metrics appropriate for portfolio management and indexing. Further, it's important to note that annual company CSR reports (in which each company discloses their ESG updates) are often published on different timetables than the ESG rating firms' annual updates. This lack of coordination can sometimes result in more than a year's delay before ESG ratings reflect the new company data. Monthly ESG rating updates avoid this risk, and thereby provide users an information edge by consuming company CSR reports in a more timely fashion.

In our view, for the reasons noted above, the existence of ESG consensus ratings elegantly addresses the innate subjectivity associated with single-provider ESG ratings. This in turn provides investment professionals with greater confidence to use these quantitative tools for tracking ESG factors throughout their portfolio construction, oversight, and investing processes.[18]

To learn more about the challenges faced by individual ESG rating vendors, and the mechanics and statistical computations involved in the creation of consensus ESG ratings, we encourage you to read, "ESG Consensus Ratings – The Key to Asset Owner Oversight."

What Should Asset Owners Do?

Meaningful portfolio oversight by asset owners is a hallmark of prudent fund stewardship. While monitoring investment performance is the most common example, the same holds true for ESG. Just as performance oversight helps identify the drivers of returns, ensures adherence to fund policies, and tracks systematic trends over time, monitoring manager ESG practices can yield similar insights.

In this regard, plan fiduciaries opposed to integrating ESG considerations into their investment programs need to be comfortable that fund assets are invested consistently with their needs and priorities. At the same time, fiduciaries who care deeply about ESG principles should have the ability to ensure those factors are being effectively integrated into their investment programs.

[18] Examples of investment managers who have published papers describing how they utilized the OWL ESG consensus ESG ratings/scores to successfully address the subjectivity of individual rating vendors, and integrate ESG considerations into their portfolio management practices include: Nomura, A Measured Approach to ESG Investing Part 1 – The ESG Overlay (Jan. 26, 2021); Nomura, ESG a Mirage? Depends How You Look (June 14, 2021); Neuravest, ESG, Alpha and Artificial Intelligence (February 2022); and Invisage, Ethical Alpha: Supercharging tech returns with ESG (Q4 2020)

In both instances, having an independent quantitative assessment of each manager's ESG practices (as opposed to relying on annual self-reported surveys) can be an essential oversight tool. Further, the ability to track compliance with fund ESG investment policies represents a concrete demonstration of the fund's commitment to its goals and policies.

To be sure, hundreds of asset owners have already begun engaging with their managers on ESG. However, the direction, degree, and scope of that engagement varies significantly.

- Many, if not most, US asset owners currently do not formally integrate ESG into their asset allocation, manager selection, and general investment policies. While sometimes sympathetic to ESG ideals, as noted earlier these asset owners feel that incorporating ESG factors into their decision-making process would necessarily narrow their investment options. Consequently, doing so might thereby breach their duties, as prudent fiduciaries, to maximize fund returns. Further, having taken this position, these funds often have concerns that ESG principles might nevertheless inadvertently seep into their portfolios (notwithstanding their policies to the contrary).

- In contrast, many other asset owners (particularly in the UK and EU) view ESG to be an important strategic consideration; and at the same time, not *per se* inconsistent with investment performance. These asset owners therefore expect their managers to at least consider ESG factors in their investment and portfolio construction processes (subject to not compromising returns). This view is consistent with SFDR Article 6 (referenced in footnote 11).

- Still other asset owners believe that ESG factors provide long term societal value, and therefore feel that incorporating ESG into their investments is not only consistent with their fiduciary responsibilities, but imperative. To this end, these funds engage managers offering products that either tilt/over-weight holdings with positive ESG KPIs, and/or allocate fund assets to products with specific ESG investment mandates. These approaches are consistent with SFDR Articles 8 and 9 (referenced in footnote 11).

Manager-provided Qualitative Oversight

Most commonly in the US, many asset owners (and investment consultants) conduct qualitative due diligence to help assess the degree to which ESG principles have been integrated into their managers' investment processes. While opponents of ESG may ask their managers to attest that they don't apply such principles (e.g., footnote 14), ESG proponents frequently ask a range of questions, including:

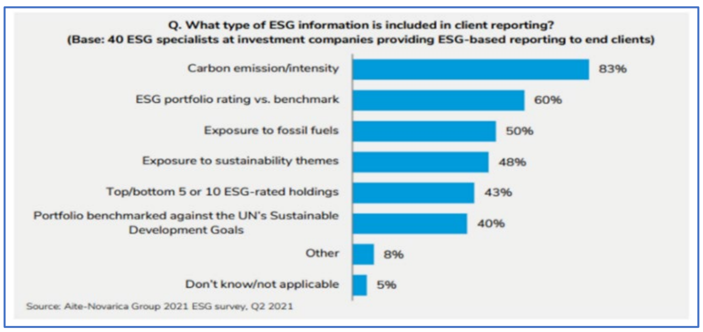
- Is a manager's ESG efforts supported from the top?
- Does the manger engage and partner with ESG experts in assessing investment priorities?
- Is there an ESG-specific team that works alongside the manager's investment team?
- How long has the manager been considering/utilizing ESG criteria in their investing?
- How robust is the ESG analysis used by the manager?
- Does the manager participate in industry-wide ESG initiatives?
- Is the overall portfolio's ESG profile improving over time (i.e., trending in a positive direction)?

Additionally, some asset owners ask their managers to detail specific changes the managers have made to their investment strategies based on ESG considerations. Such actions might include:

- Changing the portfolio weight of a holding (or excluding a position entirely) due to ESG considerations
- Modifying a product's sector or industry weights due to ESG considerations
- Supplementing or switching their ESG data sources
- Requesting ESG-related investment mandate changes

Indeed, as shown in Table 2 published by the Aite-Novarica Group below, some managers already proactively include ESG-related information in their client reporting. This is often used to supplement the qualitative information gathered by the asset owner through periodic questionnaires.

Table 2



Irrespective of a fund policy's direction toward ESG, while the qualitative due diligence described above has much value and should be a key component of asset owner oversight, it nevertheless has three important limitations. The first limitation is that it relies entirely on self-reported information provided by the very managers being monitored. Just as asset owners routinely obtain independent third-party confirmation of manager investment returns, asset owners should also strive to find independent means of validating their manager's ESG representations – at least at a high-level.

The second drawback to the current oversight regime, as noted earlier, is that it typically solicits/collects ESG information on individual portfolio holdings. This therefore still requires the asset owner to roll up each manager's feedback on their respective holdings into a series of portfolio-level evaluations. And the lack of ready-made summary reports can be cost prohibitive for many asset owners.

Third, the administration of, and response to, qualitative questionnaires is typically a laborious process for managers and asset owners alike. For this reason, most qualitative oversight measures are conducted on an annual basis (rather than quarterly).

Again, whether asset owners and managers instinctively feel ESG-related principles have merit, or conversely, believe it conflicts with their responsibilities as prudent fiduciaries, it has often been an operational burden to engage in more frequent oversight. Happily, the recent consumption and integration of independent consensus ESG ratings into portfolio-level reporting changes this dynamic.

Independent Quantitative Oversight

For institutional investors seeking a balance between meaningful oversight and operational costs, portfolio-level summary reports (that utilize consensus ESG ratings) provide a meaningful and cost-effective solution. In effect, the ESG ratings serve as a proxy for the massive raw data set that lies beneath.

Asset owners can thereby simply focus their analysis and oversight efforts on monitoring the ESG ratings (and the various ESG sub-components) of the securities held in each manager's portfolio. And where counterintuitive, inconsistent findings, and/or outlier securities are flagged, the asset owner can then follow up with those managers.

In this regard, it is worth noting that the fund's managers should be intimately familiar with every security they hold in their portfolios. As such, they are ideally suited to respond with sound rational explanations for each holding and traded security. In fact, this tool can similarly provide buy-side portfolio managers and compliance officers with an internal *check-and-balance* of their portfolio construction decisions.

Equally important, the ease and efficiency with which portfolio-level consensus ESG rating reports can be digested facilitates the deployment of more frequent oversight – which is critical for tracking patterns and trends. In this fashion, asset owners who routinely monitor investment performance on a quarterly basis can now apply a similar approach to ESG oversight. This is consistent with the recommendations articulated by the UN in PRI's "Investment Manager Monitoring Guide" (2020), which encouraged asset owners to conduct their ESG *"review and assessments … on a regular basis."*

Benefits and Insights from Portfolio-level Reporting

Particularly for asset owners who utilize third-party investment managers, regular quarterly/annual reviews facilitate meaningful follow up discussions. In this regard, the use of portfolio-level ESG reports powered by independent consensus ESG ratings enable asset owners to quickly and easily:

- Exercise periodic oversight of their managers' commitment to, or avoidance of, ESG factors
- Monitor whether the managers' practices are consistent with their representations
- Track how each portfolio's positions change over time
- Identify any ESG outliers

More specifically, the insights gleamed from these reports can help flag a variety of potential issues, including:

- **Validate (or challenge) the achievement of ESG ideals and manager representations**
  As noted earlier, the meteoric rise in interest for ESG has likewise spurred a desire on the part of investment management firms to supply ESG-related products to meet that demand; and not surprisingly, some ESG claims are misrepresentations and simply reflect changes in marketing rather than substance. This has been noticed by regulators who have already begun investigating bogus claims, levying fines, and incorporating ESG into their examination regimes. Similarly, in the US several states have made it clear they will not blindly accept assertions from managers that the managers are abstaining from integrating ESG factors into their portfolio management activities.

To this end, portfolio-level consensus rating reports help ensure ESG utilization is consistent with each strategy's investment mandate and those managers' representations. Furthermore, these reports provide a quick high-level means of quantifying each portfolio's compatibility with a fund's investment and asset allocation policies as they pertain to ESG.

- **Compare portfolio ESG ratings to industry peer universes**
  It's important that asset owners and managers have the flexibility to evaluate portfolio holdings on both an absolute and a relative basis. This is no different than reviewing a manager's investment performance on an absolute basis as well as against a benchmark index and/or peer universe.

  More specifically, some asset owners may proscribe investments in companies that fall below a certain absolute ESG rating. Other asset owners may still desire exposure to certain sectors or industries but want holdings that do a better job managing ESG risks relative to other companies in those sectors/industries. Oil and gas companies, for example, may typically have lower environmental ratings than the broad market, but certain companies within the oil and gas industry will have superior ratings relative to other companies in that industry.

  Different asset owners may legitimately hold different views and take different approaches regarding this issue. To facilitate all perspectives, the portfolio-level summary reports can quantify both absolute and sector/industry-adjusted ratings.

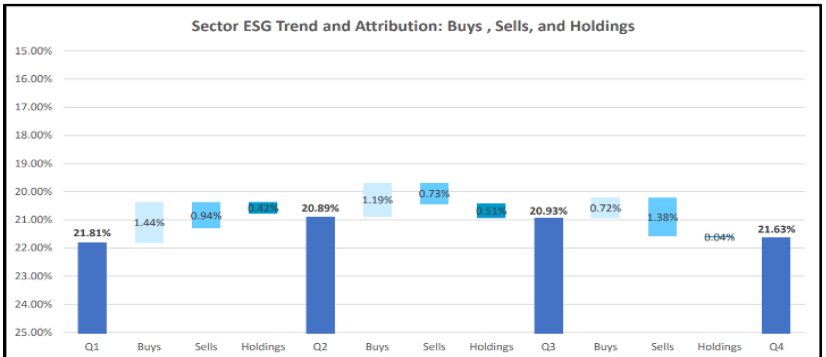
- **Track positive (or negative) ESG trends and early warning signals of "ESG ratings drift"**
  Just as with monitoring investment performance and trading costs, asset owners are best served by looking for trends and patterns over time. Certainly, a counterintuitive or unusual finding in any given quarter is important. However, equal if not more important insights can be gleamed by looking at the manager's practices over multiple quarters. In this fashion, asset owners can track whether their managers are building portfolios in a progressively positive, negative, or neutral ESG fashion (as may be consistent with the direction of the fund's policy).

  Related, just as asset owners monitor investment performance to ensure their managers are not straying from the strategies they were hired to provide, asset owners can now track their portfolios as a safeguard against "ESG style drift." Ultimately, the trend of a portfolio's ESG ratings (whether positive or negative) is a reflection of the manager's most current views and perspectives, realized by replacing higher ESG-rated holdings with poorer ESG-rated securities (or vice versa). For this reason, portfolio-level reports can also provide insights into each manager's trading activity.

- **ESG attribution trends based on buys, sells, and holdings**
  More sophisticated portfolio-level ESG summaries decompose a portfolio's ESG rating in several ways. One way is to assess whether the overall ESG rating is driven primarily by the companies the manager bought, sold, or simply held from one quarter to the next.

  This level of analysis enables asset owners to ascertain if a portfolio's improving/declining ESG rating was driven by the new ideas a manager has (i.e., to either buy or sell a security), or if the companies currently held in the portfolio are simply doing a better job of managing their ESG-related risks. And in the latter instance, follow up discussions between the asset owners and their manager can help determine if the improved ratings of those holdings were just serendipitous, or if the manger was aware of that trend and can demonstrate that those improvements factored into the manager's decision to keep holding those securities. Figure 1 below provides an example of such an analysis

Figure 1



Sector								
	Q1		Q2		Q3		Q4	
	Value (M)	ESG Rank	Value (M)	ESG Rank	Value (M)	ESG Rank	Value (M)	ESG Rank
Aggregate Portfolio	$ 2,030	22%	$ 1,918	21%	$ 1,995	21%	$ 1,983	22%
Holdings	$ 2,771	21%	$ 2,600	22%	$ 2,633	22%	$ 2,718	21%
Buys	$ 784	16%	$ 509	14%	$ 662	16%	$ 588	18%
Sells	$ 412	13%	$ 682	18%	$ 414	16%	$ 547	14%

- **Quantify and unbundle ESG-attribution by pillars (i.e., "*What if E conflicts with S or G?*")**
  Similar to buy, sell, and holding attribution, it's also important to understand whether a portfolio's overall ESG rating is due to particularly strong/weak environmental, social, or governance ratings. This is especially true for asset owners who have a deeply held view on one or two of the three ESG pillars, but not all three.

  To be sure, every asset owner will have their own priorities and there's no one right approach. Some funds may care deeply about diversity, equity, and inclusion initiatives for example, while other funds may care passionately about environmental or governance matters. Still, other funds may care about none, or all three pillars.

  Ultimately, this level of attribution analysis enables asset owners to better understand the ESG trade-offs implicit within each portfolio holding. Of course, as with every fund policy, it's critically important that asset owners clearly communicate their priorities to each manager, and then review portfolio-level summary reports to ensure each manager adheres to those priorities.

- **Flagging ESG outliers**
  Flagging ESG outlier holdings is an act of sound governance. In most instances, the manager should have compelling reasons for holding their securities (notwithstanding a strong or poor ESG rating).

However, the check and balance associated with this type of oversight is a hallmark of a healthy partnership between the asset owner and their managers.

Further, the summary reports can also quantify not just the specific rating that triggered an outlier flag, but also the ratings of all three ESG pillars. In this manner, asset owners again have the benefit of a more robust understanding of the potential trade-offs for having a strong environmental rating verses a weaker social and/or governance rating (or vice versa).

It also goes without saying that the size of each outlier (relative to the portfolio's other holdings) should be part of the asset owner's oversight focus. Adherence to fund policies, regardless of size, is always important. However, understanding the degree to which an outlier holding impacts the overall portfolio (as a result of its size) is equally important.

Table 3 below, and particularly the ratings of Meta Platforms and Tencent Holdings therein, provide an example of the potential ESG tradeoffs uncovered with this type of ESG-attribution analysis.

Table 3

FIVE WORST HOLDINGS - GOVERNANCE RANK						
#	Security Name	Market Value ($)	Overall ESG Rank	Environmental Rank	Social Rank	Governance Rank
1	SS&C TECHNOLOGIES HOLDINGS	$ 6,809,112	81%	63%	81%	91%
2	FASTENAL CO	$ 7,558,388	48%	36%	45%	78%
3	CREDIT ACCEPTANCE CORP	$ 4,024,523	73%	66%	72%	77%
4	META PLATFORMS INC-CLASS A	$ 10,403,662	33%	15%	47%	72%
5	TENCENT HOLDINGS LTD	$ 82,426,344	22%	10%	30%	70%

- **Compliance with ESG regulatory frameworks and client policies/directives**
  Closely tied to the general oversight reports are ESG compliance reports that use consensus ratings to flag portfolio holdings that are in violation of global regulatory and client directives. Generally speaking, these reports can be customized to reflect the prohibited transaction screens established by each fund (such as carbon emissions, firearms, tobacco etc.) In addition, current monitoring tools can also dynamically track portfolio holdings that are involved in ESG-related controversies.

Conclusion

Regardless of one's view about the benefits or harm associated with integrating ESG principles into a fund's investment program, having an independent quantitative assessment of each manager's ESG practices (as opposed to relying on annual self-reported surveys) can be an essential oversight tool. Ultimately, plan fiduciaries need to be comfortable that fund assets are invested consistently with their needs and policies.

Unfortunately, almost all ESG-related data and assessments are currently subjective, non-standard, self-reported, and unregulated. Many companies don't even collect, let alone disclose, all the relevant data. This presents severe challenges to both asset owners and managers who would otherwise be inclined to monitor ESG considerations within their investment programs.

Although ESG ratings have the potential to solve this problem, the severe divergences historically observed between the ratings of each vendor limited their usefulness. This all changed with the development of consensus ESG ratings.

Use of consensus ESG ratings shifts the ESG oversight regime from being heavily based on a single provider's data sources and subjective judgements/priorities toward a more quantitative statistical optimization of the marketplace's broad consensus. The advantages of consensus ESG ratings verses those provided by a single rating vendor include:

- Unbiased and more robust data sources
- Reduced subjectivity and significantly broader coverage
- Monthly and quarterly reporting cycles

Applying ESG consensus ratings in a portfolio-level reporting framework also minimizes, if not eliminates, the need for data-aggregation capabilities and internal subject-matter expertise. This in turn enables asset owners, managers, and compliance officers to quickly quantify and assess the degree to which ESG considerations are being incorporated into portfolio construction activities and/or complying with fund policies. Practical insights include:

- Validate (or challenge) manager representations pertaining to ESG
- Comply with ESG regulatory frameworks and client policies/directives
- Flag ESG outliers and identify "ESG style drift"
- Track positive (or negative) ESG trends and compare to relevant peer group universes
- Quantify and unbundle ESG attribution (e.g., "*What if E conflicts with S or G?*")

Bottom-line, ESG consensus ratings provide greater transparency and increased confidence to investment practitioners when developing high-level views (in either direction) on ESG-related issues. Ultimately, whether used as a supplement to existing ESG-initiatives or as the primary means of monitoring ESG practices, these portfolio-level reports are an important tool in the evolving ESG ecosystem.

"Information is data endowed with relevance and purpose"

Peter Drucker

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