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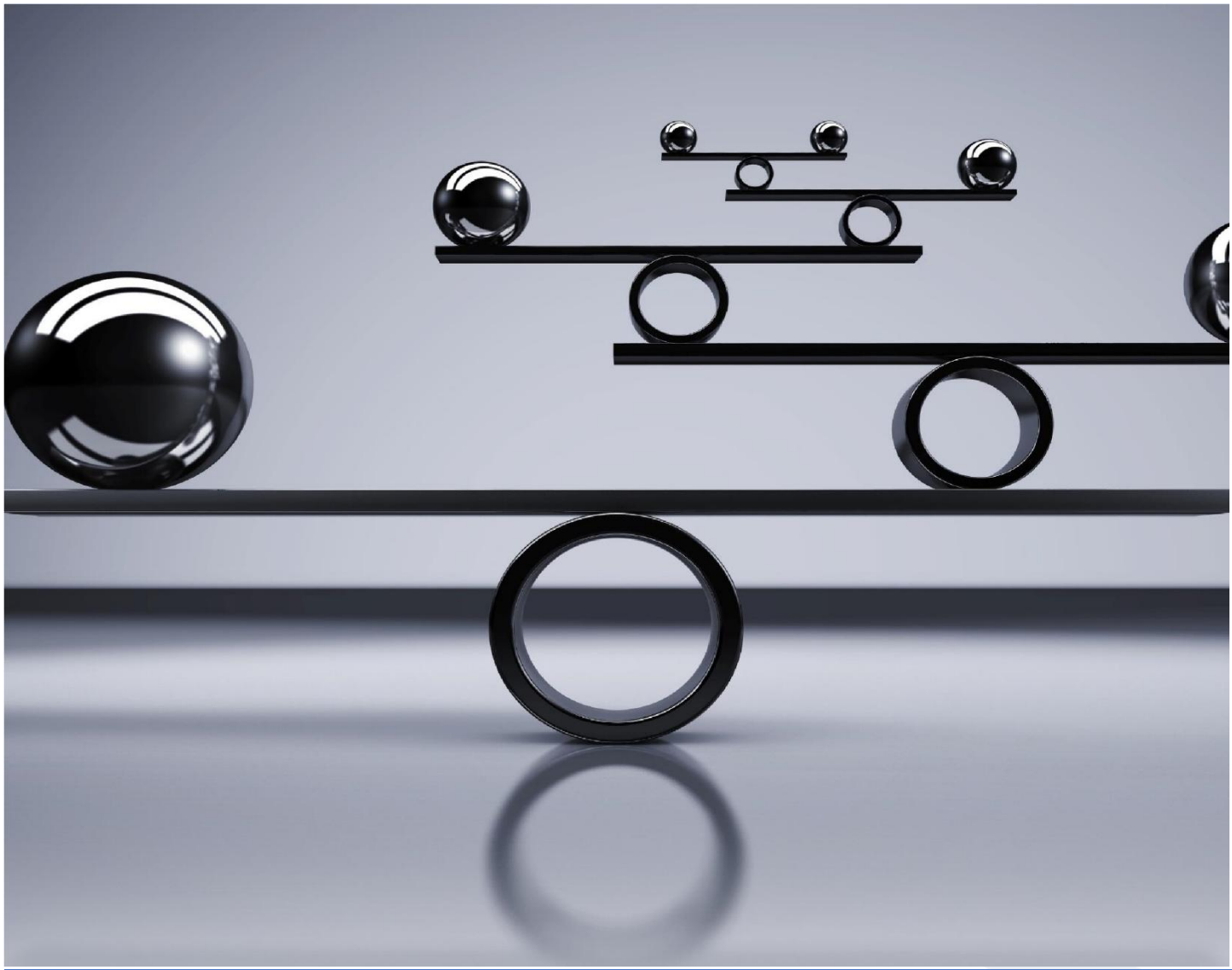

Stages of Integrated ESG Assessment Within Investment Processes: (Scorecards to Assess ESG Risk & Opportunity, and Materiality Assessment & Risk Mapping)

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As an example, a credit analyst identifies a company that has no third-party ESG rating available but that is issuing investment-grade bonds that might be investable. In this case, the analyst creates their own ESG assessment. A custom ESG self-assessment tool that reflects the sector-specific risk issues relevant to the issuer is created, and the company management or investor relations team is asked to fill this out. An ESG scorecard based on the self-assessment response is created with ESG factor scores ranging from 0 to 5, and high or low scores are then used in valuation or further assessment work.

Ethical marketing might, for example, be identified as a key ESG social risk (perhaps via a risk-mapping process, which is covered in the next subsection) for pharmaceutical companies X, Y, and Z:

- Company X has no policy and a history of violations, so it scores a 0.
- Company Y has a brief policy and no violations, so it scores a 3.
- Company Z has a detailed policy and one minor violation, so it scores a 4.

Scores of 0 could make a company unattractive, and scores of 5 could lead to further investment work. Alternatively, total scores of all factors in the scorecard are used in further assessment or valuation work.

The scorecard can take a qualitative judgment of a factor and put a form of quantitative score on it.

ESG rating agencies can provide scores, and a form of scoring is typically used in commercially available ESG rating services. These can be used raw or adjusted by practitioners to reflect their own views. These scores can then be compiled for use in assessment or idea generation.

The scorecard technique could be used on private companies as well as public companies. Challenges to creating private company scorecards are that a rating agency score is less likely to be available for a private company, and less information about it is available in the public domain. This scorecard technique can be adapted to scoring countries for sovereign bond analysis or to infrastructure and real estate. For example, environmental policies could be scored for infrastructure and commitments to a carbon net-zero plan, or corruption levels could be scored for countries.

In summary, developing a scorecard involves the following steps:

- Identify sector- or company-specific ESG items.
- Break down issues into a number of indicators (e.g., policy, measures, disclosure).
- Determine a scoring system based on what good/ best practice looks like for each indicator/issue.
- Assess a company and give it a score.
- Calculate aggregated scores at issue level, dimension level (ESG level), or total score level (depending on the relative weight of each issue).
- Benchmark the company's performance against industry averages or peer group (optional).

Materiality Assessments and Risk Mapping:

Some ESG issues might be material for companies in a specific industry (e.g., water stress can disrupt the operations of mining or beverages companies, which rely heavily on clean water in their production processes) but not for those in other sectors (e.g., water stress has little effect on media or financial companies).

One should note that not all risks can be managed. Material ESG risk that has not been managed by a company takes two types: (1) unmanageable risk, which cannot be addressed by company initiatives, and (2) the management gap, which represents risks that could be managed by a company through suitable initiatives but which might not yet be managed.

As explained, some risks are manageable, such as the risk of on-the-job injuries, which can be managed, for example, through establishing stringent safety procedures, having emergency response plans and safety drills, and promoting a safe culture.

Some risks are not (fully) manageable, such as the carbon emissions of airplanes in flight. An airline can manage some of the issues (e.g., by modernizing aircraft, installing winglets, and working on information and communication technology systems to minimize the time that airplanes spend idling on the runway), but it cannot easily manage all of an airplane's flight emissions. As a result, the airline has some unmanageable risk on carbon emissions, which should contribute to its unmanaged risk score on that issue.

Unmanageable risk is only one of the two components of unmanaged risk. The second component is the management gap, which relates to the manageable part of a company's material ESG risks and reflects the failure of the company in managing these risks sufficiently, as reflected in the company's management score.

EXAMPLE:

Human Capital:

Human capital is difficult to manage. A company can employ hundreds of thousands of people, and imagining a management program that could eliminate all risk of sexual harassment, low morale, or high turnover is very hard. However, companies are expected to have full control over these policies. Moreover, Sustainalytics has confidence that strong policies can effectively promote a working culture that limits material risk from sexual harassment or a workplace with destructive low morale and turnover. However, companies have challenges in mitigating risks in the labour supply chain. Therefore, a manageable risk factor is applied to distinguish that some risks within the issue cannot be managed.

In terms of a company's risk management capabilities, a review of controversial cases can be helpful.

A controversy case is defined as an instance, or ongoing situation, in which a company's operations or products allegedly have a negative ESG impact.

Determining which ESG issues are most material is not an exact science, and there might be important differences between what each investor considers most material, even when analyzing the same company. This is because forecasting how much one ESG or risk factor will affect a financial metric such as future cash flow is typically a matter of judgment.

Frameworks such as the materiality maps provided by the SASB are helpful in providing some guidance, but investment professionals often develop their own view on what is most material. This spectrum of opinions concerning materiality is exemplified through the

different examples of materiality maps provided in Exhibit which highlight the differing views investors might take.

Example Materiality Map of High-Level Sectors Across ESG Factors

	Airlines	Autos	Banks (DM)	Banks (EM)	Beverages	Capital goods	Chemicals	Construction materials	Food and home and personal care	Food retail
6										
5			Business ethics and culture					Business ethics and culture		
4	Ownership and control	Ownership and control	Executive remuneration	Ownership and control			Business ethics and culture	Health and safety	Product responsibility	
3	Community development	Product responsibility	Board structure	Business ethics and culture	Business ethics and culture	Ownership and control	Product responsibility	Regulatory threshold and compliance	Assessment and disclosure	Board structure
2	Employment quality	Resource management	Customer privacy and protection	Product responsibility	Product responsibility	Business ethics and culture	Resource management	Resource management	Climate change impact	Product responsibility
1	Climate change impact	Regulatory threshold and compliance	Community development	Community development	Resource management	Regulatory threshold and compliance	Regulatory threshold and compliance	Climate change impact	Resource management	Resource management

	Leisure	Luxury	Mining	Oil and gas	Pharma	Real estate	Retailing	Technology	Telecoms	Utilities
6									Executive remuneration	
5		Executive remuneration	Business ethics and culture	Ownership and control			Ownership and control	Business ethics and culture	Ownership and control	Community development
4		Ownership and control	Health and safety	Business ethics and culture	Business ethics and culture		Product responsibility	Employment quality	Customer privacy and protection control	Customer privacy and protection
3	Regulatory threshold and compliance	Customer privacy and protection	Assessment and disclosure	Health and safety	Human rights	Regulatory threshold and compliance	Health and safety	Health and safety	Community development	Resource management
2	Climate change impact	Human rights	Resource management	Resource management	Community development	Assessment and disclosure	Pollution of air, water and soil	Product responsibility	Resource management	Climate change impact
1	Assessment and disclosure	Resource management	Regulatory threshold and compliance	Climate change impact	Product responsibility	Climate change impact	Resource management	Pollution of air, water and soil	Regulatory threshold and compliance	Regulatory threshold and compliance

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Source: HSBC (2016).

The exhibit highlights the numerous and shifting nature of many ESG factors.

One publicly available sector materiality assessment is provided by the SASB (see Exhibit). This shows that different industries can have different exposures.

One can deduce that individual companies in the same market-defined sector might be judged to have different material ESG factors affecting their business. For instance, within insurance, a US healthcare insurer will have different factors affecting it than a car insurance firm would.

Investors can find more direct comparisons useful in analysis. In the healthcare industry example, using the SASB materiality map, a pharmaceutical company is judged to have a material exposure to fair marketing practices.

- Pharmaceutical company A is judged to have a low-risk exposure to this factor because it has up-to-date policies and training programs and has never had a regulatory warning letter.
- Pharmaceutical company B is judged to have a high risk to this factor because it lacks a strong policy, training is minimal, and the company has received several fines and warnings from regulators.
- Pharmaceutical company C is judged to have no risk to this factor because it engages only in pharmaceutical research and does not have any commercially marketed

products. Here we can see that even though the factor is material to the sector, it is of limited risk or arguably no risk to the company because the company is not exposed. These pharmaceutical companies can be more directly assessed on this same factor compared to each other.

As seen earlier, the same technique can be applied to whole sectors or sub-sectors, as well as companies. For instance, biodiversity as an E factor is not seen to affect the whole pharmaceutical sector but might have an impact on the agriculture sector.

Using the SASB as a Baseline Framework in a Materiality Assessment:

One example of where you might want to use the SASB as a baseline framework in a fundamental active investment process might be for a bio-pharmaceutical company that has a cannabis plant as its raw active ingredient. (This applies to the company GW Pharmaceuticals.)

"Materials sourcing" is not considered a material ESG risk for biotechnology and pharmaceutical companies.

However, an analyst might judge that a cannabis-derived medication would be a material risk on two accounts:

Growing the plants is potentially a complex operation with enhanced risks compared to standard manufacturing.

The regulatory oversight is more complex because both the drug regulator and the pharmaceutical regulator (in the United States, the Drug Enforcement Agency and the Food and Drug Administration, respectively) would be involved. For a standard pharmaceutical, only the pharmaceutical regulator would be involved.

The analyst might further judge that an ESG opportunity exists here as well because of the technology needed to harvest the plants, the knowledge protection around that technology, and the barriers involved in having to satisfy two regulators.

This might lead to longer intellectual property protection (and longer cash flows) as well as higher barriers to entry (and lower likelihood of competition). In this example, the social impacts might be more complex to judge as well, whereas all other aspects of the company's analysis might correspond to where the SASB has judged most risk to be (e.g., energy, water, and waste under E).

As of 2019–2020, a trend has developed in company reporting to include more material ESG factors. However, various stakeholders do not agree on materiality and how to report, so developing proprietary materiality assessments could continue to be an important technique for investors to potentially develop their own analytical framework alongside standardized frameworks, such as those of the SASB or the Global Reporting Initiative (GRI). As the SASB becomes more established as a leading materiality framework, it might be worth further investigation because calls are increasing from stakeholders for such standardization.

ESG Risk-Mapping Methodologies:

ESG risk mapping can also be done at the research stage. Here, an individual company (equity or credit) or sector has its risk mapped to a specific theme or factor, usually one that has been judged "material."

Risk mapping could also mean mapping a portfolio or investable universe against a specific ESG risk (e.g., climate risk, water-related risks) to identify which sectors or companies contribute the most to this particular risk profile (e.g., carbon- or water-intensive

companies). Examples of risk-mapping methodologies include carbon footprinting or testing portfolios against different climate scenarios.

Mapping can also be done for material opportunities (e.g., opportunities from recycling or the transition to renewable energy) as well as risks. It can be scored, for instance, on a 10-point scale or given a qualitative label, such as low or high risk. This shows how the scorecard technique (described earlier) can be combined with a mapping technique.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!