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Challenges For ESG Investing and Criticism for ESG Integration

ESG & Sustainability Transformation

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There are many hurdles and challenges for ESG integration. These include:

- Disclosure and data-related challenges, such as: data consistency, data scarcity, data incompleteness, and a lack of audited data.
- Comparability difficulties include a lack of comparability between ESG ratings agencies, comparisons across different accounting and other standards, comparisons across geographies and cultures, and inconsistent use of jargon terminology.
- Materiality and judgment challenges, such as: judgments that are difficult and uncertain, and judgments that are inconsistent.

The challenges in ESG integration across asset classes arise because different types of assets and different strategies integrate ESG using different techniques.

Challenges from Incomplete Datasets and Identifying and Assessing ESG Data

As can be seen from the case studies and ESG techniques, many of the processes start with data gathering and original research gathering. However, a few challenges exist:

- ESG data are not consistently reported across companies, geographies, and sectors.
- Most ESG data are not audited.
- Some ESG data are not easily available in public databases and are difficult to obtain.

ESG factors can be judged material and useful, but the data might be incomplete. For instance, carbon pollution is often judged material, but it can be measured in at least three scopes: scope 1, 2, and 3 emissions. Currently, in the top 2,000 companies in the world, few data are available on scope 3 (as of 2018, 10% of companies reported scope 3, and by 2020, this had increased to 18%), yet evidence indicates that scope 3 makes up more than 50% of the world's carbon (and GHG equivalent) pollution impact.

ESG data can be incomplete, unaudited, unavailable, or incomparable between companies because of the different reporting methodologies used. These issues make the assessment of ESG factors impossible in certain situations. A lack of data or a company unwilling to disclose information can make identification of relevant ESG factors difficult.

Data Disclosure Challenge:

A debate is ongoing over ESG data disclosures at a company level. These disclosures vary between companies and regionally. Also ongoing are efforts via organizations such as the SASB and the GRI, and continuous evolution from the IASB on "broader corporate reporting."

Surveys suggest that a range of investors view ESG disclosure at companies as inadequate. This might be partly because investors and management teams view materiality differently and might also have conflicting aims. Investors could claim that assessing a material piece of ESG information is difficult without data disclosure. Companies can argue that the vast range of possible ESG data and the differing demands of investors, stakeholders, and rating agencies make the resource demands unreasonable.

A further challenge is that there is no consensus agreement on the details of what good ESG disclosure might look like (although again, see the SASB's evolving work here) and that this might differ by strategy and asset class. Historically, public markets disclosure has

been higher than private markets disclosure. The needs of fixed-income and sovereign bond investors can (and do) differ from those of equity investors.

Comparability and Materiality Judgment Challenges:

ESG ratings agencies use different techniques and assessments so that their ratings are not easily comparable. ESG ratings do not correlate like bond credit ratings, nor do agencies use the same methods of scoring.

Judgments on ESG materiality might differ between analysts. Many ESG terms are used inconsistently and are difficult for non-specialists to interpret.

These differences can be magnified by cultural or regional differences. For instance, different countries have different governance best practices or differing views on risk and materiality. Japanese companies have a much lower number of independent directors on their boards than European and US companies do on average, which is reflected in the Corporate Governance Code of Japan. Different countries might also put different weights on social factors (e.g., US companies are less concerned about having a policy on work or labour unions than German companies are).

Where materiality can be judged, assessing the level of impact can be difficult, and how ESG factors interact with financial performance over time is uncertain.

The field has many jargon terms (e.g., responsible, impact, sustainable, socially responsible, and ethical and green investment). Many of these terms are not used consistently by specialists and are confusing to non-specialists.

Integration Challenges:

Because of the different third-party databases, many QESG factors are not agreed upon, and the data are relatively short run. Also, to what degree the ESG factors might correlate with other established quantitative factors, such as "quality," "value," or "momentum," is uncertain. Index-tilting strategies might therefore fail to reflect desired factors appropriately.

Many investment firms have separate ESG analyst teams. This separation can move ESG expertise away from investment decision-makers and thereby create a challenge to integration. Perhaps ESG analysts are more junior (perhaps because the focus on this area at, for example, the business school level is still recent), so lower weight is given to their views and providing a challenge.

In fundamental active strategies, many ESG factors are difficult to judge and quantify. Impacts to cash flows, growth rates, or DCF assumptions are also hard to express. As noted earlier, in quantitative strategies, limited consensus remains, and historical data provide an integration challenge.

Investment Firm Culture Challenge:

A significant number of investment professionals still do not integrate ESG or believe that ESG has limited financial impact; this can be challenging for teams and within firms. Firms might not have significant resources to buy third-party ESG data, or a firm's global nature might make culturally different attitudes to ESG factors difficult to integrate globally across the firm.

ESG integration is often different across asset classes, which can make being consistent or explaining across a firm difficult. Investors are likely to make differing judgments on materiality or weight factors, which causes a lack of comparability or a difference of opinion, even within firms.

Additional resources are typically needed for ESG integration, finances, and personnel, which raises both financial and operational challenges within firms.

ESG integration techniques have only recently started to become part of the curriculum at business schools and within universities. Typically, this means that investment professionals would not have had as much detailed training on how to deal with the challenge of integration.

Despite advances in techniques and understanding, significant challenges to ESG integration remain.

Criticism for ESG Integration:

One of the most common criticisms of ESG investing is the difficulty for investors to correctly identify, and appropriately weigh, ESG factors in investment selection. Critics tend to express four primary concerns about the precision, validity, and reliability of ESG investment strategies:

Too inclusive of poor companies – ESG mutual funds and exchange-traded funds (ETFs) often hold investments in companies that might be seen as “bad actors” in one or more of the ESG spaces.

Dubious assessment criteria – The criteria used for selecting ESG factors are too subjective and can reflect narrow or conflicting ideological or political viewpoints. Non-material or sociopolitical factors might be overemphasized. Materiality assessments might be considered flawed.

Quality of data – The information used for selecting ESG factors often comes (unaudited or assured) from the companies themselves. This complicates the ability to verify, compare, and standardize this information.

Potential lack of emphasis on long-term improvements – Some financial advisers screen investments first for performance and only after that for ESG factors. This initial emphasis on performance can exclude companies with high ESG practices that focus on longer-term performance.

Finally, some critics would argue that evidence for the benefits of ESG are mixed or not proven. These critics suggest that the time horizon for assessing ESG is too short to prove benefits. Critics also point out time periods during which certain sectors that are often excluded (e.g., tobacco) perform well as evidence that ESG detracts value. Note that as discussed earlier, exclusionary strategies are only one type of strategy, which some investors do not consider part of ESG integration but rather a separate type of investment process.

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