

Challenges to ESG Investing and Criticisms of ESG Investment Integration

ESG & Sustainability Transformation

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12/2023

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There are many obstacles and challenges to integrating ESG in investing. These include:

- Data and disclosure challenges, such as: data consistency, data scarcity, incomplete data, and lack of audited data.
- Comparability challenges, including lack of comparability between ESG rating agencies, comparisons between accounting standards and other standards, comparisons across geographies and cultures, and inconsistent use of jargon.
- Materiality and measurement challenges, such as: difficulty and uncertainty in assessment, and inconsistency in judgments.

Challenges in integrating ESG across asset classes arise because different asset classes and strategies integrate ESG using different techniques.

Challenges from Incomplete Datasets and Identifying and Assessing ESG Data. As we can see from ESG research and techniques, many processes start with data collection and aggregating source studies. However, there are still some challenges:

- ESG data is not reported consistently across companies, geographies, and industry sectors.
- Most ESG data is not audited.
- Some ESG data is not readily available in public databases and is difficult to access.

ESG factors may be judged to be material and useful, but the data may be incomplete. For example, carbon pollution is often judged to be material, but it can be measured in at least three scopes: scope 1, 2, and 3 emissions. Currently, there is very little scope 3 data available for the world's top 2,000 companies (as of 2018, 10% of companies reported scope 3, and by 2020, this had increased to 18%), yet there is evidence that scope 3 accounts for more than 50% of the world's carbon pollution impact (and equivalent greenhouse gas emissions).

ESG data may be incomplete, unaudited, unavailable, or not comparable across companies due to different reporting methodologies. These issues make it impossible to assess ESG factors in certain cases. Lack of data or a company's reluctance to disclose information can make it difficult to determine relevant ESG factors.

Disclosure Challenges:

There is an ongoing debate about the disclosure of ESG data at the company level. These disclosures vary across companies and regions. There are also efforts through organizations such as SASB and GRI, as well as the ongoing development of "broader corporate reporting" by the IASB.

Surveys show that many investors consider ESG disclosure by companies to be inadequate. This may be partly because investors and management teams at companies have different views on materiality and may also have conflicting objectives. Investors may argue that assessing a material piece of ESG information would be difficult without disclosure. Companies may argue that the large volume of ESG data and the varying information needs of investors, stakeholders, and rating agencies make the need for resources to ensure disclosure unreasonable.

Another challenge is that there is no consensus on the details of what good ESG disclosure should look like (although again, see SASB's ongoing efforts on this), and this can vary by investment strategy and asset class. Historically, public market disclosure has been higher than private market disclosure. The needs of government bond and fixed income investors can (and do) differ from those of equity investors.



Challenges in Assessing Comparability and Materiality:

ESG rating agencies use different techniques and assessments, making their ratings difficult to compare. ESG ratings are not correlated like bond credit ratings, and they do not use the same scoring methods.

ESG materiality assessments can vary among analysts. Many ESG terms are used inconsistently and are difficult to interpret for non-specialists.

These differences can be magnified by cultural or regional differences. For example, different countries have different governance best practices or views on risk and materiality. Japanese companies have a much lower average number of independent directors on their boards than European and American companies, which is reflected in Japan's Corporate Governance Code. Different countries may also place different weights on social factors (e.g., US companies are less concerned about having employment or union policies than German companies).

While materiality can be assessed, assessing the magnitude of impact can be difficult, and how ESG factors interact with financial performance over time is uncertain. The field is rich in specialized terminology (e.g., responsibility, impact, sustainability, social responsibility, green investing, and ethics). Many of these terms are not used consistently by experts and are confusing to non-experts.

Integration Challenges:

Because of disparate third-party databases, many QESG factors are not unified and ESG data is relatively scarce. In addition, the extent to which ESG factors may correlate with other established quantitative factors, such as "quality," "value," or "momentum," remains uncertain. As a result, index-tilting strategies may not adequately reflect the forward-looking factors.

Many institutional investors have separate ESG analysis teams. This separation may dilute investment decision makers' ESG expertise and thus create integration challenges. ESG analysts are still in their infancy (perhaps because the field has only recently gained traction, such as in business schools), and the challenging perspectives and capabilities of ESG analysts are still undervalued.

In fundamental active investment strategies, many ESG factors are difficult to assess and quantify. The impact on cash flows, growth rates, or DCF assumptions is also difficult to articulate. As noted earlier, in quantitative strategies, consensus is limited and historical data presents integration challenges.

Cultural Challenges of the Investment Organization:

A significant number of investment professionals still do not integrate ESG or believe that ESG has limited financial impact; this can be challenging for investment teams and organizations. Firms may not have the significant resources to purchase third-party ESG data, or the global nature of the firm may make culturally different views on ESG factors difficult to integrate on a global, firm-wide scale.

ESG integration also often varies across asset classes, which can be difficult to align or explain across the investment organization. Investors may have different assessments of materiality or weightings, which creates a lack of comparability or differences of opinion, even within firms.

Additional resources are often required for ESG, financial, and human resource integration, which poses both financial and operational challenges for investment firms.

ESG integration techniques are only just beginning to become part of the curriculum in business schools and universities. This often results in investment professionals not receiving detailed training on how to address the integration challenge. Despite advances in knowledge and technology, significant challenges to ESG integration remain.

Criticisms of ESG Investing Integration:



One of the most common criticisms of ESG investing is that investors have difficulty accurately identifying and appropriately weighing ESG factors in their investment choices. Critics tend to express four main concerns about the accuracy, validity, and reliability of ESG investing strategies:

Over-inclusion of poor companies – ESG mutual funds and exchange-traded funds (ETFs) often hold investments in companies that could be considered “bad actors” on one or more ESG issues.

Opaque evaluation criteria – The criteria used to select ESG factors are too subjective and may reflect narrow or conflicting political or ideological views. Non-material or socio-political factors may be overemphasized. Materiality assessments may be considered flawed. Data Quality – The information used to select ESG factors often comes (unaudited or unassured) from the companies themselves. This complicates the ability to verify, compare, and standardize this information.

Potential lack of focus on long-term improvements – Some financial advisors screen investments based on performance first and ESG factors second. This initial emphasis on performance may exclude companies with strong ESG practices that focus on long-term performance.

Finally, some critics will argue that the evidence for the benefits of ESG is unclear or unproven. These critics argue that the time horizon for ESG assessments is too short to demonstrate benefits. Critics also point to certain sectors (e.g. tobacco) that are often excluded as performing well, and this is evidence that ESG undermines investment value. Note that as we have discussed in previous articles, exclusion strategies are simply a type of strategy that some investors do not consider as part of ESG integration but as a separate type of investment process.

To learn more about ESG and sustainability-related models, please contact [YTT Consulting!](#)

