Feature

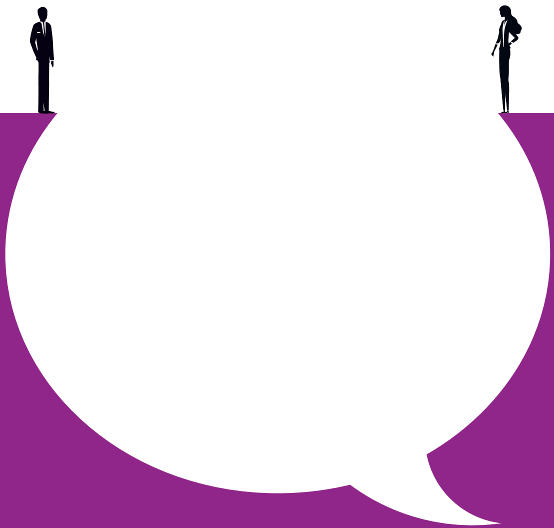
Understanding ESG data for corporates

By Joshua Kendall
Head of Responsible Investment Research and Stewardship, Insight Investment

ESG risks can have a clear impact on the creditworthiness of a company, and can therefore be material for fixed income investors' portfolios. These include UK pension funds which invest heavily in the asset class.

However, investors seeking to take ESG risks into account in their investment decisions face difficult questions. Even if you believe ESG analysis should be directly integrated within corporate bond research processes, there are challenges to overcome.

Dealing with these challenges is difficult, but we believe it is possible using a systematic approach to identify ESG risks, backed up by qualitative analysis and engagement with company management.



The challenges for responsible investors

ESG risks are complex: The different factors and risks covered by the single term 'ESG' are extensive and complex – ranging from how climate change might affect a company's supply chain, through to the political ramifications of upcoming regional elections, and the specific governance structures and processes of a corporate entity.

These issues require time, knowledge and expertise to analyse, and to judge whether they are material for a company's creditworthiness.

Gaps exist across the market: The lack of standardised ESG disclosures in many areas mean gaps exist, and comparability can be a problem.

For many smaller issuers, particularly emerging market or high-yield companies, the availability of relevant non-financial data lags information from larger issuers – investors must make a judgement call as to how to fill such gaps.

Different ESG data providers take a different view on these questions: Each ESG data provider generates useful information, but different providers reflect different emphases.

These factors result in variance in ESG ratings for the same entities (see Table 1).

Table 1: ESG ratings from different data providers can vary significantly

Issuer	ESG data provider 1	ESG data provider 2	ESG data provider 3
US energy company	4	2	4
APAC utilities company	4	5	3
US food retail company	3	2	4

[1]As at 30 September 2021.
Ratings range from 1 (best possible) to 5 (worst possible).

Fixed income investors need to focus on default risk: Default risk is the prism through which fixed income investors view potential investments, but the relevance of ESG factors to this risk can vary significantly across different sectors.

For example, we consider health and safety, and carbon emissions, as important risks for companies operating in the mining sector, but we see these as generally of lower importance for financial services companies. The exception is with corporate governance, where we consider the risks an important part of our evaluation for every type of issuer and credit quality.

Crucially, the relevance of ESG risks can differ across different fixed income instruments from the same issuer, given varying structures and maturities. This can add another layer of complexity.

Facing the challenge: the role of ESG ratings

We believe investors need a systematic way of digesting the information from many sources, to help make an informed view. ESG ratings, which aim to flag companies exposed to prominent and material risks, can play a clear role – but we believe it needs to be clear how ratings align with an investor's own opinion on ESG credit risk.

As an example, we found at Insight that no single data provider aligned with our judgements on such risks, so we developed our own methodology using data from multiple inputs. This also incorporates our own analysts' qualitative judgement on the materiality of ESG risk factors for specific industries and sectors.

Insight's credit analysts frequently engage with companies on ESG issues, and they have a degree of oversight when it comes to our ratings. Our analysts can recommend that a rating is manually raised or lowered: recommendations are reviewed and authorised by an ESG panel, which ensures that the analyst's recommendation aligns with our methodology.

We engaged with a European car parts maker after our ESG rating was downgraded to the worst possible level, driven by a downgrade in its social rating. The risks identified were product quality and safety, with an issue regarding product reliability; supply chain management, where there was limited disclosure on the extent to which suppliers were certified; and labour management, with concerns around processes for restructuring and job losses.

The company responded to our questions with additional information, and following a formal review the social rating was upgraded, based on the new information provided during the engagement.

Through a combination of such quantitative and qualitative work, we have sought to develop ratings which specifically highlight risks relevant to corporate debt investors.

Going beyond ESG data

Qualitative judgement is still necessary to understand the implications of ESG ratings, which can be a result of multiple intertwined and complex datapoints. It is also necessary to discern the specific data driving ratings – so analysts can then consider how a company's management may, or may not, be dealing with a specific risk.

It seems clear that to identify/manage ESG risks effectively, an investor needs to engage actively with issuers: both to understand the risks more clearly and how they are managed; and to encourage improvement where appropriate and necessary.

Important information
Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations. The use and influence of our ESG ratings in specific investment strategies will vary, potentially significantly, depending on a number of factors including the nature of the asset class and the structure of the investment mandate involved. For an investment portfolio with a financial objective, and without specific ESG or sustainability objectives, a high or low ESG rating may not automatically lead to a buy or sell decision: the rating will be one factor among others that may help a portfolio manager in evaluating potential investments consistently.