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Stewart Investors
Sustainable Funds Group

# The problem with ESG scores

Sustainable investing is facing a wave of new regulation, seeking to improve transparency and standardise reporting requirements for sustainability funds. The intentions behind these regulations are laudable; to reduce greenwashing, help separate the wheat from the chaff, and reorient capital towards more sustainable companies.

However, as with many regulations, there is a risk of unintended consequences. One of the key risks we see, is that investors are increasingly turning to third-party environmental, social and governance (ESG) data providers to help them with their analysis, and more worryingly, to help them decide whether a company is sustainable or not.

Some ESG data can be useful in certain circumstances, but an over reliance on simplistic ESG scores can be a dangerous strategy, especially when using them to build investment portfolios. Relying too heavily on ESG scores is also unlikely to help reorient capital towards more sustainable companies.

## Why, what is the problem?

Unfortunately, ESG data suffers from a multitude of flaws, and in our view, does not focus on the areas that matter. One of the main challenges is that ESG **scoring methodologies** tend to focus on how well companies manage their internal processes, rather than the real-world impacts of their products and services.

Here are a couple of examples:

- PepsiCo*, the maker of soft drinks and snacks, tends to score quite favourably on ESG assessments. It has great disclosure in areas like its health and safety policies, Board diversity, and climate targets. These things are all very important, but they don't answer the vital question; do Pepsi's products make the world healthier and more sustainable?
- British American Tobacco* has been recognised as a leader on the Dow Jones Sustainability index for the last 20 years. This accolade is based on ESG scores from S&P. With sales of over 600 billion cigarettes each year, is it really a sustainable company?

Secondly, when you look at the scores themselves, there are often **large variations between the scores and ratings** from different ESG data providers. One company may be rated as best in class by one provider and worst in class by another. This is because each provider has their own methodology, with different areas of emphasis.

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These issues are compounded by the fact there are **gaps and a lack of consistency in the source data** being collected from the companies being assessed. When ESG data providers cannot find the data they need, they use estimates, which sometimes result in strange outcomes.

Finally, there are **inherent biases in the scores**, with larger, developed market companies tending to score better than smaller companies, especially in emerging markets. Smaller companies often lack the resources needed to produce lengthy sustainability reports, and so are at risk of being penalised for their lack of data.

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### So how do we assess whether a company is sustainable or not?

At Stewart Investors, we look to invest in companies that are well placed to contribute to, and benefit from, sustainable development. We look for companies that can help reduce our ecological footprint, or advance human development, or ideally both. These attributes are difficult to identify by relying solely on ESG scores. As William Cameron said in 1963: "*Not everything that counts can be counted, and not everything that can be counted counts.*"

We prefer to do our own research, which is highly qualitative in nature and based on a wide variety of information sources, including bespoke commissioned research. We take a broad and rounded approach to assessing the sustainability credentials of a company, by asking a variety of questions, for example:

- How do the products and services contribute to sustainable development? Are they helping us solve difficult problems, meet vital needs, and do more with less?
- How does the management team think about sustainability and how do they act upon their beliefs? Do the company's leaders act with integrity and honesty? What is their time horizon? How do they treat all of their stakeholders, e.g. employees, suppliers, customers, and the communities where they operate?
- How does the company manage the positive and negative impacts of its operations? Is it actively managing its carbon and water footprint, and reducing its waste – what is the overall direction of travel?
- How adaptable is the company to changing sustainability trends? How is it placed to benefit from sustainability tailwinds and navigate sustainability headwinds, e.g. changing regulations?

None of these things can be easily captured in a single metric or ESG score. Instead, we prefer to use sensible judgement, and base our analysis on a broad base of both qualitative and quantitative evidence.

**Lorna Logan**
April 2022

## Investment terms

View our list of investment terms to help you understand the terminology within this document

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