ESG Buy-Side Integration: Then & Now

A 3-Year Comparison of Investor Views on ESG Integration (2017 vs Today)

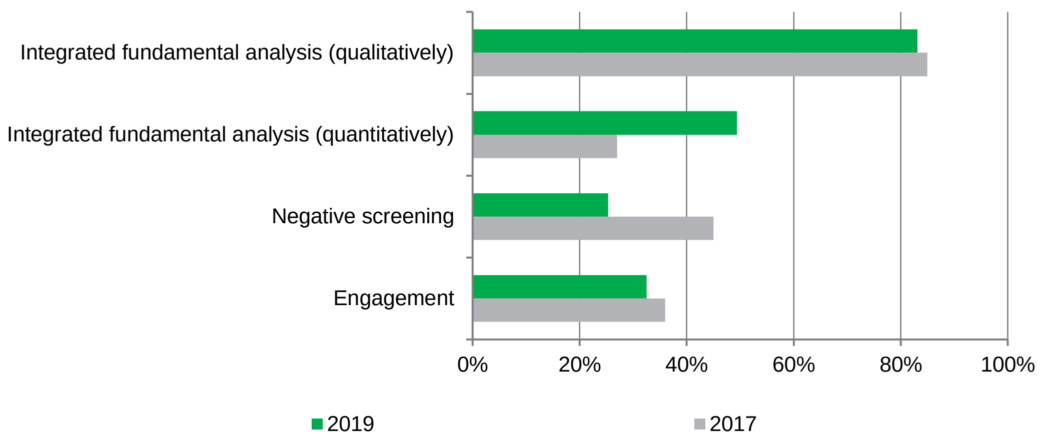
ESG Integration 2017-2019

IHS Markit's *Perception Analytics* team maintains constant communication with buy-side institutional investment managers on behalf of clients, surveying them regularly on questions of interest both to specific clients as well as the entire universe of our research. During 3Q19, the group collected responses from 85 buy-side firms from 15 countries representing over $5.1T in EAUM with respect to their usage of ESG information to make investment decisions. The questions were identical to those asked of a similar universe in 3Q17, with a goal of viewing the progression of this trend in the asset management community over time.

Key Findings

1 - Investors have broadly added ESG integration into their investment process since 2017.

Figure 1 - How are ESG factors incorporated into investment decision-making?



Notes: Participants had the option of providing multiple responses.
Source: IHS Markit

-The industry is now awash in data. In 2017, PMs and analysts covering stocks conducted a primarily qualitative analysis of ESG; in 2019, almost twice as many respondents explicitly cite using quantitative methods (49% in 2019 vs. 27% in 2017).

Investors are now taking in ESG data at both a *high level* (ratings from third-party providers) and also a *more granular level* (raw ESG data used to create a proprietary quantitative view of the ESG risks of an investment). However, the availability and reliability of data was cited by many participants as concerning, especially in the small-cap range.

-More firms are now staffed to conduct ESG research. Compared with 2017, ESG analysis processes are now more rigorous and are often handled by dedicated ESG, risk, or engagement teams. While stewardship teams (often responsible for the voting decision) may have handled this task previously, 48% of investors polled mentioned a specific in-house ESG research team.

-Positive screening strategies are much more common than before. While the most common dedicated strategy around ESG may have previously been a "negative screener" approach (i.e. "market segment *minus* poor ESG"), we now see many more investors identifying positive ESG attributes in their strategies. Negative screening was highlighted by *fewer* investors as a core strategy, down to 25% from 45% in 2017.

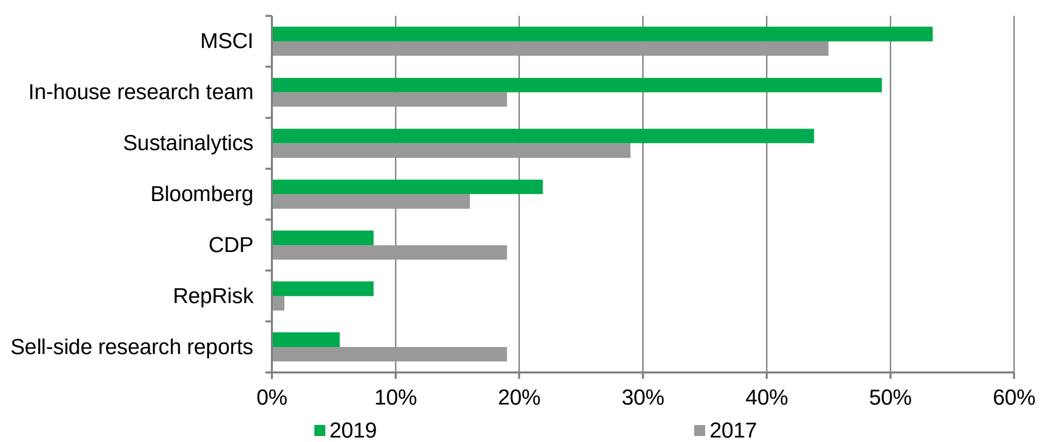
Positive "inclusion" strategies are now easier to conduct with additional data available, and a longer time series helps investors identify companies that have made *progress* on particular ESG criteria, even those in industries that may be seen as limited by the nature of their business.

-Governance concerns remain core to investors. Most rank-and-file analysts and PMs have a deeper background in reviewing companies from a "G" perspective than from "E" or "S" – hence nearly a quarter of respondents, unprompted, suggested governance reviews are an integral part of their analysis.

"Evaluating sustainability and ESG mostly resides with the industry analysts but PMs are also involved. Our enterprise risk team has a quantitative approach to ESG and they occasionally weigh in. The funds we have are not bound to any ESG requirements, but we give it consideration."
North American mutual fund ($100B+ AUM)

2 - Investors use an even more diverse range of ESG data sources, with more eyeballs in different parts of the company using them than before.

Figure 2 - What are the key resources you rely on for ESG research?



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- Consolidation has shrunk the range of data / research providers to some degree. Our 2017 community cited 26 distinct providers used for ESG insights to help derive both the investment and voting decision; a slightly-larger 2019 audience cited 21 providers in use. Further, we saw a greater concentration in usage from the largest two providers: MSCI was cited by 53% of respondents (+8%) and Sustainalytics 44% (+15%). The most acquisitive provider since our last survey, ISS, was mentioned as an *investment decision* data source by 15% of respondents, up from 9% in 2017.

Increasing concentration may be felt in the asset owner community as well – multiple respondents noted that their clients (outside asset owners) push managers to use these large providers.

- Ratings agencies are used more widely – but not necessarily trusted. Several respondents highlighted the fact that they subscribe to multiple ESG data and ratings surveys deliberately, since the methodologies and coverage universes of providers vary and ratings are calibrated differently. Most respondents mention a consistent need to review outputs and come up with their own views of a company's ESG risks, using external research only as an initial source.

- There is increased interest in providers that centralize timely ESG information on companies. Several respondents highlighted names like *RepRisk* and *TruValue Labs* that source "controversies" data from news stories and other public sources and can alert analysts to evolving risks in portfolio holdings. These two names in particular garnered just a single mention in our 2017 survey, but came up in 12% of responses in 2019.

- Some smaller investors source all of their ESG information internally. Both large and small investors described taking their own view using company-disclosed information such as the sustainability section of the website, dedicated sustainability reports, and the standard annual report, proxy statement, and other filed documents with 39% of respondents mentioning these resources directly. However, a surprising number of smaller investors noted *exclusively* using their own research.

- A few providers showed less consumption from investors. *CDP* and *RobecoSAM* both saw fewer citations in this year's survey. Note that our survey took place prior to RobecoSAM's acquisition announcement by S&P; separately, CDP data is sourced into a number of financial data terminals (including *Bloomberg* and *Eikon*), so it may be difficult for the analyst to isolate the end source of the data being used.

"There are number of our clients that pay attention to MSCI ratings. I personally do not think that those ratings are particularly good, but it is what we have to work with. I consider those ratings to be less valuable because as you move down the scale in terms of market capitalization, the less accurate the research is. The ratings agencies are simply not putting the resources into researching the smaller cap names."

North American mutual fund ($100B+ AUM)

3 - Investors' opinions diverge on what the primary role of IR should be in ESG

- IR's role should vary by industry and region. Study participants do not consider data providers an adequate replacement for their own due diligence and company engagement. They rely on issuers to give them insight into ESG practices. For companies in industries that directly touch impact investing or green revenue, ESG is of singular importance to the investment story, and respondents cite IR teams as needing to be a complete resource given the topic's materiality. However, respondents do not necessarily believe IR needs to be an expert on *non-material* items, and suggest that they direct inquiries to other internal experts.

Two emerging markets managers noted that an issuer may need to help a PM describe the environmental & social aspects of doing business in specific countries in order to help solidify the company's investment case. Generalist investors also expect IR teams to highlight the relevant ESG concerns for the industry.

- Manager expectations vary based on company size. When dealing with smaller corporates, analysts typically interact with the C-suite or field experts and leverage IR as a gateway to knowledgeable individuals. They state that as firms grow or endeavor to become more efficient at dealing with a large investor base, IR personnel should become well versed in the technical details of a company's investment case, with ESG topics becoming increasingly important in this sense.

- ESG can be a differentiating factor in the story IR is telling. Some investment managers that do not explicitly cite "engagement" as one of the ways they incorporate ESG into their investment process nevertheless note that proactive outreach from their companies is appreciated. Further, IR's influence over producing the disclosures necessary to meet rating agencies' needs was cited – some managers have even connected rating agencies with company IR to make sure accurate information is used.

Authors: Brian Matt, CFA and Alexi Meghir

Brian Matt, CFA, is Director and Head of ESG, Americas, within IHS Markit Corporate Solutions. Alexi Meghir is a Research Analyst in the Perception Analytics division of IHS Markit Corporate Solutions.