



Morphic  
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**ESG RATINGS,  
NO QUICK FIXES**



“ Not everything that counts can be counted, and not everything that can be counted counts. ”

### Attributed to Albert Einstein

Humans have a strong preference for quick fixes to hard problems. Look at the never shrinking world of fad diets and “30-second workouts” to get “summer ready”, when the reality is that “habits trump goals”: changing your daily routine slightly will lead to much larger and better lasting results.

For this reason, many investors who consider Environmental, Social and Governance (ESG) issues are increasingly looking for data providers to give stocks a rating or ranking as a quick fix to make their portfolio ESG compliant as fast as possible. Data providers such as MSCI, FTSE and Sustainalytics encourage investors to use their ratings as the standard by which portfolios should be measured, embedding themselves in this growing area of investing. Some funds are already [pushing the idea](#) that only stocks with high ESG ratings are “true ESG”.

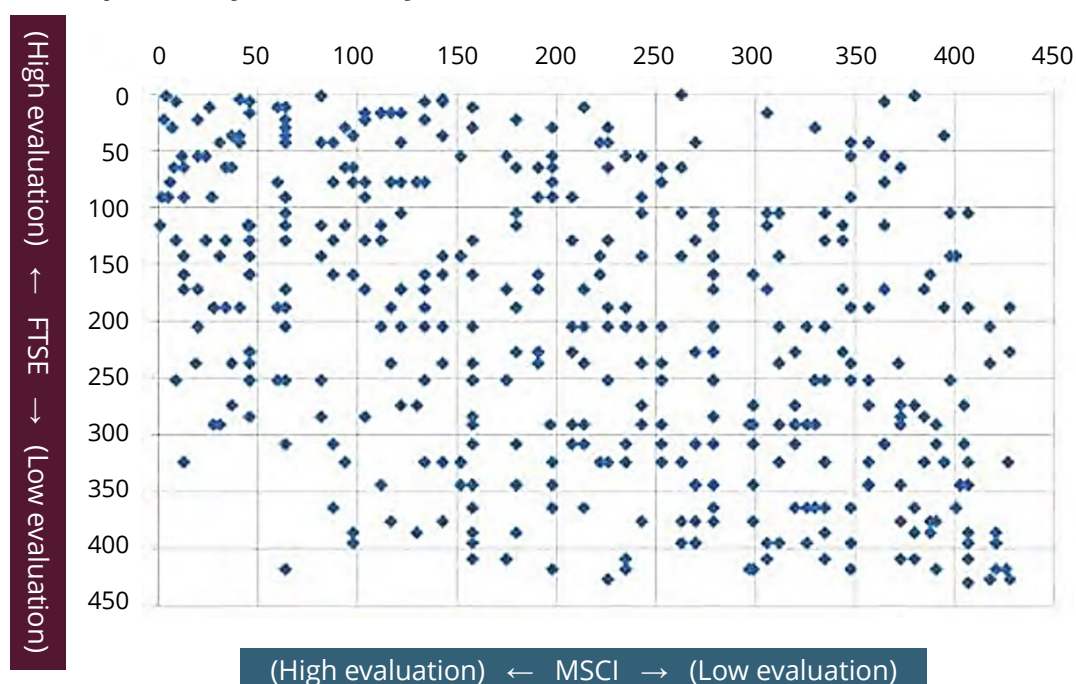
So what role, if any, should ESG ratings play inside a responsibly managed portfolio? We passionately believe that outcomes are what matter – that is, good ESG integration should

result in better outcomes for both investors as well as the planet in the medium-term. We also believe any choice we make should be backed up with data.

One big problem when looking at ESG ratings is inconsistency. What this means is when one rating agency gives a good ESG score to a company, another agency may give that same company a bad score. Without consistency, it makes it rather difficult to make objective comparisons across fund portfolios if two funds use different service providers.

Investment bank CLSA analysed the ratings for 400 stocks from two different data providers – MSCI and FTSE (**Figure 1**). The chart plots each company as a point, with the two providers on each axis. If both providers had identical scores for each company, the blue dots should form a line running from top left to bottom right. As can easily be seen, there is nothing of the sort. Indeed, there would appear to be close to no correlation across the two providers.

**Figure 1 – Comparison of ESG scores from FTSE and MSCI**



Source: CLSA, GPIF

Or as CLSA puts it in their report:

*"[This report does] not discredit ESG data or the practice of scoring ... it underscores the danger of relying on a simple final score for investment decisions".*

This should not be surprising to anyone who invests for a living. Taking into account dozens of factors across three distinct areas (eg, Board of Director independence; employee diversity; and carbon emissions) and creating a single number would require many assumptions and oversimplifications.

But there is a deeper, perhaps more insidious outcome, which worries us as ESG advocates. What if the idea of only investing in "high ESG" stocks becomes mandated or popularised through passive ETFs that slavishly follow ESG indices that contain the "best-in-class"?

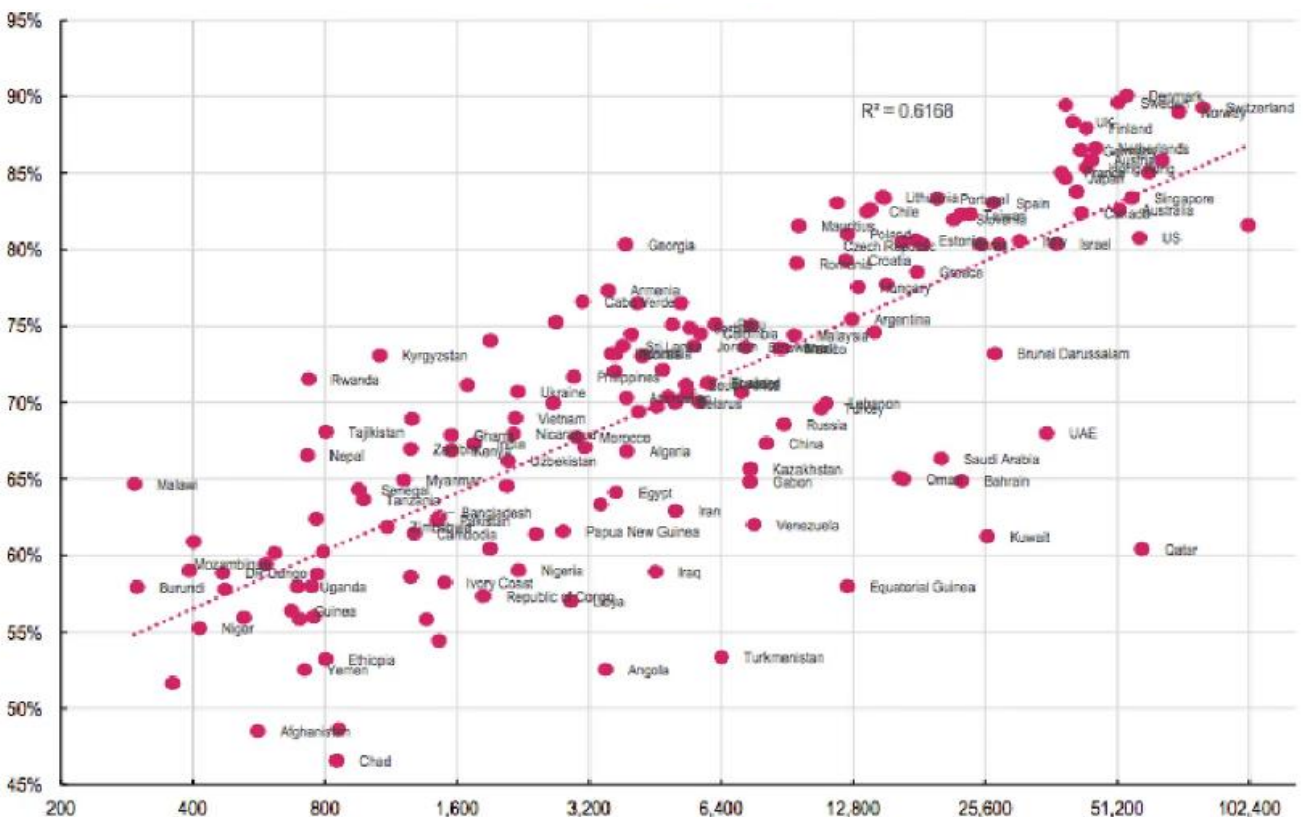
Then global capital allocations will flow to some lucky few, lowering their cost of capital, whilst raising it for others.

Another study conducted by Renaissance Capital looked at the characteristics of ESG scores by country of listing and then plotted them against the GDP of that country (**Figure 2**). Unlike the first chart, here there is a relationship. Unsurprisingly, rich countries have better ESG scores.

As Renaissance notes, emerging and frontier markets are:

*"(almost by definition) less well governed, more corrupt and increasingly polluted... Sending children to school, avoiding slavery, giving women the vote and therefore having a democracy, low corruption and clean water are all ESG goals that the UK and the US (among others) only endorsed as they got rich, not before they started industrialising."*

**Figure 2 – ESG scores for 167 countries compared with GDP per capita (\$), 2016**



Source: Renaissance Capital, UN, World Bank, IMF

“ If your ESG goal is to invest in mostly white, rich, Christian heritage Scandinavian countries, then this index is for you. ”

## Renaissance Capital report on the problem with high ESG scores

If outcomes are what you as an investor care about – those outcomes being lower child mortality, more electrification etc - then even if Emerging Markets have lower absolute ESG ratings, directing capital to them will allow for the highest overall rate of improvement for the global economy.

This conclusion challenges the narrative espoused by amongst others Alliance Bernstein, that investors should question their managers on their choices to invest in low-rated ESG companies. The opposite appears to be true: investors should also challenge their managers as to why they have invested only in highly rated ESG stocks!

Nuance is needed here as well and investing in low-rated stocks in Australia for the sake of it is unlikely to increase either investor returns (low rankings inside countries have been shown to underperform) or improve the world. But it reminds one of why context matters.

This raises the question of whether an ESG framework will in the future impede investment from regions that are deemed “poor ESG candidates”. If poor countries can develop through green energy alone, there is not necessarily a conflict. If they cannot, they will end up being starved of capital, that starvation being caused by the rating houses in their effort to promote better ESG standards!

It would be nothing short of a tragedy if this were to occur: poor countries being told, essentially, they need to be poor to make western investors feel good about themselves.

## BROADER ISSUES FOR ESG INVESTMENT PRODUCTS

The flaws in ESG ratings unfortunately flow on to a number of ESG products offered in Australia and internationally.

We were shocked recently to discover that one heavily promoted Exchange Traded Fund (ETF) based on ESG ratings still includes as its second largest holding Johnson & Johnson (J&J). This is despite the fact that J&J is facing [a barrage of litigation](#) relating to asbestos contamination in its famous Baby Powder product and allegations of a longstanding management cover-up.

The problems are particularly apparent in ETFs, yet they also apply to several funds that are marketed in Australia as actively managed ethical products. They have large universes of stocks and appear to focus the bulk of investment analysis on either using screens to eliminate companies with poor ESG scores or, focus on stocks with high ESG scores.

ETFs can generally have a valuable place in investors’ portfolios, but when it comes to ESG products investors should look beyond the marketing wrapper, and check closely on the actual ingredients.

In practice, to avoid genuinely bad companies whose fall from grace can cause damage to investors’ wealth, funds that focus on a case by case research for more concentrated portfolios will give better outcomes.

## IMPLICATIONS FOR MORPHIC

How does Morphic use this data? We have been a consistent advocate of the “*improving is better than best*” ESG model for investing. The Funds have a large allocation of Emerging Markets and we have invested in stocks in Emerging Markets that may have lower ratings, but which are working to improve outcomes in those countries.

We engage with companies with poor governance, looking to publicise both the improving examples and call out those with poor practices who seek to do nothing. We may have exposure to certain carbon intensive industries (such as cement) where there is a materially positive impact to that society and its economic growth in combination with management with best-in-class (locally) environmental understanding.

Because, most of all, we believe the best outcomes for the world occur when capitalism is used to improve lives, not in telling poor people to stay poor.

## ABOUT THE AUTHOR



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**Chad co-founded Morphic Asset Management in 2012. He was previously a Portfolio Manager and Head of Currency and Macroeconomics at Hunter Hall, a leading ethical Fund Manager, for five years. He has worked at BT Investment Management, Putnam and the Federal Treasury over his 15-year career.**

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