THE ESG RISK RATINGS
MOVING UP THE INNOVATION CURVE

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The ESG Risk Ratings
Moving up the innovation curve

Today Sustainalytics launched its ESG Risk Ratings, the firm’s next generation ESG research and ratings product. The ratings are designed to help investors identify and understand financially material ESG-related risks within their investment portfolios and how they might affect long-term investment performance. Supported by a robust materiality framework, our ESG Risk Ratings provide a quantitative measure of unmanaged ESG risk and distinguish between five levels of risk: negligible, low, medium, high and severe (see Figure 1). Investors can use the ESG Risk Ratings for ESG integration, investment analysis, index and fund creation, voting and engagement, and screening and benchmarking.

“As the integration of ESG factors plays an increasingly important role in investment decision making worldwide, our clients are seeking better signals that allow them to meaningfully evaluate the impact of ESG risks on their investments,” said Dr Hendrik Garz, Head of Sustainalytics’ ESG Rating Products.

“Building on our commitment to deliver innovative products and services, Sustainalytics’ ESG Risk Ratings deliver powerful ESG data points that can be integrated into valuation models and portfolio construction in meaningful and multifaceted ways.”

Our ESG Risk Ratings distinguish between five levels of risk

Figure 1: Allocation of companies across ESG risk categories, July 2018

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1 This is a preview of a comprehensive “white paper” that will be published later this month.
The background – Responsible Investing has entered a new stage in its development

Responsible investment (RI) has gone mainstream. The evidence is compelling and widespread: continued growth in the volume of managed assets that incorporate environmental, social and governance (ESG) information, improved and more extensive corporate ESG disclosures, a surge of academic and practitioner studies investigating the outperformance potential of ESG research, the sudden proliferation of ESG indices and the expansion of ESG integration techniques across asset classes, including equity, fixed income and alternatives. It is estimated that RI strategies, broadly defined, account for 27% of all professionally managed assets worldwide, up from 20% in 2012.

Against this backdrop, it is no surprise that investor needs and expectations concerning ESG ratings have also evolved. In our view, this evolution has followed an S-curve that has passed through three distinct stages, as shown in Figure 2.

**Figure 2: The evolution of ESG ratings**

The Rating 1.i phase was about interpreting company disclosures

The first phase of ESG ratings, Rating 1.i, roughly took place from the early 2000s to early 2010s. The primary focus of rating products in this phase was interpreting company disclosures. As a rule, ratings did not differentiate between industry-specific issues or apply industry-specific weighting schemes but instead were based on a generic multi-stakeholder perspective.

In the Rating 2.i phase, which roughly corresponds to the period from the early 2010s to today, rating approaches moved up the curve significantly. Investor demand for more sophisticated integration tools increased, company disclosures became more detailed and prevalent, and the market started to put more emphasis on the concept of materiality. Ratings in this phase began...
differentiating company assessments based on the industry-specific relevance of issues and using new metrics to evaluate sustainable governance practices. What continued to dominate, however, was the multi-stakeholder perspective.

**Rating 3.0 – The ESG Risk Rating**

With its clear focus on financial materiality, replacing the vague multi-stakeholder view of previous generations’ rating models, our ESG Risk Rating makes a big leap into the next phase of this evolution – Rating 3.

**Key features**

The ESG Risk Rating introduces several new and innovative concepts, including exposure, unmanaged risk and ESG issue betas. These ideas come together to produce more comprehensive and more investor-relevant insights. The rating also has a clear focus on financial materiality: it measures the degree to which a company’s enterprise value is exposed to material ESG issues. Although previous ratings recognized the importance of industry-specific topics, the ESG Risk Rating goes a step further by reflecting the relevance of each ESG issue in the unique context of each company within its subindustry. The rating’s absolute risk scores allow, for the first time, cross-sectoral ESG risk analysis. And whereas Ratings 1.

**Figure 3: Key features of the ESG Risk Rating**

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innovation</td>
<td>The ESG Risk Rating introduces several new concepts, including exposure, unmanaged risk and ESG issue beta.</td>
</tr>
<tr>
<td>Materiality</td>
<td>Focus on financially material ESG issues makes the rating more pronounced and meaningful.</td>
</tr>
<tr>
<td>Granularity</td>
<td>Model-specification on the subindustry level sets the basis for a more granular and insightful rating signal.</td>
</tr>
<tr>
<td>Comparability</td>
<td>Absolute risk scores allow for comparative risk analysis across subindustries, while still supporting best-in-class approaches.</td>
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<tr>
<td>Dynamic weighting</td>
<td>As a company’s exposure to an ESG issue changes over time, so, too, does the weight assigned to that issue.</td>
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</tbody>
</table>

*Source: Sustainalytics*

**Multiple applications in investment decision-making**

Our ESG Risk Rating can be used by investors in multiple ways. It allows for much better integration of ESG risk related information into fundamental company analyses and security selection processes. With its focus on risk and financial materiality, it speaks to the needs of equity and fixed-income investors alike. Investors focused on ESG impact will find value in our assessment of the financial materiality of ESG issues for their company engagement processes. And last, but not least, screening-oriented investors in particular will appreciate the cross-sectoral comparability of rating outcomes.
Improving portfolio performance – promising early results

We expect that many of our clients will be interested in the portfolio application of the rating, and many are likely to question the extent to which the ESG Risk Rating can be reasonably expected to boost risk-adjusted returns. To support our clients with this research question, we recently tested a wide spectrum of investment strategies using our new rating methodology. We ran 96 absolute, momentum and best-in-class strategies on eight ESG issues across three regions (North America, Europe and Asia-Pacific). The strategies covered 102 months (January 2010 to June 2018) and were benchmarked using the so-called “Carhart multifactor model”.

The results are promising. The abnormal returns of a selection of our best performing strategies, shown in Figure 4, vary between 4.1% and 13.2% per annum, which is economically highly material. Overall, 41 of the 96 tested investment strategies yielded statistically significant alpha, spanning from 2.2% to the already shown 13.2% per annum.

* Grey columns: statistically significant at 1% level; gold columns: 5% level; teal columns: 10% level; ABS: portfolios based on score comparisons across all sectors; BIC: best-in-class score comparisons; MOM: momentum strategies (based on annual changes of unmanaged risk scores on respective material ESG issue)

Figure 4: Selection of our best performing investment strategies based on the ESG Risk Rating, 2010-18, Carhart-model based alphas in % p.a.*

Conclusion – a new era in ESG ratings

With the release of Sustainalytics’ ESG Risk Ratings, we have moved into the third phase in the evolution of corporate ESG ratings. The rating is built on core features, including financial materiality, granularity and comparability, and we foresee numerous applications for our clients in the context of investment decision-making. Based on our early testing, which yielded 41 strategies with statistically significant alpha up to 13.2% per annum, we are confident that the ESG Risk Rating can provide signals to investors that will allow them to structurally improve the risk and return profiles of their portfolios.
About Sustainalytics

Sustainalytics is a leading independent ESG and corporate governance research, ratings and analytics firm that supports investors around the world with the development and implementation of responsible investment strategies. For over 25 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Sustainalytics works with hundreds of the world’s leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes. With 13 offices globally, Sustainalytics has more than 390 staff members, including over 180 analysts with varied multidisciplinary expertise across more than 40 sectors. Over the last three consecutive years, investors named Sustainalytics among the top three firms for both ESG and corporate governance research in the Independent Research in Responsible Investment Survey. For more information, visit www.sustainalytics.com.

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