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PURCELL COMMUNICATIONS

Context Is King – Why ESG Investors Need a Better Story

Over the last year, we've been immersing ourselves in the compelling but sometimes confounding world of ESG investing. We've tackled the first of three communication challenges for the industry – Murky Terminology – and we think there's been progress there, as firms are increasingly using "ESG" or "sustainable investing" as a standard (despite some ongoing complaints).

The next challenge is context – specifically, how to explain "impact" in an information setting that is rapidly evolving. Individual and institutional investors alike are hamstrung by still-developing standards, data, definitions, and structures. The sheer volume of ESG reporting isn't helping; in fact, it seems to contribute to the confusion.

Of course, blurry information can also breed skepticism (an issue we will return to in our final paper about perception). But confusion and skepticism are issues that effective communications are designed to solve. We are keeping track of the many attempts and approaches to putting ESG information in a clear context, and we can point out some best practices.

CONCLUSIONS

- ESG data is not now, and may not be soon, reliable enough to stand on its own.
- Asset managers and advisors demonstrate leadership when they tell a coherent story about what they are trying to achieve and how.
- The better you are at explaining the context around ESG data, the more sustainable value you provide to your clients, and the more confidence they will have in you.

Tackling the Communications Challenges of Values-Based Investing — A Series

Murky Terminology | **Evolving Context** | Stubborn Perception

This is the second in a series of three reports we are creating, looking at the three biggest communications challenges for values-based investing.

To receive more reports like this one, email us at admin@purcellcom.com.

THE DATA PROBLEM

The investment industry is knocking itself out to generate better, more consistent, and more standardized ESG data. The effort is interesting, and fun to keep track of. What it's not – yet – is helpful.

ESG data is riddled with different perspectives about what's important or how goals should be measured. Recent studies have uncovered some unsettling truths about the challenges this presents:

> *"As a stakeholder, you can't be comfortable with [ESG data] quality. If we compare this to financial reporting, for example, we need to go back around 100 years to find the same level of maturity."*
>
> *– Sara Bernow, McKinsey*

Truth #1: The data being provided by companies is inconsistent.

Earlier this year, the U.S. Government Accountability Office found "limitations" in ESG disclosures and "differences in methods" that make cross-company comparisons difficult.

Truth #2: ESG rating agencies can't agree on what's "good."

MIT looked at six ESG rating agencies and found that correlation among them was on average 0.61. By comparison, credit ratings from Moody's and Standard & Poor's are correlated at 0.99.

Truth #3: Having more data makes it harder to evaluate a company's social impact.

Harvard Business Review reports that the more ESG data a given company reports, the wider the variability in the ESG scores it receives.

These truths are not minor. They reveal systematic challenges for ESG data analytics.

If we accept that ESG data is problematic – and we do – then the investment industry is left with a choice. **Option 1** is to make the most of existing data, on the assumption that problems will be resolved quickly. Major players like Blackrock want that to be the case, and it's understandable – data sophistication is critical to the stars, bars, and ranking systems used by investors of all stripes.

But some of this thinking is, frankly, wishful. Traditional financial accounting standards took more than a century to evolve. FASB – the Financial Accounting Standards Board – has a 37-year head start on SASB – the Sustainability Accounting Standards Board. In truth, the more we look, the more we believe that pursuing a perfect set of data standards may be a fool's errand.

And that brings us to **Option 2** – communicate in a way that acknowledges and addresses the data problem.

TELLING A BETTER STORY

Without clear, standardized data, how can asset managers communicate about the non-financial impact of their ESG portfolios? To date, many have simply punted on this challenge. According to research by the Deloitte Center for Financial Services, "only 44 percent of managers share ESG data with institutional clients and even less (30 percent) do so with retail clients."

> *"Investors ignore the limitations of today's ESG data at their own peril. We believe placing ESG data in context is key to making sound investment choices."*
>
> *– Generation Investment Management, The Future of ESG Data*

If professionals are struggling to use or report data, how can clients make sense of it? Spoiler alert – they can't. We've read hundreds of ESG communications, including commentaries, prospectuses, marketing materials, and research, and we've found that:

- Investor suitability is almost never directly addressed.
- Data sources and their inherent biases are rarely explained with rigor.
- Proprietary approaches are not explained in transparent ways.
- There is insufficient discussion about ESG decision-making.

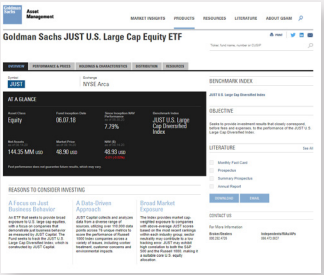
This is a tremendous challenge – and also a tremendous opportunity for those who get it right. Let's take a look at a couple of approaches that we think are on the mark.

SOLUTIONS

It turns out that getting it right is not as hard as it sounds – but it is counterintuitive to our industry. The answer lies in bridging the gaps with clear stories that provide transparency where the data does not.

Solution 1: One effective approach is to *tell the story of your ESG data*. Why did you choose it? What does it represent? How do you use it? This example, from a report for the Goldman Sachs JUST US Large-Cap Equity ETF, answers those questions in three quick paragraphs that appear in every quarterly report (see **Figure 1**).

Figure 1: Reasons to Consider Investing from Goldman Sachs JUST US Large-Cap Equity ETF Report



REASONS TO CONSIDER INVESTING

A Focus on Just Business Behavior

An ETF that seeks to provide broad exposure to U.S. large cap equities, with a focus on companies that demonstrate just business behavior as measured by JUST Capital. The Fund seeks to track the JUST U.S. Large Cap Diversified Index, which is constructed by JUST Capital.

A Data-Driven Approach

JUST Capital collects and analyzes data from a diverse range of sources, utilizing over 110,000 data points across 76 unique metrics to score the performance of Russell 1000 Index companies across a variety of issues, including worker treatment, customer concerns and environmental impacts.

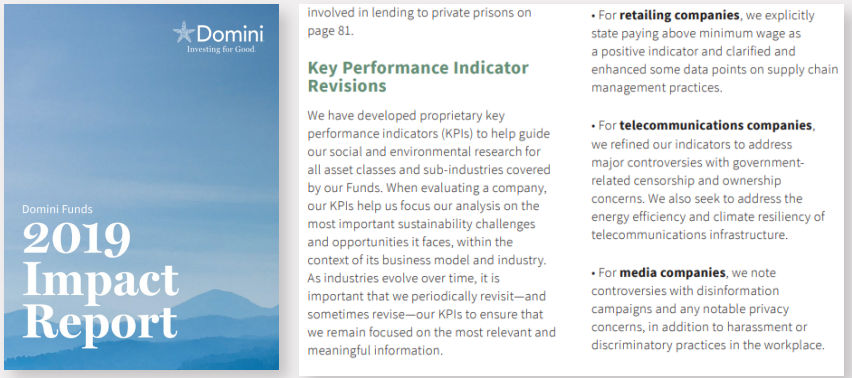
Broad Market Exposure

The Index provides market cap-weighted exposure to companies with above-average JUST scores based on the most recent rankings within each industry group; sector neutrality may contribute to a low tracking error. JUST may exhibit high correlation to both the S&P 500 and the Russell 1000, making it a suitable core U.S. equity allocation.

Source: Goldman Sachs JUST US Large-Cap Equity ETF

A slightly different example comes from the Domini 2019 Impact Report. In this case, the data being used is proprietary, and the sources aren't discussed. But rather than leave investors with a black box that makes it impossible to assess the suitability of the portfolio, they talk in detail about what they are looking for in the data, what they are learning, and how they are updating their approach (see **Figure 2**).

Figure 2: Key Performance Indicator Revisions from Domini 2019 Impact Report



involved in lending to private prisons on page 81.

Key Performance Indicator Revisions

We have developed proprietary key performance indicators (KPIs) to help guide our social and environmental research for all asset classes and sub-industries covered by our Funds. When evaluating a company, our KPIs help us focus our analysis on the most important sustainability challenges and opportunities it faces, within the context of its business model and industry. As industries evolve over time, it is important that we periodically revisit—and sometimes revise—our KPIs to ensure that we remain focused on the most relevant and meaningful information.

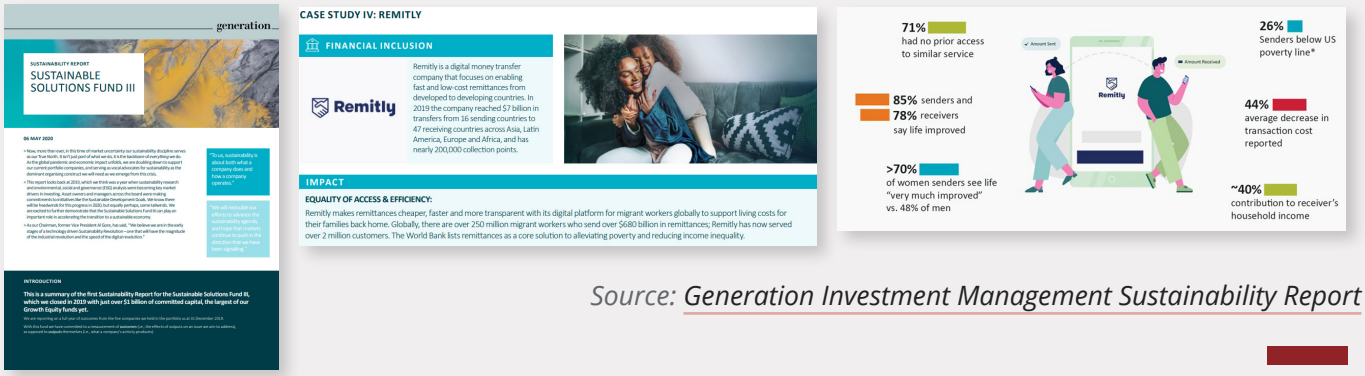
- For **retailing companies**, we explicitly state paying above minimum wage as a positive indicator and clarified and enhanced some data points on supply chain management practices.
- For **telecommunications companies**, we refined our indicators to address major controversies with government-related censorship and ownership concerns. We also seek to address the energy efficiency and climate resiliency of telecommunications infrastructure.
- For **media companies**, we note controversies with disinformation campaigns and any notable privacy concerns, in addition to harassment or discriminatory practices in the workplace.

Source: Domini 2019 Impact Report

Solution 2: *Create case studies of key portfolio holdings.* Case stories show your thinking and your actions. In that way, they allow investors to gauge how suitable your strategy is to their personal values. Most major ESG investors use case studies in some way, and there are lots of ways to approach them.

Our favorites combine ESG metrics with stories of specific company activities that produce tangible benefits for a key stakeholder group. Generation Investment Management's annual Sustainability Report does this job very effectively, and supplements the stories with video statements from the companies themselves. Any investor reviewing these reports walks away with a very clear picture of what ESG impact they are contributing to with their investment (see **Figure 3**).

Figure 3: Remitly Case Study from Generation Investment Management Sustainability Report



Source: Generation Investment Management Sustainability Report

We also appreciate case studies that combine financial information with ESG content, so investors understand both the social impact and the impact on their financial goals. T. Rowe Price's annual ESG Report does this well by explaining the investment case from both a financial and an ESG perspective (see **Figure 4**).

Figure 4: AIA Group – A Strong Focus on Responsible Investment Reduces Potential Exposure to Downside Risks from T.Rowe Price Annual ESG Report

Source: T.Rowe Price Annual ESG Report

This kind of storytelling is unusual in financial communications, especially in the institutional space. But for now, and for some time to come, it paints a better and more accurate picture than ESG data can alone. It facilitates investor decision-making and, importantly, makes it easier for those investors to explain their decisions to their own stakeholders.

And did we mention…? Portfolio reporting that does not provide adequate context invites both skepticism and criticism.

TRUST IS THE BIG PICTURE

There are a lot of things that are different about ESG investing compared with traditional investing. But one thing remains constant: The issue is trust.

- ESG investors want to contribute to a better future, and they want to trust that their advisors and asset managers are similarly motivated.
- ESG investors want to provide their financial support to firms that share their values, and they want to trust that asset managers know how to identify those companies – and are working to learn how to do it better.
- ESG investors want to believe they are part of the solution. Asset managers and advisors who give them those stories close the loop and cement the trust relationship.

The irony is that the very stories that clients are looking for from the investment industry are the same stories that the investment industry is looking for from the companies they invest in. Corporate ESG reports do a lot of storytelling because they know that proper storytelling – about your motivations, your data, and your activities – is an effective way to build credibility.

> *"For an investment manager to capture a greater share of growth in assets under management, credibility with investors will likely be critical … Having sustainable products on the shelf might be a necessary first step, but long-term success will likely reside in the ability to demonstrate to investors that the firm has holistically adopted sustainable practices."*
>
> *– Deloitte Center for Financial Services*

CONCLUSION

We are heartened by change in this industry, and the degree to which investors are communicating on ESG themes. However, people aren't communicating well enough now to fully win the battle of perception – a subject we'll return to in **Part 3** of this series.

In the meantime, we'd like to hear more from you about the challenges you face in ESG reporting. Please send your thoughts, questions, and examples to admin@purcellcom.com.