HARDING LOEVNER

THE TROUBLE WITH ESG RATING PROVIDERS

Excerpted from the International Small Companies Third Quarter 2020 Report

After the giant German payments processor Wirecard admitted to accounting fraud involving fictitious cash and profits and declared bankruptcy in June, *The Financial Times* ran an article looking back at third-party assessments of the company's environmental, social, and governance (ESG) practices.[1] ESG screening is increasingly seen as, among other things, a way for investors to avoid malefactors, so the *FT* wanted to see how well the ESG rating systems had worked. The results, as the article stated, were "underwhelming." Before its collapse, Wirecard had earned median-grade ESG ratings from MSCI and Sustainalytics, the two most prominent and widely used ratings services, and fell in similar mid-tier or neutral ESG categories in rankings from other services. As a middle-of-the-pack company in ESG terms, Wirecard was held in some ESG-focused passively managed exchange traded funds, including big funds managed by Blackrock and Vanguard.

As the article noted, there were a few prescient outliers that had deliberately avoided Wirecard on governance grounds. At Harding Loevner, though we don't put our strategies forward as "ESG focused," we integrate ESG factors into our fundamental assessment and valuation of every company that we consider for investment. It's notable that we covered Wirecard until 2016, when we expelled it from our pool of companies qualified for investment because it no longer met our "management quality," i.e., governance, criteria. The analyst who made the judgement to remove it cited his growing unease regarding the company's financial disclosure (including the opacity around its cash flow accounting), its failure to explain clearly the logic of a series of acquisitions, and prior (unproven) public accusations of fraud. Each of these concerns were surfaced in our checklist for identifying corporate governance weaknesses that our analysts complete for each of their covered companies.

As a cautionary tale about the limitations of ESG ratings, the surprising downfall of this once-$13 billion market cap company is arguably even more relevant to investors in companies with smaller capitalizations. With thousands of companies under coverage, ratings providers like MSCI are inherently limited in how deeply they can assess ESG risks of firms. MSCI relies on a combination of company reporting, macro-level data, other publicly available information, and (as it acknowledges in its ratings disclosures) uneven levels of engagement between its analysts and company managements. Because small companies tend to be more resource-constrained than large companies, their reporting tends to be more limited and their one-on-one engagement with ESG ratings providers can be more infrequent. These firms are also less well-covered by brokers' research departments and the media, further restricting the publicly available information on them. In a sign of the limited interest in ESG assessments of the smallest companies given the costs involved in rating them, 22% of all companies in MSCI's own small cap global index have no ESG rating from MSCI whatsoever, compared to just 1% in its large cap global. When comparing by market weight instead of by company numbers, the lack of small cap coverage is lower, only 8%. This indicates that MSCI is prioritizing covering larger companies within its small cap indexes.

MSCI provides a multitude of ESG metrics including controversy scores on specific issues, as well as ratings that look separately at individual companies' exposure to and mitigation of E, S, and G risks compared to what it sees as best practices. Its most-commonly used ratings (the ones typically relied on by ESG passive investment vehicles), however, are "letter" ratings that combine all ESG criteria into one grade, from AAA (high resilience) to CCC (low resilience). To tabulate these ratings, MSCI uses criteria it identifies as being relevant to each industry, basing the ratings on how each company performs *relative only to other companies in that same industry*. On this basis, a petroleum or mining company has as good a chance of outshining, in ESG terms, other companies in its comparative group as a company in any other industry does, even if that recognition does not equate to its having "low" ESG-related risk in any broader or intuitive sense.

As fundamental, bottom up investors, we have never outsourced judgement on risks, ESG or otherwise. While we use MSCI's and data from other external providers to inform our decision-making, we do our own scoring. Moreover, because our ESG scores are assessed against all other companies, not limited to companies in their industry, we let the chips fall where they may. Each analyst is responsible for identifying and assessing the material ESG-related risks or opportunities facing each of the companies that they cover. Companies are assessed across three dozen criteria, including such factors as impact from environmental regulation, water consumption that could face scarcity costs, human capital management, and supply chains. Analysts incorporate these factors into the assumptions of their financial models for companies, including cash flow projections. A low score, for example, will degrade projected cash flows and, all else being equal, reduce the amount we are willing to pay for a business.

The long investment horizon over which we assess our companies means we are focused on all risks to the sustainability of the comparative advantages that allow them to achieve high profitability and long-term growth, which include risks stemming from environmental, social, and governance factors. In the process of identifying the merits of a business, our analysts weed out companies that have elevated ESG-related risks, and they flag the material ESG-related risks of companies that *do* meet our investment criteria to ensure we monitor them closely.

[1] "Anatomy of a Scandal: Wirecard Tests ESG," Financial Times Moral Money (July 1, 2020).

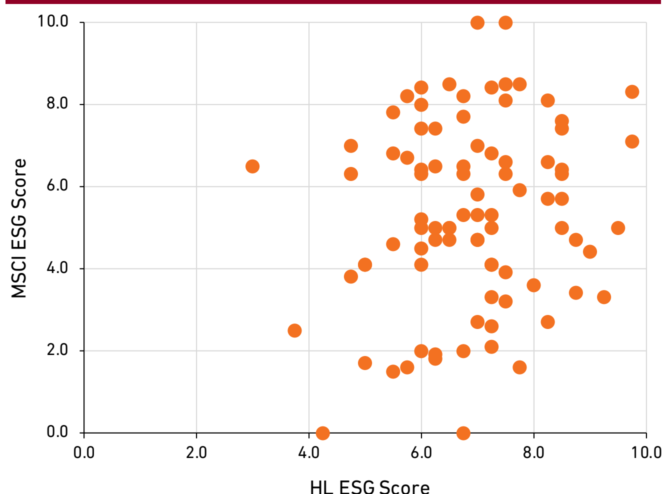
None of which is to say our companies necessarily earn high marks from external ESG ratings agencies, like MSCI. To the contrary, we have found that the correlation between our assessments of companies' resilience to ESG-related risks and MSCI's grades is low, and that is particularly true for small caps. The following chart shows a breakdown of our portfolio holdings ranked by their scores on our internal ESG scoring system (a score of 10 is equivalent to MSCI's rating of AAA, or highly resilient to ESG-related risks) vs. a numerical representation of MSCI's letter grades. Of the roughly 90% of our companies that we score well, i.e., greater than 5.5, only about 40% earn a similar favorable grade from MSCI, and slightly more are arrayed at the opposite end. We should note that over 15% of our holdings lack an ESG rating from MSCI and thus don't appear in the chart.

We are not trying to build portfolios with superior third-party ESG ratings. Rather, we are trying to build portfolios with favorable risk and return characteristics. To that end our analysts and portfolio managers pay close attention to ESG risks because these factors can contribute profoundly to the success or failure of our investments. External ESG ratings are for us an input, a useful reference point. An external rating that differs from our own may signal an asymmetry between our deep fundamental knowledge of the company and the rater's unavoidably superficial and possibly distorted knowledge. Such asymmetries can be important contributors to our opportunity to generate alpha in small caps. Favorable ESG ratings are attractive to investors with explicit ESG mandates. If flows into explicitly ESG-focused products continue to grow, the valuation premium for companies with appealing ESG profiles should widen. But higher valuations not associated with sustained superior profitability lead to lower long-term returns. To the extent that poorly- or non-MSCI-rated firms slip under the radar of ESG-focused funds, our ability to uncover high-quality growing companies with low ESG risks before they are endorsed by the ratings providers is potentially a way, then, for us to purchase them at a better price.

An example of a high-ESG-scoring company on *our* radar is **Vaisala**, based in Finland. The company was founded 84 years ago by Professor Vilho Vaisala, among the first developers of the radiosonde, a package of sensors sent aloft, typically by balloon, to measure pressure, temperature, wind, humidity, and other atmospheric variables. While routine weather forecasting remains an important part of its business, the company has leveraged its monitoring capabilities to expand into more specialized, and more profitable, applications such as supporting renewable energy producers, who need accurate wind and solar radiation data to forecast their power production. Assessing air quality, especially in large emerging markets like China and India, is another growing market. With these environmentally related areas of emphasis, Vaisala is clearly aligned with trends likely to persist for some time. The company does present ESG-related concerns, however, pertaining to governance as it is still controlled by its founding family, has separate controlling and minority classes of shares, and few independent board directors. Our engagement with management over the years has helped us gain comfort that the interests of the controlling family are well aligned with those of minority shareholders. Vaisala has no ESG rating from MSCI (unsurprisingly, since it's not even in the MSCI Small Cap Index), but our view is that this is a highly sustainable business. We are more than happy to see its earnings, and our reasonably-valued investment in them, compound until such time as the market comes around to our view.

Another company that scores well in ESG-related terms is **YouGov**, a UK-based market research firm. Its proprietary database allows the company to undertake fast, large-scale data analysis on behalf of its customers and develop innovative new services. While it is clear that its environmental and governance risks are limited, a material social risk is directly tied to its business model. As reflected in recent landmark legislation in Europe and California, increased regulatory attention is being paid to data privacy, in an effort to ensure that people have control over data about them. Indeed, one of YouGov's biggest growth avenues is helping advertisers compensate for the loss of real-time consumer data resulting from Google's and Apple's phase-outs of tracking cookies. But YouGov's own services rely on insights gleaned online from over 8 million panelists in more than 40 countries—each one of whom has the right to the privacy of the data he or she helps to generate. To manage this exposure, the company has introduced a new feature utilizing blockchain technology to give panelists greater control over which of their data is being used and how. This company is another where we have no MSCI report against which to compare our assessment of the risks, which we must weigh against the prospective long-term returns.

HL ESG SCORES VS. MSCI ESG SCORES FOR HL GLOBAL SMALL COMPANIES MODEL



Source: MSCI Inc., Harding Loevner. As of September 30, 2020.

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