Investment Note **16 July 2019**

Hermes: Industry ESG scores for small and mid-cap companies can be misleading

As the integration of ESG factors into investment decision-making becomes increasingly mainstream, over-reliance on simple answers and third-party industry data, rather than assessing complexities and directly engaging with companies, could lead to smaller companies being unfairly penalised by investors on the basis of partially informed ESG criteria. Given the scarcity of clear disclosures from small and mid-cap (SMID) companies versus large cap peers, ***Hamish Galpin, Lead Manager of the Hermes SDG Engagement Equity Fund at Hermes Investment Management****, explains why reliance on data can give rise to a misleading picture of smaller companies' ESG credentials.*

The disparity between larger and smaller companies' disclosure of basic ESG metrics is striking and even in developed markets, ESG disclosure levels can be very patchy. These large gaps demonstrate the need to gain further sources of ESG information, and more importantly, to meet with corporate boards and management teams to develop a fuller picture of a company's governance and management of important environmental and social risks.

ESG disclosures: consistently inconsistent

The lack of readily available ESG information in the SMID segment means that proactive engagement with company boards is required to generate profitable insights. Investors are unlikely to find such information from off the shelf tools, i.e. published databases, given the lack of disclosure. Furthermore, the information found on databases is by definition, historic, which compromises ratings derived from that data. ESG ratings can certainly raise red flags about major issues within companies, but in aggregate, the scores have some clear shortcomings.

Given the need to create scale, off-the-shelf ratings are often constructed without analysts forming a fundamental understanding of businesses or specialist industries. This can result in ESG ratings missing genuinely material factors influencing the performance of companies or taking a kitchen-sink approach and combining the meaningful with the trivial to form a confusing array of data points.

Imperfect picture: why ratings distort ESG optics

Integrating ESG thoroughly into an investment process requires managers to sift through a wide variety of corporate disclosures as well as alternative data sources and in so doing consider a raft of issues, supply chain practices, resource usage and workforce management issues among them. Where it is available, investors should ideally consider ESG information alongside traditional fundamental analysis, with more detail on sustainability issues to be derived through direct contact with management. This latter process requires a rigorous approach aligning and integrating a range of variables, which is not easily outsourced to third parties.

Researchers have identified **four key failings of ESG ratings**, which are amplified when applied to smaller companies:

- **Market-cap bias** – companies with more communication resources tend to score better
- **Disclosure/geographic bias** – national regulatory disclosure requirements drive scores, and scores reward disclosure (not necessarily performance)
- **Industry bias** – ratings do not discern between very different business models in the same industry, with more mature and regulated industries generally scoring higher
- **Reactivity** – ratings are dragged down for an extended period of time following a controversy, despite the high likelihood that the companies responsible have consequently implemented changes that could improve their performance relative to peers.

To illustrate the clear water between ratings-driven decisions and in-depth ESG investment analysis, we look at holding, Brunswick Corp, which would likely be less favoured if we relied solely on ESG scores from third-party research houses.

Brunswick is a US marine engine and boat manufacturer. Despite having a below average ESG rating, we believe that it is a high-quality company:

- While previously lagging in best practice, Brunswick has improved aspects of its corporate governance, including declassifying its board to ensure all directors faced election each year
- Manufacturing facilities are cutting-edge in terms of energy usage, air quality and waste reduction – indeed its principal Fond du Lac facility in Wisconsin has been winning sustainability awards since 2014
- The company has a strong culture evidenced by very low employee turnover as well as high referral rates and a high proportion of female employees.

Historically, the firm's ESG disclosures at a group level have been limited. While its engine business produces a good sustainability report, it had not been well promoted or replicated at a group level. However, the company has been consistently open to our engagement on ESG topics and has committed to expanding its sustainability strategy and reporting across the group. As disclosures improve, we expect the ESG rating of Brunswick to rise, although it will inherently continue to lag the reality on the ground. This case demonstrates the need for credible and meaningful ESG analysis and investors that are committed to this, cannot and should not, depend on ESG ratings.