CHAPTER 3

TRANSLATING INVESTMENTS INTO ESG SCORES

> **Greenwashing poses a risk to investors and could be detrimental to the asset management industry's credibility... we strongly support regulatory initiatives to set consistent standards and increase transparency for sustainable portfolios.**
>
> BlackRock

Navigating Conflicting Ratings

Translating ESG Investments into Higher Scores

A major source of frustration is how each ESG scoring system—from Refinitiv to Bloomberg, from Fitch to RepRisk—produces vastly different results. In the pharmaceutical sector, by way of example, the two most widely-used ESG scoring formulas use vastly different weighting systems: one draws 50% of its score from governance issues and only 9% from environmental issues whereas the other weighs them at 31% and 22% respectively. As a result, the same company can obtain vastly different scores from different systems, hampering their ability to improve those scores.

Having first mapped hundreds of ESG issues used by the eight largest scoring systems (Figure 2), we find that answering the three questions in Figure 7 provides a clear path forward to maximise scores.

Score Maximizing Follows Investments, Not the Other Way Around

Of course, for score maximising to be successful, companies must first make meaningful investments. The strategies in Figure 7 rely on a strong set of investments to back them up. Companies that let scores drive strategy are often those accused of greenwashing, and the eventual loss of credibility almost always outweighs temporary benefits of this practice. Furthermore, re-establishing credibility can be an extremely difficult and expensive task; it is therefore imperative to look beyond the next quarterly report when assessing ESG strategies and risks.

◄ **Figure 7. Three Questions to Maximise Scores.** Implementing ESG strategies can at times feel like playing roulette, reliant on and reacting to circumstances outside one's control. We find a more precise analogy to be blackjack, where quantitative strategies can improve a company's odds over the long term.

Determining Appropriate Transparency

Case Study

The Problem

To continue the case study from above (Figure 3), the Fortune 100 company had been making a strategic decision to not disclose any quantifiable data around Issue "C" in their public reports because doing so would erode a competitive advantage. However, this non-disclosure appeared to adversely affect their ESG score, so the company asked TACTIX to examine their ESG strategy.

The Outcome

We first validated that policymakers' ESG-linked perception of the company was strongly favourable (0.89) and significantly above competitors. The company could therefore conclude its current ESG investments were achieving the desired effect on one important audience. Second, the company was then able to communicate this research to an institutional investor concerned about ESG, addressing the needs of a second important audience.

Finally, in-depth analysis revealed an alternative path forward; we identified a selection of other disclosures that, when enhanced, would have a large positive impact on the company's ESG score. This allowed the company to keep Issue "C" confidential. We worked with the company to choose a subset of those disclosures and achieved a meaningful increase in their ESG score without eroding their competitive edge.

▶ **Figure 8. When Scoring Zero is not Harmful.** By identifying where greater disclosure is advantageous—and where it is not—companies can prioritize disclosures that align with the business needs and the needs of stakeholders.

	Issue A Environmental	**Issue B** Social	**Issue C** Social	**Issue D** Governance	**Issue E** Governance
Importance to Policymakers[1]	13 / 100	68 / 100	74 / 100	92 / 100	52 / 100
S&P ESG Score[2]	95 / 100	29 / 100	0 / 100	14 / 100	30 / 100
Level of Investments[3]	High	Very High	Very High	Moderate	Very Low
Policymakers' Perceptions of the Company[4]	0.86	0.71	0.89	0.57	0.60
Policymakers' Perceptions of the Competitors[4]	0.61	0.81	0.72	0.70	0.79

Very Strong Very Weak

1. Using TACTIX' 2-axis framework in Figure 1, how important is each issue to policymakers in this jurisdiction?
2. Company's ESG score on each issue according to S&P Global
3. Company's relative level of investment to each ESG issue
4. 0 = imminent adverse action; 1 = flawless reputation

Data Source: TACTIX Global Risk Communications 2021

> The best champions for any sector will be trade associations that take active leadership on ESG issues.

Avoiding Exclusionary Actions

Keeping up with Moving Goalposts

Building an integrated ESG strategy is like building a championship team, but with a host of additional challenges. Not only do the 'rules' change at the end of every season, but each referee interprets them slightly differently. In addition, four times per year the owners ask management for detailed reports on every one of their players and may force management to change the roster at a moment's notice. Suffice it to say, building a championship team under these conditions is a trying task.

Not Being the Slowest Gazelle

However, unlike the sports team analogy, ESG strategies are not always about winning the championship. While a handful of companies in each sector will gain a competitive advantage from their ESG positions, for others, the old wisdom applies – you do not need to be the fastest gazelle, you just cannot be the slowest. Two considerations come to mind:

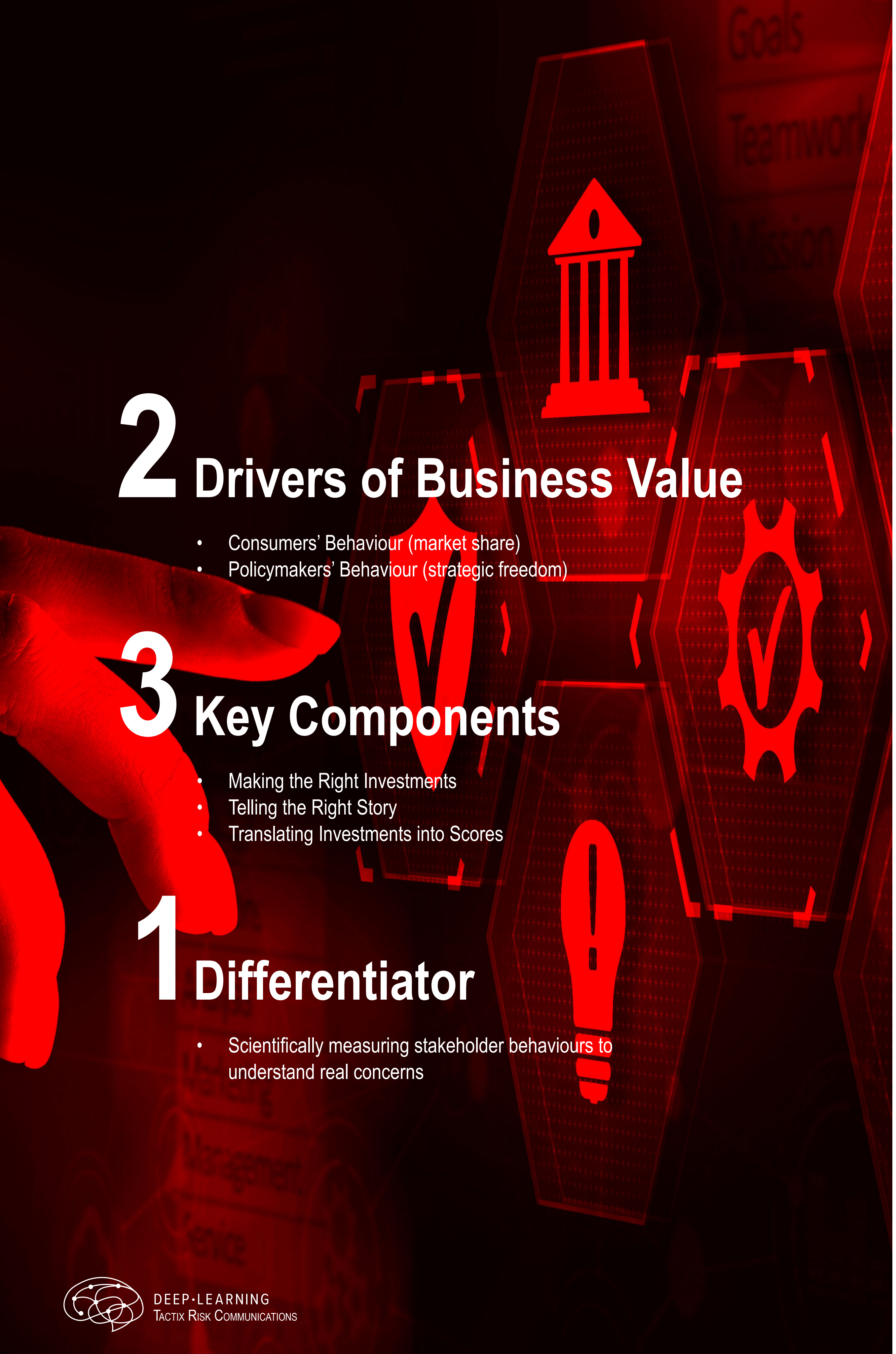
- First, companies must ensure they do not trail all direct competitors. Most companies find this kind of rivalry is intuitive and relatively easy to act on
- Second, companies must work to prevent their entire industry sector from falling too far behind others. Investors have traditionally built exclusionary lists from a narrow group of sectors (e.g., nuclear power), but these lists are growing (see Figure 9). In addition, reporting standards are identifying a growing list of technologies (e.g., both SASB and GRI identify crop protection tools as problematic)

Preventing the entire sector from becoming an ESG black sheep requires a degree of collaboration that can be very difficult in some industries with a high degree of rivalry. This means that as ESG scores become ever more important, the best champions for any sector will be trade associations that take active leadership on ESG issues.

▶ **Figure 9. Setting Realistic Objectives.** The list of exclusionary issues is growing, and companies need to ensure they are not swept up in it. Trade associations can play a key role in promoting the strong ESG position of the sector so long as it is done in a rigorous, data-backed way.

	Calvert Equity	Handelsbanken Hallbar Energi	iShares ESG Aware MSCI EM	iShares ESG Aware MSCI USA	iShares Global Clean Energy	iShares MSCI USA SRI	KLP AksjeGlobal Indeks	Nordea 1 - Global Climate and Env't	Nordea 1 - Emerging Stars Equity	Northern Trust World Custom ESG	Parnassus Core Equity	Parnassus Mid Cap	Pictet - Global Environmental Opp	Pictet - Water	Putnam Sustainable Leaders	Stewart Investors APAC Leader Sust	TIAA-CREF Social Choice Equity	Vanguard FTSE Social Index	Vontobel mtx Sust EM Leaders
Adult Entertainment						■												■	
Alcohol	■	■				■	■				■	■		■				■	
Biocides										■									
Civilian Firearms	■		■	■		■													
Conventional Weapons	■	■				■	■	■	■	■	■	■		■				■	■
Gambling	■	■				■	■				■	■		■		■		■	
GMO	■					■													
Nuclear Power	■					■		■	■		■	■						■	
Nuclear Weapons			■	■		■	■	■	■	■				■				■	■
Tobacco	■	■	■	■		■	■	■	■	■	■	■		■		■		■	■
Global Social Norms		■				■				■									
Thermal Coal		■		■		■	■	■	■		■	■		■		■			■

Data Source: MSCI ESG Research LLP as of December 31, 2020



2 Drivers of Business Value

- Consumers' Behaviour (market share)
- Policymakers' Behaviour (strategic freedom)

3 Key Components

- Making the Right Investments
- Telling the Right Story
- Translating Investments into Scores

1 Differentiator

- Scientifically measuring stakeholder behaviours to understand real concerns

Conclusion

Drivers of Business Value

Managing environmental, social, and governance (ESG) issues has made its way from the fringe to the C-suite, and from impact investors to institutional investors. And with good reason. Failing to make ESG a part of decision-making puts market share at risk (as consumers' expectations of companies grow) and risks costly regulatory intervention (as policymakers ratchet up restrictions). Despite the many different stakeholders in this space, these two—consumers and policymakers—have the strongest ability to translate a company's ESG decisions into business value.

Key Components

We have found that the strongest ESG strategies involve three components: **Making the right investments** based on what drives the behaviours of consumers and policymakers; **Telling the right story** in a way that both provides a competitive edge and does not alienate reluctant stakeholders; and **Translating investments into scores** by finding high-impact metrics that matter to key audiences.

Differentiator

But all three of these components share one thing in common: the need to be more scientific in understanding stakeholders. Companies that can quantify how their decisions will be received by consumers and policymakers are best positioned to prioritise and manage the most impactful risks.

DEEP•LEARNING

TACTIX RISK COMMUNICATIONS

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