Moving ESG investing forward

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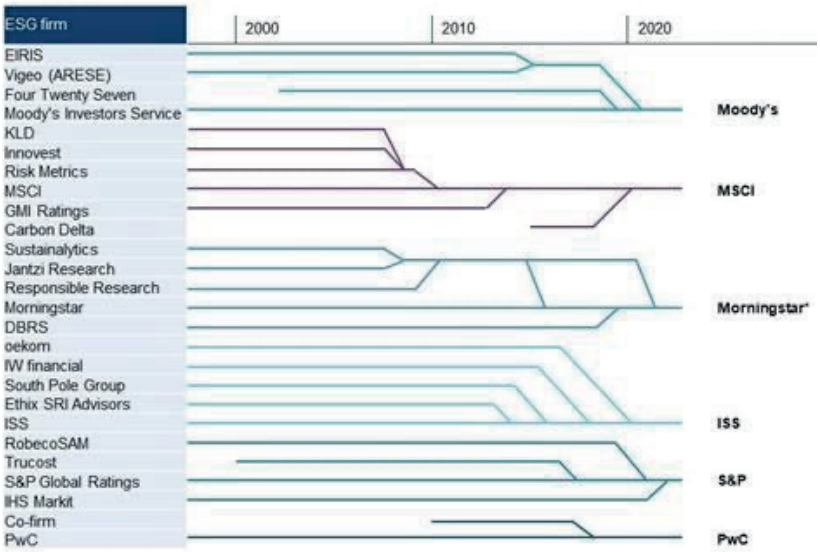
When Ivo Knoepfel coined the term "ESG investing" in his landmark 2004 UN report, "Who Cares Wins," he unleashed an almost inconceivable rise of sustainable investing. With this rapid growth in ESG has come the insatiable demand for ESG data. According to SustainAbility, an ESG consultancy, the number of ESG ratings and rankings providers has grown from about 20 in 2000 to over 600 by 2020. Even with recent market consolidation, this number has grown since then (Exhibit 1).

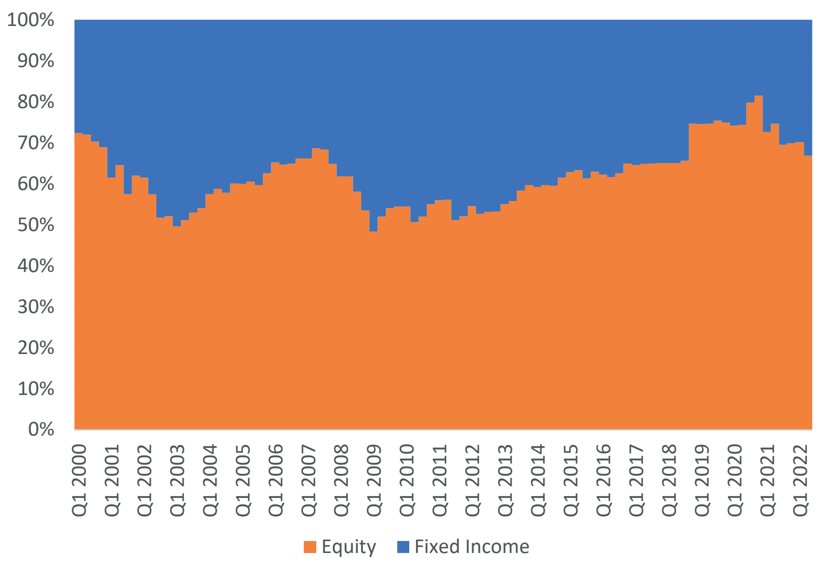
Exhibit 1: ESG provider market consolidation, 2000-2020



Source: Andreas Dimmelmeier (2020) Mergers and Acquisitions of ESG Firms: Towards a New Financial Infrastructure?; Do ESG information providers meet the needs of fixed income investors? (2021), UNPRI.

Exhibit 2: ESG fund AUM is heavily weighted towards equities

% of total net assets in sustainable funds at quarter end



Source: Morningstar
Note: Morningstar defines a strategy as a "Sustainable Investment" if it is described as focusing on sustainability; impact; or environmental, social, and governance, or ESG; factors in its prospectus or other regulatory filings

The early pioneers of ESG investing were almost exclusively equity investors. For example, net AUM in sustainable equity funds was over 2.5x higher than net AUM in sustainable fixed income funds back in 2000, a number that hasn't budged much since then (Exhibit 2). As a result, the ESG data industry grew up mainly catering to their needs.

One legacy of this origin story is that most data vendors assess companies at the holding company, rather than operating company, level. This makes sense for equity investors, as equity shares are only listed for the parent company. If a company is acquired, its shares are replaced by cash or are converted to the acquiring company's shares.

For fixed income investors, though, this isn't the case. Subsidiaries often issue their own debt, separate from the debt issued by the parent. From an ESG perspective, it makes little sense to penalise the subsidiary for the environmental performance of the parent's other subsidiaries. After all, why should we restrict capital to a pure-play hydroelectric company simply because a different subsidiary owns a thermal coal generation plant?

If the point of ESG investing is to help companies transform their business models to be more green or socially conscious, we should aim to lower the cost of capital for the parts of a business that perform well on ESG factors. The fact that green operating companies are being penalised for activities conducted by their affiliates significantly hampers fixed income investors' ability to integrate ESG risks and promote ESG impact. This is especially true for larger asset managers looking to integrate ESG at scale, as they must rely on data aggregators for many ESG needs.

The impacts of this data limitation are particularly problematic in the utility sector, where holding companies will often own numerous operating companies. In cases where operating companies are not evaluated separately, management teams are not being appropriately awarded for investing significant capital in their pure-play transmission and distribution (T&D) subsidiaries – an integral component of the transition to a lower carbon economy.

Conclusion

The bottom line is this: if we want to truly transform the ESG market at scale, there is a growing need for more nuanced data that caters towards different types of investors. In many cases, the ESG data vendors are the gatekeepers of that data.

It's easy to blame the data vendors for their issuer mapping methodology, but they too are hamstrung by the information available to them in corporate disclosures. From PGIM Fixed Income's perspective, the best way forward is to encourage issuers to report environmental and social performance data broken out across their subsidiaries.

Active managers do have a leg up as they can seek out and evaluate operating company-level information that might not be available through the data providers. PGIM Fixed Income, for example, actively engages with issuers to get this data and we are already incorporating it into our ESG impact analysis.

But this simply isn't enough. For the market to mature, this information must be publicly disclosed and available through the most widely used data platforms. This should be a win-win for both investors and issuers and is certainly a topic we will look to advance in our engagement strategy. Our hope is that issuers and data vendors see the value in this approach as well, so that together we can move ESG investing forward.

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