What is Allan Gray's view of ESG ratings and scores?

We do not make use of external environmental, social and governance (ESG) ratings or scores and make investment decisions based on our own bottom-up, fundamental investment research, which includes ESG research.

The role of ratings in the investment process

Our process involves the allocation of a company to an analyst. The analyst conducts rigorous fundamental research on the assigned company as a core focus, spending time to understand the business model, interrogate the financials and assess ESG risks. A range of external factors are also evaluated, including competitive dynamics, the level of commodity prices, potential regulatory changes and the impact of macroeconomic developments on the business.

The analyst's research culminates in an estimate of the intrinsic value of the business based on a long-term view. This forms the basis of the investment case, which is captured in a detailed report and presented to the Investment team. The team scrutinises, challenges and debates the case to ensure that the thesis is sound.

Following this robust review, each member of the Investment team submits a vote and an aggregated "buy" or "sell" status is formalised. Team members also vote on a risk rating – referred to as a "star rating" – which seeks to ensure sufficient diversification by prescribing portfolio exposure limits based on an assessment of the complete risk profile of an investment. Securities from other asset classes are assessed through similar processes.

Therefore, an ESG factor can influence both a company's "buy" rating (through its impact on the company's valuation) and its star rating (through its impact on the risk profile of the company).

To encourage careful consideration of ESG risks in deciding on the above ratings, analysts are expected to classify 1) environmental and social risk, 2) governance risk and 3) total ESG risk as "low", "medium", "high" or "uninvestable". This additional step results in the calculation of an "overall ESG risk rating" for each company based on the analysts' individual ESG risk ratings. However, the purpose of the ESG risk rating is to encourage debate, rather than to drive investment decisions.

Once a share has been voted onto our "buy list", the portfolio managers decide whether to include the share in the portfolios they manage. The "star rating" determines how much can be bought, but the ESG rating is non-restrictive.

External ratings

We do our own holistic qualitative and quantitative research which enables us to form divergent views when justified, supporting our contrarian approach to investing. As with external valuations, external ESG ratings and scores are therefore of limited use to us. We mostly rely on primary sources of ESG information when conducting research, but external sources, including information from ESG data providers and reports by sell-side brokers, may augment our internal research.

As investors grapple with making sense of a deluge of ESG information, turning to a simple, distilled score can be tempting. We caution against this approach for the reasons discussed below.

1. Reliability

We encourage greater focus on ESG risks by financiers and within the investment community more specifically. We acknowledge the work done by a number of providers in seeking solutions that help investors better understand ESG risks. However, we also caution against overreliance on the ratings that some produce.

Our own due diligence of several ESG data and rating providers revealed several inaccuracies, mainly as a result of "passive" information sourcing, i.e. where the data aggregator does not engage with the company but rather uses web scraping and other techniques to obtain publicly available data. Examples of inaccuracies include:

- Linking controversies, which feed into ESG ratings, to the wrong company
- Failing to identify key controversies
- Incorrectly stating numbers, such as 1) the revenue of banks when excluding non-interest revenue in calculating carbon intensities, 2) carbon emissions data and 3) the tenure of external auditors
- Incorrectly classifying companies as state-owned or otherwise

We trust that the quality of data will improve as providers expand their ESG teams or improve their data review mechanisms. However, we still prefer relying on our own research, while mindful that even direct ESG data remains unaudited for the most part, diminishing reliability.

2. Burdensomeness

Data providers should develop effective data quality assurance processes. Requesting covered entities to review information may be helpful. However, we are mindful of the strain faced by issuers as a result of the proliferation of rating providers and data collection services. The use of "private and unique" surveys by providers results in an onerous burden for issuers who must respond to many non-standard requests for information despite already producing comprehensive sustainability reports in many instances.

The ESG data and ratings industry appears concentrated from a market share point of view. However, there are many startups and smaller players. Based on our discussions with JSE-listed issuers, responding to the various providers' requests for information has, in some cases, become very time consuming. The proliferation of ESG scores therefore adds a cost to the system. We support comprehensive disclosure, but we expect companies not to waste shareholders' capital on monitoring and reporting that does not add value. The standardisation of sustainability disclosure and consolidation among providers may reduce the reporting strain borne by issuers in future.

3. Subjectivity

There is no "right" way to formulate an ESG rating. For example, how much of a company's final ESG score should relate to emissions – and how this should vary between sectors – depends on a subjective view of relative importance. Indeed, scores and ratings are not only methodology dependent, but may reflect moral judgements and even political agendas.

Users should ideally be able to interrogate the factors underlying ratings and the weighting and direction of the impact of each factor on the overall score. Although some providers share information on their methodologies, broad KPIs assessed, materiality weightings, etc., the proprietary nature of the methodologies that have been developed often restricts full public disclosure, resulting in opaqueness and label confusion.

When presented with an ESG score, it is tempting to accept it on face value, or to make inferences about what is meant without interrogating the components. This can result in the inefficient allocation of capital and investors being exposed to risks they thought they avoided. For example, investors tracking the world's largest ESG index, the constituents of which are chosen based on the ESG ratings of the index provider, may reasonably believe they have limited exposure to ESG "sinners". However, ESG offenders such as Coca-Cola, Pepsi and social media companies have featured prominently to date. Investors may not appreciate that the provider sought only to measure companies' resilience to financially material ESG risks and not the externalities they generate.

4. Comparability and completeness

Comparability of ESG scores across rating providers is difficult because of differences in methodology and the inherent subjectivity. For example, one might rate an oil and gas company highly if it is improving from an environmental point of view, while another might rate it poorly simply as a result of the nature of its core business.

Even where ratings supposedly aim to measure the same construct, to date we have seen poor correlation in ratings between different providers. This is not necessarily a bad thing, as differences of opinion make a market, but it supports the view that scores are merely reflections of opinion. Interestingly, there are studies suggesting that improved sustainability disclosure widens the divergence of ESG ratings rather than driving consensus.

Comparability across providers is also affected by whether scores are absolute or relative (i.e. measured against the broader market or against peers), whether they signal unmitigated risk only, as well as whether they reflect "double materiality" (capturing both the outward sustainability impact of a company and the inward impact of sustainability considerations on the company's bottom line) or a one-directional view. The world of ESG is rapidly evolving and we can expect the issues on which companies are evaluated to change as well. Such changes should affect the comparability of ratings over time and therefore the ability to measure improvement.

In terms of completeness, the limited coverage of the investment universes within South African, broader African and frontier markets poses a challenge to local investors and to fund providers calculating look-through scores for their funds.

5. Cost

Access to data and ratings comes at a steep price. A 2022 report by ERM, a global sustainability consultancy, claims that 33 institutional investors spent an average of US$487 000 per year on external ESG ratings, data and consultants. We cannot justify such spending in the context of our process. Even if a single provider may be more affordable than its peers, it would in most instances be necessary to consider scores by multiple providers to evaluate differences of opinion, which is cost prohibitive.

6. Conflicts of interest

ESG scores are increasingly being used in ways that could introduce conflicts of interest. They could, for example, affect share prices (through the inclusion effect caused by prominent ESG indices) or executive remuneration (when ratings are used to assess executives' ESG performance). This could result in the same type of problematic behaviour observed in the credit rating industry prior to the global financial crisis.

We caution against "pay-to-play" arrangements whereby rated companies pay rating providers. Instead, we advocate for the use of subscription models where the users of ESG ratings pay. Calls for the clear separation of rating providers from their consultancy arms are also warranted. Providers should be wary of conflicts of interest and inside information risk when engaging rated companies directly. Separately, we are mindful of the risk of companies reverse-engineering high ESG ratings rather than focusing on genuine improvement.

7. Usefulness

Most ESG rating providers aim to help investors manage risk exposure, while some believe they can help investors achieve better investment returns. To date, the relationship between financial performance and ESG ratings remains uncertain. Claims that higher-rated companies typically exhibit lower price volatility are clouded by certain observations, such as that larger companies typically have higher ratings. Perhaps company size (and the associated extent of ESG disclosure) is a better predictor of share price volatility than any ESG rating.

Furthermore, changes in ratings do not necessarily reflect improved ESG performance – in many instances merely reflecting changes in methodology or disclosure additions. High ratings may result in companies who score well losing focus on continued improvement over time. Within the investment industry, ESG scores (and the associated labelling of funds) offer managers an easy way to meet clients' need for ESG risk disclosure while potentially shirking their responsibility to engage meaningfully with clients on nuanced topics.

8. Oversimplification

Considering the breadth of ESG issues that should be considered in a holistic company-level assessment, important issues are often reduced to a 2-5% weighting in the overall score. By focusing only on a final score, or on funds based on such overall scores, material risks may be overlooked.

Ultimately, we echo the view that if ESG tries to measure everything, it ends up measuring – and meaning – nothing. Ratings are at best immature, and at worst useless simplifications.

At Allan Gray, we prefer a qualitative assessment of a company's ESG issues. We then form a view on what we consider the most material ESG issues for the company in question, which may change over time. These ESG issues are quantified within the investment valuation, either explicitly (for example, if the value of an impending carbon tax is known) or, if the risk and associated cost is still uncertain, by applying an appropriate discount to the valuation to account for this heightened uncertainty.

We have engaged with several data and rating providers to better understand the market. We believe that ESG *data* providers have an important role to play in collating information for use in investment research and client reporting. We acknowledge the role that ESG *rating* providers have played in shaping the way in which the industry thinks about ESG, but remain agnostic to the ratings they produce.

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