A New Sustainability Measure – ESG Risk Ratings

Introduction

We recently transitioned our investment process from standard ESG ratings to ESG risk ratings, both provided to us by Sustainalytics – one of the industry leaders in sustainability data.

The effects that environmental, social, and governance (ESG) issues can have on the risks for companies are becoming better understood. More data, improved measurement, and better risk models all contribute to this knowledge.

At GSI we continually look to improve how we identify and manage risks in our portfolios, including ESG risks. To this end we believe that the latest approach, using ESG risk ratings in our investment approach, as described below, is a significant improvement.

We believe that ESG risk ratings have several advantages over the standard ESG approach. First, each company is assessed on the ESG risks relevant to that firm's business; second, there is a more direct link between the ESG risk ratings and the ESG risk to the companies; and third, the ESG risk ratings are comparable across sectors and companies – they are in a "single currency", as Sustainalytics puts it.

In this note, we describe the methodology that Sustainalytics uses in order to come up with the new ESG risk ratings, the rationale behind the change and how the new risk ratings impact our investment process.

The previous ESG methodology rates all companies separately along three dimensions, namely environmental ("E"), social ("S") and governance ("G"). These three dimensions are then combined into an overall ESG score. It represents an assessment of how sustainable a company's operations and management are according to these dimensions. Investors can then make up their mind whether (and how much) they want to invest in a company taking its sustainability into account.

In contrast, ESG risk ratings measure to what extent the enterprise value of a company is at risk due to a company's exposures to ESG issues that are material to is business. Rather than a volatility, the risk rating can be viewed as a downside risk measure.

According to Sustainalytics, the new metric is a risk measure rather than a pure assessment of a company's ESG credentials which was the case for the previous ESG score. The new risk metric is determined by adding up the unmanaged risk factors of a company with regards to the most pertinent ESG issues for the company.

For example, a company might be at higher risk of regulatory/legal action or of negative publicity if material ESG issues such as carbon exposure, labour rights, etc. are not effectively managed.

How are ESG risk ratings measured?

ESG risk ratings measure the following three main criteria:

Exposure	**Management**	**Unmanaged Risk**
How much is a company's enterprise value exposed to **material ESG issues (MEIs)**?	How well is the exposure to MEIs managed?	How much of the MEI exposure remains unmanaged?

Exposure and Management

So, it's all about MEIs! MEIs are assessed at the sub-industry level. Sustainalytics has identified a total of 20 MEIs across all sub-industries. Examples include:

Carbon Emissions

Human Rights

Resource Use

Land Use

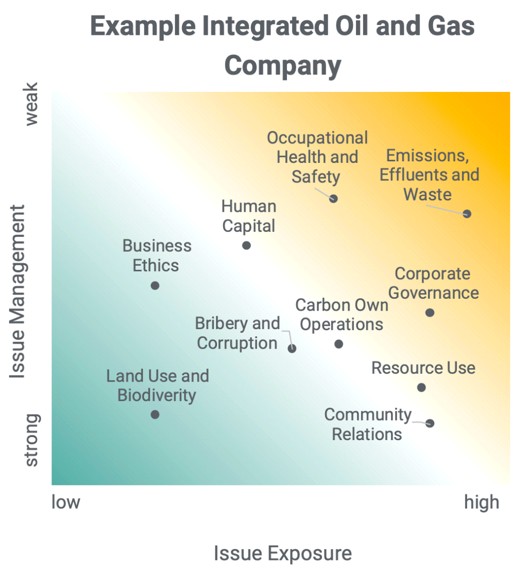
Biodiversity

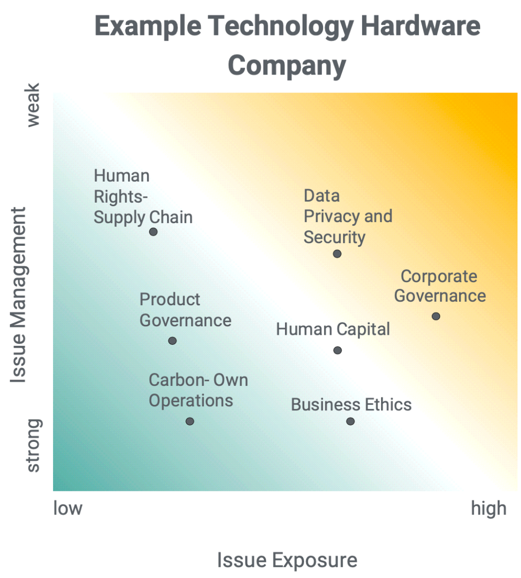
However, for individual companies, only some of the MEIs are relevant. Companies in certain industries may naturally have a higher exposure to some MEIs rather than others. For example, airlines are highly exposed to carbon emissions. Textile companies are often exposed to human rights issues in the low-wage countries where clothes are generally produced. Rather than assessing companies and sub-industries on the exact same criteria across industries, each firm is assessed on the MEIs that are most important for that particular type of company and not others.

The next question refers to how well a company manages any potential exposure to a set of MEIs. Exposure to MEIs is often unavoidable given that a company operates in a certain industry such as textiles. However, companies can still differentiate themselves from their competitors in terms of how well they manage these exposures. Do textile companies actively check their suppliers with regards to potential human rights violations, environmental issues, etc. or do they ignore these issues?

Examining companies from these two MEI angles, namely MEI exposure and MEI exposure management gives us a more comprehensive picture of how companies operate along the ESG exposure/management dimensions.

The following graphs illustrate these two dimensions using two examples, an oil and gas company and a technology hardware company.





Source: Sustainalytics.

The graphs show the MEI exposure on the horizontal axis and the MEI management on the vertical axis. The dots in the graphs are the individual MEIs that are relevant for each type of company.

Naturally, given that the two companies are in different sectors, the set of MEIs for each is quite different. In these graphs, the ideal case of low exposure and strong management of that exposure would show up as a dot that is close to the bottom left. All dots that are further away from the bottom left indicate either a higher exposure and/or weaker management of an exposure which could potentially put the company value at risk and it would therefore usually be reflected in a higher ESG risk rating.

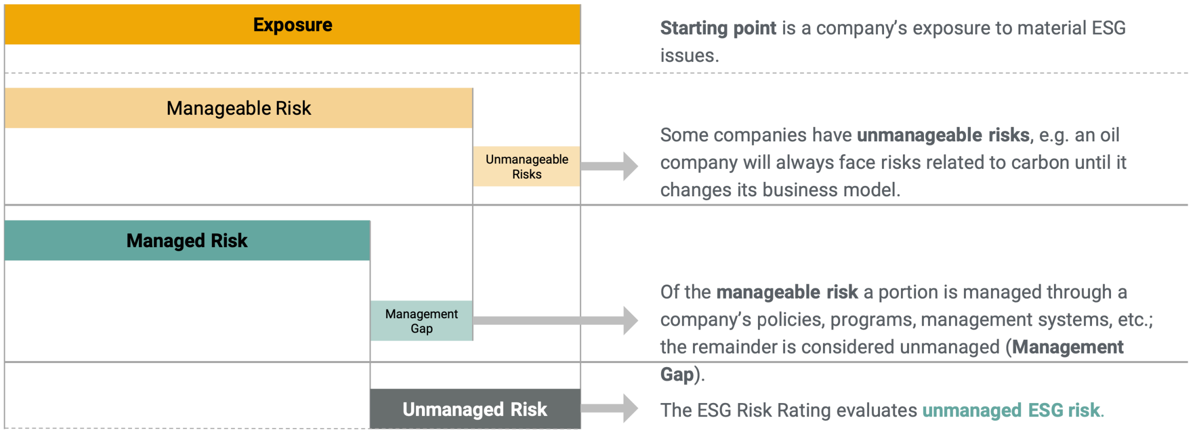
For example, in the first graph, “Resource Use” is a high exposure but the company has been able to manage that exposure well. Hence that MEI’s risk rating impact will be moderate at most. For a technology company “Data Privacy and Security” is a big issue, so the company has a high exposure to this MEI and it has not managed that exposure particularly well for whatever reason. As a result, the risk rating impact of this MEI is likely more substantial.

These issues lead us to the next topic, namely unmanaged ESG risk and the extent to which this type of risk is manageable.

<u>Unmanaged ESG Risk</u>

Unmanaged risk refers to the component of a company’s MEI exposure that is currently not managed by the company, either because the company has so far neglected to do so or because that component is unmanageable. For example, oil companies, airlines, etc. have exposure to carbon that is unavoidable, at least given the current state of technology.

The different components of MEI exposure can be illustrated using the following diagram.



Source: Sustainalytics.

Regardless of whether any unmanaged risk is manageable (called the "management gap" in the diagram above) or unmanageable, this component has an impact on the enterprise value that is at risk due to its existence. As a result, the final ESG risk rating is calculated by summing up all individual MEI unmanaged risk scores. This represents the risk to the enterprise value of a company due to the existence of these MEIs and how the company management deals with these issues. This risk may arise due to regulatory actions a company might be exposed to, potential lawsuits arising from unmanaged MEIs, strike action by the work force, consumer boycotts, adverse publicity, etc.

Conceptually the new ESG risk ratings therefore suggest a stronger link between ESG risk and financial risk for a company than the previous ESG scores. This highlights the fact that even if you as a company manager or as an investor don't care about ESG per se, you should still be aware of the financial risk that may result from material ESG risk exposures and how companies manage those exposures.

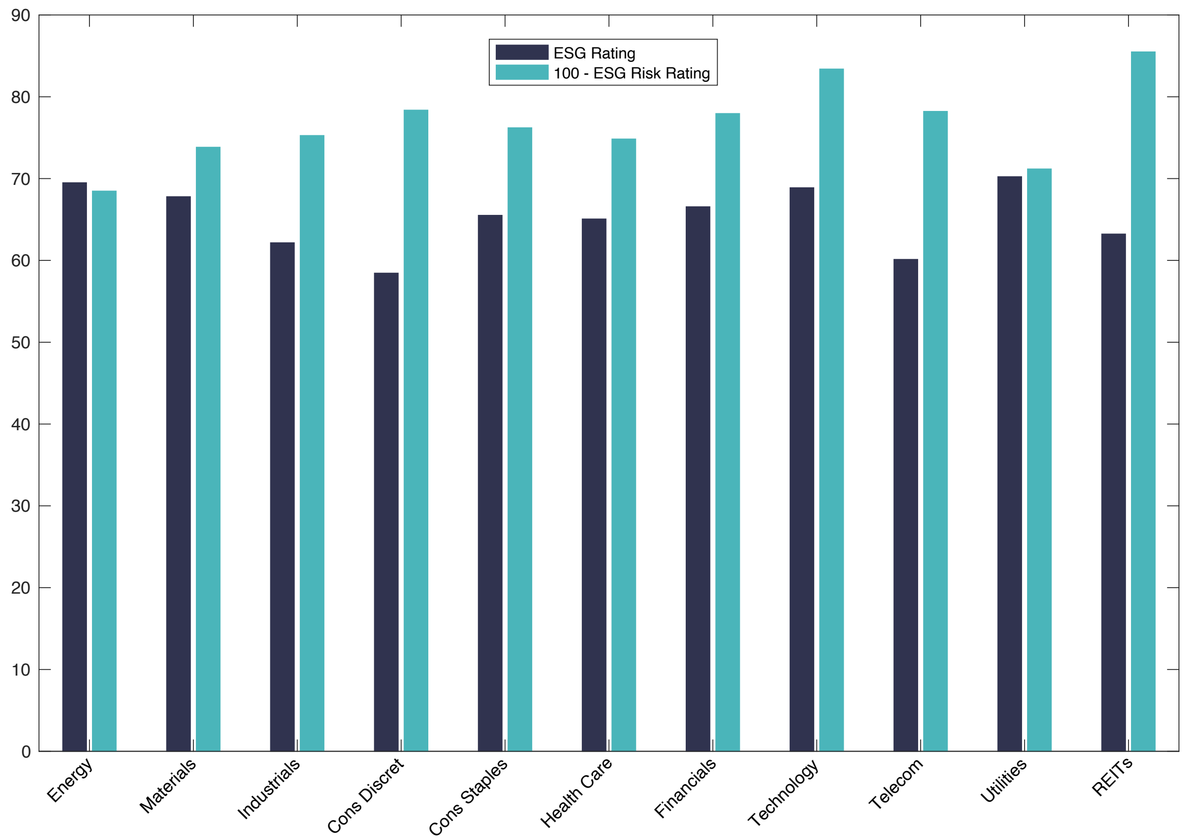
What do the new Risk Ratings look like?

An important virtue of the newly created ESG risk ratings is that they have been constructed in a way that they are directly comparable across different types of companies such as companies in different sectors, regions and size categories. This was not necessarily the case for the previous ESG scores. Sustainalytics refers to this feature as providing a "single currency" for ESG risk.

Therefore, in our investment process, we do not sector adjust or size adjust the risk ratings as we used to for the previous ESG ratings. Also, the controversy scores that used to be reported separately from the ESG scores have now been incorporated into the new risk ratings. As a result, we do not need to make a separate adjustment for controversies any more. This streamlines the incorporation of ESG criteria into our process.

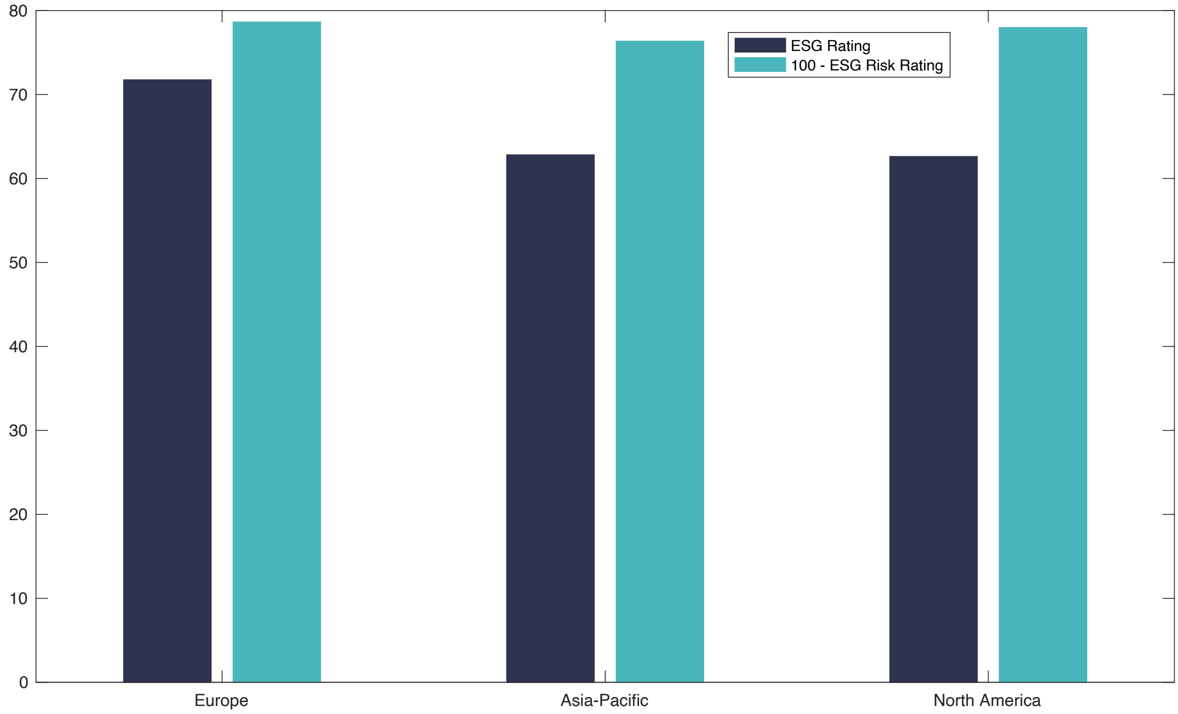
The chart below shows sector-level ESG ratings and ESG risk ratings for large and mid-cap companies on a global developed market level. The information is shown as of 31-Dec-2020. As opposed to the previous ESG scores, the risk ratings are defined in a way that a higher risk rating means higher risk. To make a risk rating (which could in theory range between 0 and 100) comparable, we subtract the risk rating from 100. In this way, higher scores are more desirable for both metrics. Given the slightly different focus of the risk ratings, there are several differences between both metrics, although they are understandably positively correlated. Some sectors display larger differences than others, particularly Consumer Discretionary and Telecom.

Global Sector-Level ESG Ratings vs. ESG Risk Ratings (large/mid) – 31-Dec-2020



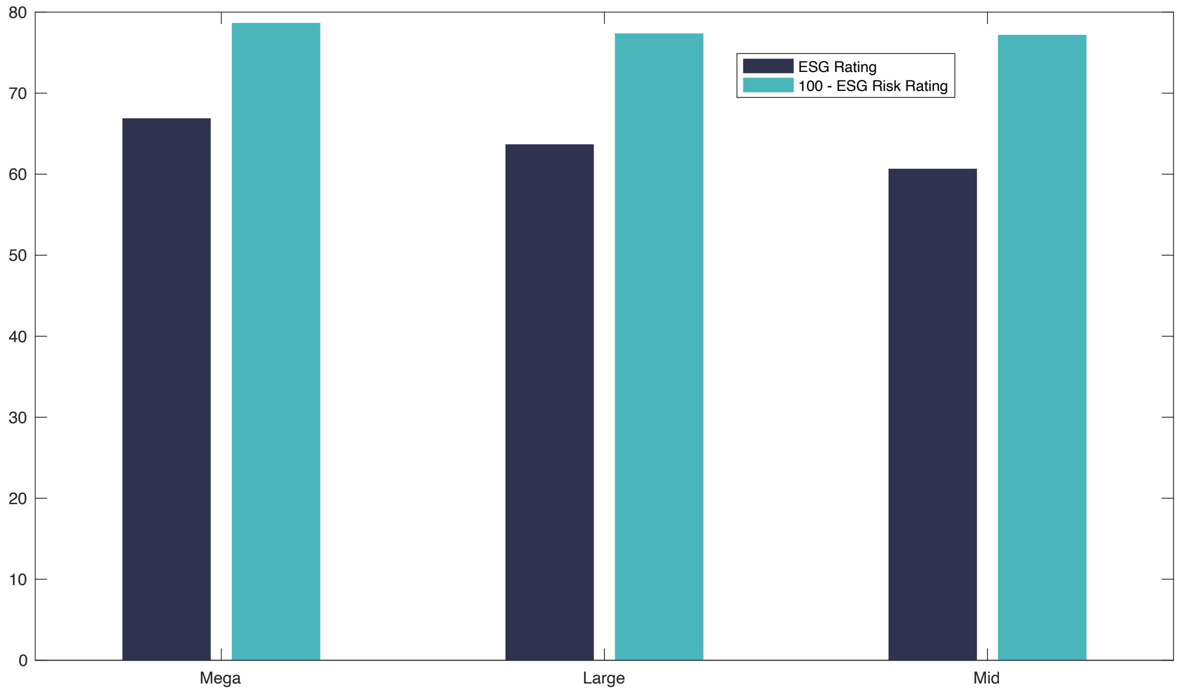
With regards to region-level ESG risk ratings, we observe in the next chart that they are now more similar across regions. The previous ESG scores are generally higher for European companies which has been a consistent pattern over time.

Global Region-Level ESG Ratings vs. ESG Risk Ratings (large/mid) – 31-Dec-2020



We can also observe in the next chart that the risk ratings of companies in different size categories, namely mega, large and mid-cap are of similar magnitude. The previous ESG scores are generally higher for mega and large cap companies, a pattern which we have consistently observed over time.

Global Size Category-Level ESG Ratings vs. ESG Risk Ratings – 31-Dec-2020



All the ratings in the above three charts are market weighted within categories but equal weighting gives very similar results.

The inclusion of the new ESG risk ratings in our investment process helps streamline our process and it allows us to incorporate the very latest ESG research into our sustainability component. Our process is designed in a way so that all other portfolio characteristics remain as they were before.

Conclusion

We have transitioned our investment process to using ESG risk ratings which reflect the latest ESG research developments. As opposed to a pure ESG score that rates companies based on their sustainability characteristics, the new ESG risk ratings assess companies' risk originating from material ESG issues. The new risk ratings come with several other attractive features such as better comparability between risk ratings of different types of companies and a more comprehensive measure of relevant ESG issues such as incorporating controversies about companies in their risk rating. Our portfolio characteristics remain the same as before in all other respects.