Higher Divergence in ESG Ratings Leads to Higher Returns

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A well-established problem facing investors with an environmental, social and governance (ESG) mandate is the wide divergence of ratings assigned to companies by different vendors. New research shows that those stocks with the greatest divergence had higher performance.

By the end of 2020, there was an estimated $35 trillion of assets (up from $23 trillion in 2016) managed under environmental, social and governance (ESG) principles – ESG investing has entered the mainstream of investing.[1] While there are seven competing vendors providing ratings to measure how companies perform along ESG standards, those ratings differ widely across vendors.

My August 24, 2020, November 23, 2020 and June 20, 2021 articles for *Advisor Perspectives* presented evidence from research demonstrating that ESG investors face considerable challenges in allocating assets because the data used to construct ESG portfolios differ so widely among providers. The result is that there can be a wide disparity of ESG ratings for the same company.

Divergence in ratings

Divergence in ratings has three sources. Raters use different categories, which can lead to disagreement (referred to as "scope divergence"). Raters measure identical categories differently ("measurement divergence"). Third, raters attach different weights to the different categories ("weight divergence") when generating an aggregated ESG rating. Florian Berg, Julian Kölbel and Roberto Rigobon, authors of the 2019 study, "Aggregate Confusion: The Divergence of ESG Ratings," found that most of the divergence in ratings could be traced to measurement and scope divergence, while weight divergence seemed to play a minor role.

Because of the divergence in ratings, funds may not be aligned with investor objectives and beliefs. In addition, the return and risk of ESG funds can differ significantly and are driven by fund-specific criteria rather than by a homogeneous ESG factor. Further complicating matters is that Dane Christensen, George Serafeim and Anywhere Sikochi, authors of the 2021 study, "Why Is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings," published in *The Accounting Review*, found that greater firm ESG disclosure generally exacerbates ESG rating disagreement rather than resolving it.

Rating disagreement and stock returns

Rajna Brandon, Philipp Krueger and Peter Schmidt contribute to the sustainable investing literature with their study, "ESG Rating Disagreement and Stock Returns," published in the September 2021 issue of the *Financial Analysts Journal*, in which they examined the relationship between ESG rating disagreement and stock returns. Their database covered ESG ratings from seven data providers (Asset 4 [now Refinitiv ESG], Sustainalytics [now Morningstar], Inrate, Bloomberg, FTSE, KLD [now MSCI] and MSCI IVA) for a sample of S&P 500 firms between 2010 and 2017. Following is a summary of their findings:

- The average pairwise correlation between the ESG ratings of the seven rating providers was about 0.45 – in stark contrast with the 0.99 correlation among credit ratings.

- The average pairwise correlation was lowest for governance (0.16) and highest for the environmental dimension (0.46).

- Disagreement tended to be higher for the largest firms in the S&P 500 (perhaps due to the complexity of such firms) and for firms that did not have a credit rating (potentially because the information environment for these firms is of lower quality).

- More profitable firms tended to have lower ESG rating disagreement (perhaps because they were able to dedicate more resources to ESG policies and to their ESG disclosures).

- Firms with more tangible assets tended to have lower disagreement in their environmental rating (perhaps because firms with more tangible assets were also likely to have a more negative impact on the environment, such as higher greenhouse gas emissions, and thus a potentially more easily measurable environmental rating).

- ESG rating disagreement was uncorrelated with disagreement in earnings forecasts issued by analysts.

- Stock returns were positively related to ESG rating disagreement, suggesting a risk premium for firms with higher ESG rating disagreement. The relationship was primarily driven by disagreement about the environmental dimension.

- An interquartile range increase in ESG rating disagreement was associated with an increase of 132 basis points in the annual cost of equity capital.

- A portfolio that was long high disagreement stocks and short low disagreement stocks generated monthly returns of about 21 basis points (t-stat = 2.2). Factor model (Carhart four-factor and Fama-French five-factor) alphas were of similar magnitude, with average monthly alphas ranging between 23 and 27 basis points (t-stats between 2.0 and 2.7).

- A long-only strategy of high disagreement stocks generated a raw monthly mean return of 134 basis points (t-stat = 3.5). The alphas of the long-only strategy, ranging between 14 and 21 basis points (t-stats between 1.6 and 2.4), were somewhat lower. For the environmental dimension, the results were similar.

- For disagreement about the social and governance ratings, there were not significant raw returns or alphas from the long-short strategies.

- Three commonly used measures of equity risk – volatility, idiosyncratic volatility and downside risk – were positively correlated with disagreement of ratings.

- The disagreement strategies produced significant results after considering transaction costs.

Conclusion

Their findings led Brandon, Krueger and Schmidt to conclude: “Higher stock returns for firms with higher ESG rating disagreement is consistent with the view that risk averse investors perceive more uncertainty about the ESG performance of a given firm as an additional source of risk (or uncertainty) that commands a separate premium.” They added that their “results are driven by differences in disagreement within and not between industries.” Finally, they offered this advice: “Controlling for a low level of ESG rating disagreement will allow investors who integrate ESG criteria in their stock selection process to avoid a subsequent unintended stock price decline.”

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