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Building a robust ESG scoring model for responsible investors

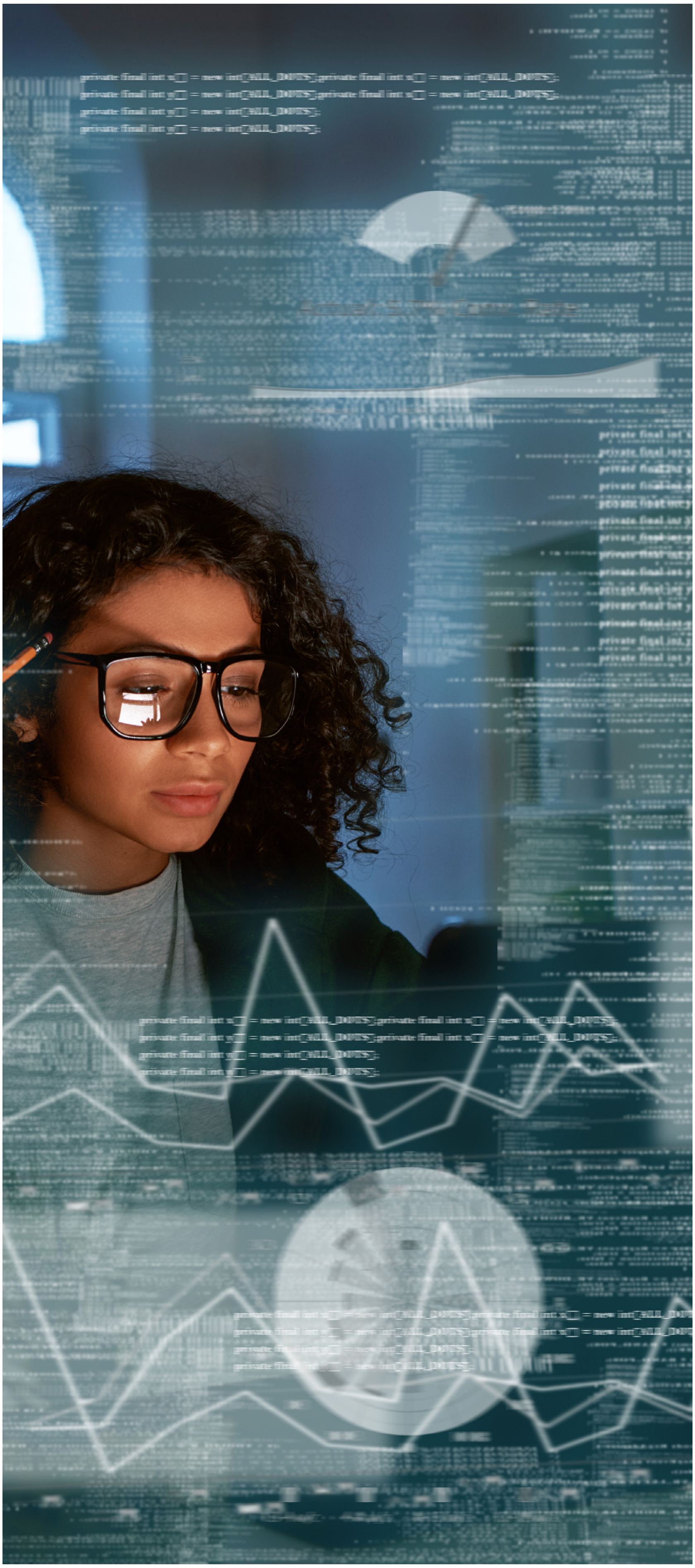
Responsible investment has never been an exact science. It is a pooling of research findings, datapoints, engagement outcomes and inputs from multiple sources to isolate the companies that can best contribute to sustainable economies – and deliver financial returns while doing so. ESG scoring aims to capture the practical output from that process, and reflect the environmental, social and governance (ESG) risks that may be at play.

Yolande Poulou
AXA IM Head of RI Tools, Models and Solutions

We believe very strongly that ESG scores should be a combination of the qualitative and the quantitative, allowing a system that can operate at scale without piling on the costs for clients. They should also acknowledge, we think, the reality of ESG – there is no magic formula. It takes deep analysis, flexibility of thought, and care in its application to deliver a tool that properly reflects risk – and which can potentially guide investment decisions which protect or enhance financial performance.

As we pursue that goal, AXA IM has moved from a so-called 'blended' approach to a 'structured' methodology known as Q^2. At its heart this was designed to allow full visibility of the components – if you blend contributions from many providers, it can become difficult to recognise which are driving outcomes. Our emphasis for the past year has therefore been on interpretability – to be able to express in detail how the research has led us to a particular score.

Our favoured approach focuses in on specialist providers, in our case MSCI for headline ESG scores (and Sustainalytics for measuring exposure to controversies). We can then look for gaps in MSCI's coverage where our own analysis can expand the investable universe or examine where we might disagree with a conclusion and adjust a score accordingly. That process is subject to peer review internally before it can be implemented as an override. It is about transparency, audit and challenge.



The future of ESG scores

This structured methodology also avoids the other drawback of blended, which ends up dispersing responsibility for the calls made across a range of providers. This made sense before, but the sector is rapidly maturing, lengthy track records are being built and leaders are emerging. This process is likely to accelerate, in our view.

Right now, correlation between ESG score providers is pretty low, especially when viewed alongside the very close alignment between the major credit rating providers. Over the next five to 10 years, however, we expect ESG scoring to become entirely mainstream – a standard part of the investor toolbox – prompting greater correlation. That will have interesting implications.

It is likely a handful of providers will emerge as powerful leaders – possibly the only players on the field. In this environment, ESG scores would likely become commoditised, driving down costs, and perhaps rolled into other, more mundane investment services. In this scenario, where ESG scores are as ubiquitous and consistent as credit ratings, it could well be that the market habitually prices issuance according to those scores.

With ESG risks fully priced in, responsible investors could then sharpen their focus on specific issues such as climate, or on particular United Nations Sustainable Development Goals (SDGs). Meanwhile, more effort would go in to forecasting official ESG ratings and anticipating potential changes, just as it works now for predicting when debt might fall out of investment grade in order to capture a spread advantage when certain investors become forced sellers.

Changing portfolios

We think the world is now well on the way to this kind of direct and immediate financial materiality in ESG measurement. AXA IM's scoring system is designed to tap into that progression while providing clarity on all the decisions made.

With our providers, we believe it works better to maintain two streams of analysis that allow us to focus on their distinctive merits. And so, we use MSCI to identify and respond to ESG-related material risks in a portfolio, while Sustainalytics provides a measure of potential reputational risks and exposure to controversies. This creates two very different ban lists and a very clear rationale as to why we may have chosen not to invest.

We then review the individual research documents produced by the specialist providers to understand how the company has been assessed against each ESG pillar. A single provider means there is a straight line between inputs and outputs, making it far simpler for our ESG analysts to bring our expertise and our experience to bear when analysing where we might disagree with a score.

One simple way that might work in practice is that our analysts are able to make real-time judgments on how events may have changed how a company operates. A new CEO that decides compensation should be linked to climate goals may lead us to arrive at a more benign view of the 'E' pillar, for example.

Crucially, that is a decision that would be entirely transparent, evidence-based, and easily communicated to clients. Institutions particularly need to understand in detail the nature and extent of ESG risks. You can see more detail on how this happens in the 'Creating an exception' section below.

Our ESG scores have three clear and direct implications for portfolio managers

1. The **first** is through the banned list of companies which have a score of 1.4 or lower.[1]

2. **Second,** most AXA IM strategies have a stated goal to outperform the ESG score of their benchmark index.

3. **Third**, any strategies which participate in local fund labelling schemes will have to report against certain key performance indicators which very often include ESG scores or a component of those scores.
In this case, the scores can allow a portfolio manager to make material refinements to the investment universe according to sustainability performance.

[1] A portfolio manager can make representations to the ESG Monitoring and Engagement Committee to hold a company that scores below 1.4 based on a valid rationale that demonstrates the non-materiality of ESG risks or which successfully demonstrates a conviction that the issuer is verifiably mitigating stated ESG risks.

Industry standard

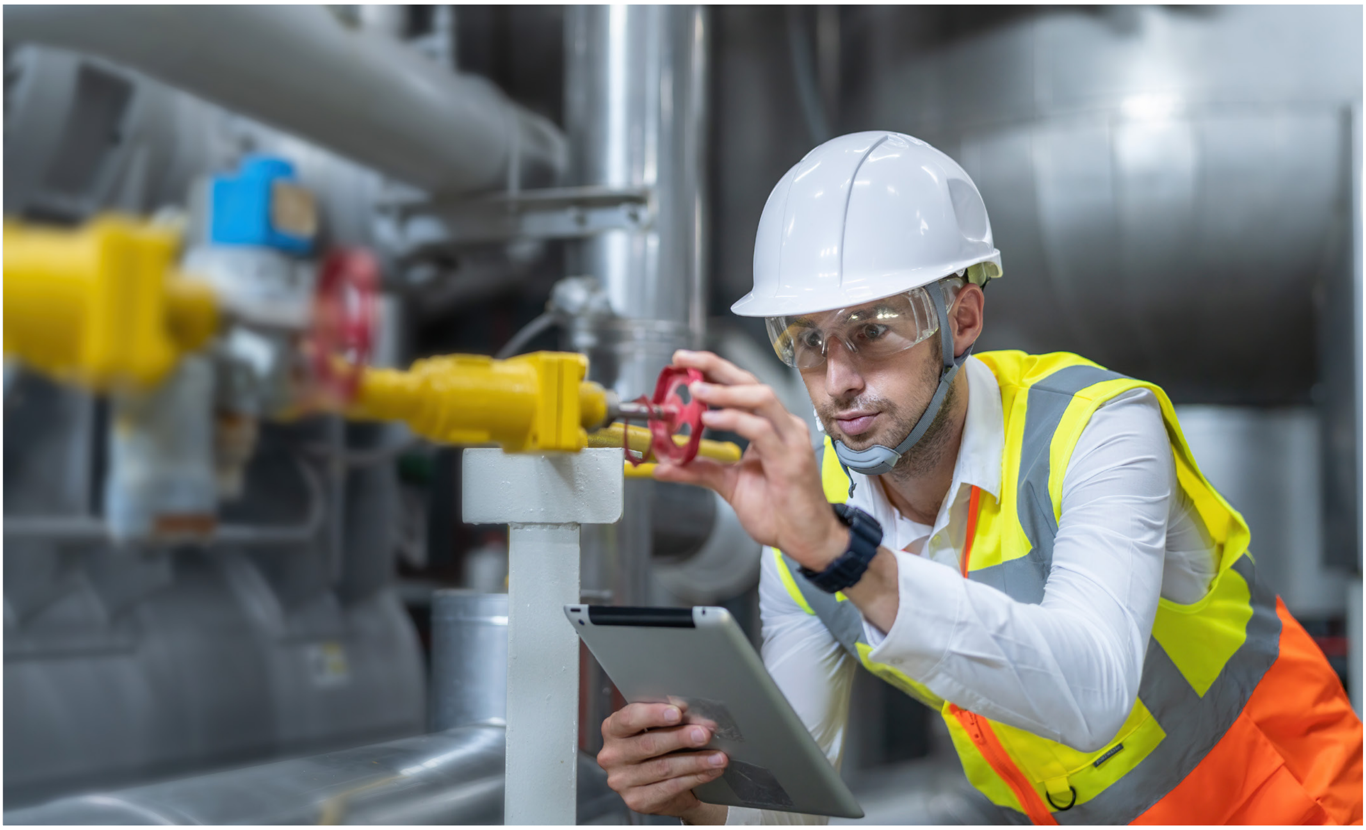
The effect on scores of the changing methodology has been, by and large, net neutral. Although this is clearly a constantly changing landscape, there is a roughly equivalent number of scores that were lowered or improved under the new structured methodology and under our system of challenge and audit.

One other important change over the last year has been to an industry-based scaling of scores rather than region-based. In other words, our ESG scores offer a picture of the best-in-class companies in a sector rather than a country. In some portfolios, that may have an overall positive (or negative effect) on ESG scores.

We feel this is a better approach, more suited to evolutions in the corporate and investment worlds. It used to be the case that a score of 10 in Europe meant something very different to a score of 10 in the US. It is far more intuitive, we think, to appreciate that a top score in the oil and gas sector means something very different to a top score in the renewable energy sector. It worth noting that industry-based scaling also captures regional elements too.

It also helps to address a major source of disparities in ESG investing: Disclosure. Our view is that regional scaling can fall far short of properly reflecting the divergence of quality in regulatory regimes. We think there should be a penalty when companies do not report in a transparent manner to investors. And so, a company scoring a 10 in Europe, where the disclosure regime is very advanced, should hold an ESG advantage over a business only meeting the lower demands of a less comprehensive regulatory regime.

Clearly, it is not a company's fault that it operates in a less advanced regulatory environment, and there may be a competitive disadvantage in seeking to meet the standards of another regime, but that's not the point. We are all about properly reflecting the material risks to investors and we think this is the best way currently of doing that. ESG scoring is an investment tool, and as such must operate with the same rigour applied to traditional financial measurement.

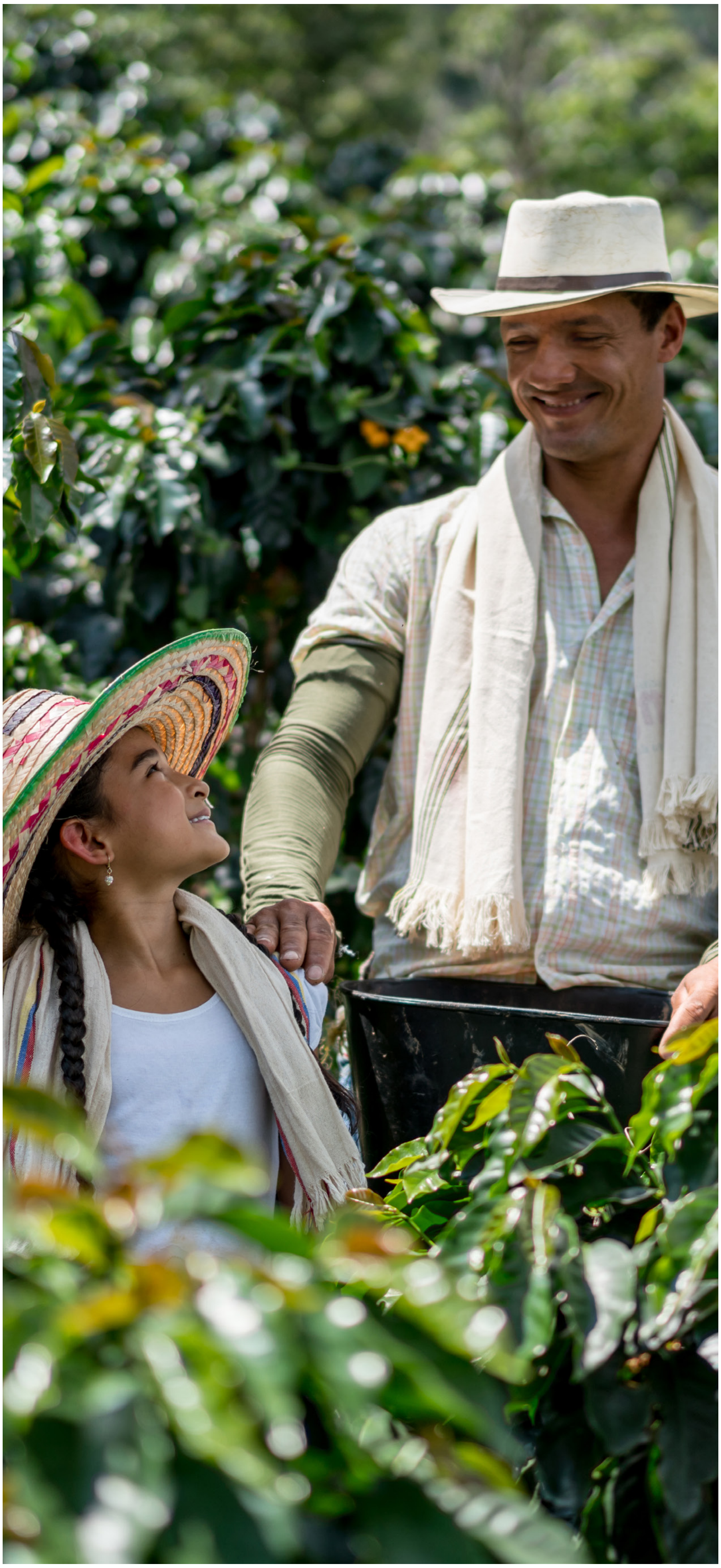


Encouraging symbiosis

In general terms, AXA IM equity portfolios are biased, relatively speaking, towards small and mid-cap companies rather than large caps. With that in mind, you may intuitively expect that moving away from regional scaling would perhaps have a damaging effect on ESG scores. In fact, the opposite has been the case. One of the reasons for that has been a parallel bias to Europe across portfolios, but there is also what you might call a 'quality bias'.

In short, within small and mid-caps, portfolio managers have already been favouring those businesses further up the ESG spectrum. It reflects a close alignment between the pursuit of robust and useful ESG measurement and the portfolio construction process – over the longer term we hope to make that relationship more symbiotic, where both feed into each other for a truly three-dimensional appreciation of the real-time risks at play. If a portfolio manager is minded to reduce their position in a company for an ESG-related reason, that should feed back into the ESG scoring, which can potentially help improve outcomes for all investors.

We think such a happy marriage between ESG scoring and portfolio construction lies just around the corner. We want to stay ahead of that evolution and believe this is best achieved through that combination of qualitative and quantitative, with a robust process of challenge and audit, and all with the goal of providing practical clarity for our clients.



Creating an exception

AXA IM's ESG scores run from 0 to 10 to one decimal point, giving us a 100-point scale to measure progress as companies either improve or slip down the scale. We further group those scores into five steps as set out in the graphic below.

Corporate ESG score definitions

ESG QUALITY	ESG SCORES	ESG BAND	RI QUALITATIVE RECOMMENTATION
POOR	0 – 1.4	RI5	The company has not evidenced adequate ESG risk management and/or the company has faced numerous controversies that are material
BELOW AVERAGE	1.4 – 4	RI4	The company is not mitigating its key or main ESG risks and this could represent a material risk for its core business in the foreseeable future
MEDIUM	4 - 6	RI3	The company has taken steps to mitigate ESG risks but sustainability is not clearly integrated in mainstream strategy
ABOVE AVERAGE	6 - 8	RI2	The company has robust ESG risk management and sustainability is integrated as part of mainstream strategy but more progress is required
HIGH	8 -10	RI1	Leading company for whom sustainability is a core part of its strategy and/or business model

Source: AXA IM 2022

These scores are not sacrosanct, and our approach is to open them up to challenge. Any system to do that must be watertight and follow a clear process of test and audit. Most commonly, a portfolio manager will bring a request for a change to a score – which if validated is then subject to the following steps at the ESG Monitoring and Engagement Committee:

- **Analysis** of the current quantitative score and its place within the portfolio/benchmark. The current quantitative score must be understood in its context, to put the proposal into perspective. Holdings and impacts are shared for awareness; they are provided by the relevant department members at QuantLab, the AXA IM division responsible for ESG scores.
- **Presentation** of the proposal by the requester. This will be a well-structured factual argument that would imply a shift in the score that aligns with the five-step scale. These quantitative and qualitative definitions are designed to ensure consistency across adjustments. The proposal should directly concern at least one of the E, S or G pillars, and result in a material adjustment of the global score.
- **Challenge and discussion** around the proposal. Voting members of the committee are supported by their team experts, if any, covering the company under review. Other portfolio management representatives are also asked to actively participate, with a view to creating a testing environment that can lead to sound decision making.
- **Vote** of the relevant committee members. In case of a reasonable doubt that the committee may face a conflict of interests, the chair has capacity to ask a voting member to abstain from the vote.

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