The Frontier Line

ESG ratings – different strokes

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on around $700 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Tom Lambert
Consultant

Tom joined Frontier in 2002 and is a member of the Capital Markets and Asset Allocation Team where he assists with various research activities including scenario analysis, development of internal risk analytics and reviewing the asset class assumptions. He maintains a strong interest in ESG aspects of investment with a particular focus on climate change impacts. Tom also assists clients and other research teams within Frontier with quantitative analysis and modelling and has been involved in the development of several Partners Platform applications. Prior to joining Frontier, Tom consulted to Telstra, where he provided quantitative analysis of pricing proposals. Tom commenced his working career with Towers Perrin in its actuarial consulting business.

Tom holds a Bachelor of Science degree with Honours from Monash University majoring in applied mathematics and statistics, and a Graduate Diploma (Environmental Studies) from the University of Melbourne. He has completed a number of units of study with the Institute of Actuaries of Australia.

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Background - the rise of ESG ratings

Investors are increasingly taking steps to understand and monitor how ESG (environmental, social and governance) issues are being managed in their portfolios.

We see several drivers for this including:

- **Materiality** - numerous examples show investee companies can materially impair their market valuation if ESG controversies emerge, e.g. BP, Rio Tinto, AMP.
- **Regulation** - there has also been increasing expectation from financial regulators around how investors manage ESG factors. This includes recent scrutiny by ASIC of companies and superannuation funds regarding potential misrepresentation of ESG credentials, usually referred to as 'greenwashing'. Further to this, Australian regulation of sustainability disclosures will become standardised with the advent of mandatory climate-related financial disclosures, to be phased in from 1 January 2025.
- **Stakeholders** – beneficiaries, customers, employees, media, and the wider community are increasingly recognising the role institutional investors have in addressing real world social and environmental issues such as climate change and human rights, so are looking for ESG information demonstrating progress in these areas.

As a result, we have seen meaningful growth in the production and distribution of ESG data and analytics for the investment industry. The types and use-cases of ESG data and analytics vary but include carbon emissions, diversity metrics, modern slavery risks, UN Sustainable Development Goals (SDGs) alignment, and of course, a wide range of *ESG ratings.*

Significantly, there has been increased investor adoption of commercial ESG ratings databases and platforms sold by a plethora of third-party vendors, the largest of whom have become household names and have built substantial businesses in this area (like MSCI and Sustainalytics). These ESG ratings databases are mostly designed to cover a vast number of securities or issuers that themselves publicly report ESG-related metrics. However, they also include variables and scoring methodologies that are proprietary to the vendor and are therefore at least partly subjective. The resultant lack of uniformity across vendor methodologies and outcomes is considered an ongoing challenge for investors and has at times been used by ESG sceptics to challenge the materiality of ESG considerations within an investment context. Nonetheless, an increasing proportion of investors now regularly incorporate such ESG analytics into their decision-making processes.

For many institutional investors however, their day-to-day investment activities focus on asset managers who run portfolios on their behalf. Frontier has included ESG considerations in its assessment and monitoring of managers for many years now. This is formalised in our ESG rating of products which is a standing element of our overall manager rating process. This helps provide clients with a conviction-based and comparable ESG score for all rated products. Over time, we have enhanced our ESG assessment approach in line with our deepening experience, in response to industry developments, and to meet client needs.

This rating process is important as it empowers clients to compare how effectively competing managers integrate ESG considerations into their investment processes (and therefore enhance measurable investment outcomes). Ultimately, this assists our clients in manager selection processes.

So, now we have ESG ratings at both a security level and at an asset manager level.

At first glance, it may seem intuitive to expect there is commonality in the outcomes of these different ratings approaches. This expected 'commonality' suggests a product with a favourable ESG rating from Frontier would and should also receive a favourable scoring from a third-party vendor. But is this expectation reasonable, or is it problematic?

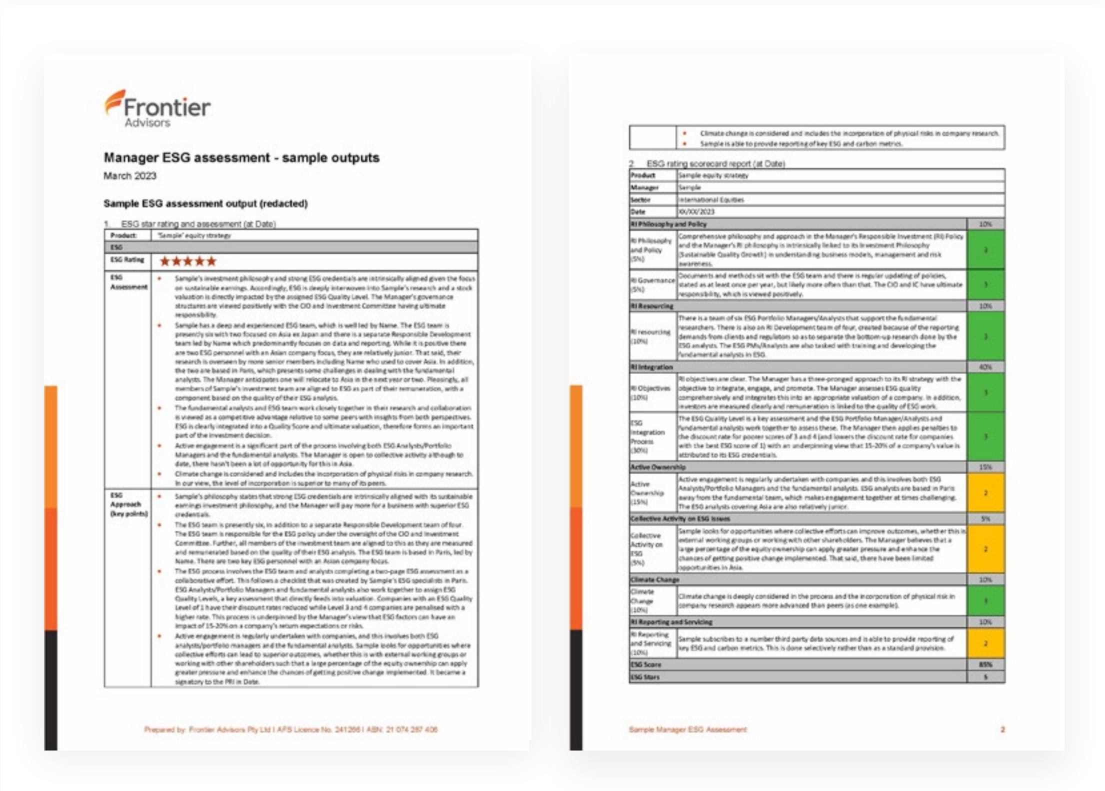
The purpose of this paper is to generate useful insights for clients by comparing the methodologies and outcomes of Frontier's ESG ratings process and those of a third-party ESG scoring system (in this case, MSCI) via a brief case study. We illustrate that a simple causal relationship between these ratings will not always be apparent and offer some explanations why this might be so. Importantly, we highlight that these different ESG rating types serve different purposes and consideration of *both*, in the right context, can provide investors with complementary tools in evaluating and addressing ESG issues.

Case study

Frontier's ESG ratings methodology

The objective of Frontier's ESG rating is to gauge how well a fund manager integrates ESG into their investment strategy and portfolio. Frontier believes fund managers with higher overall ESG ratings relative to peers, will be better placed to add financial value to clients.

Our approach to rating a product regarding ESG covers several aspects including the philosophy and policy positions towards responsible investment (RI); resourcing; objectives specific to RI; how effective the integration process is; active ownership and engagement; climate change strategy; and RI reporting and client servicing. The scoring is based on thorough due diligence undertaken by our research specialists in the context of the investment philosophy and objectives of the asset manager. This research includes reviews of offering materials and direct engagement with the manager. As with all our manager views, the ESG rating is quite qualitative and based on our researchers' opinions. All of this is put together in a scorecard with selected weightings assigned to those aspects. The resultant outcome is an ESG 'star rating' (one to five stars, with five being the most positive) and supporting commentary. This star rating provides an indication of how effectively Frontier believes the manager's approach to RI will enhance *portfolio* outcomes *in the future.*



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MSCI's ESG ratings methodology

The objective of MSCI's ESG rating is to identify the key ESG risks which may impact a particular company or issuer's financial performance, and thereby permit comparability with its peers.

Frontier established a relationship with MSCI in 2021 to offer eligible clients access to ESG and carbon reporting at an affordable cost. MSCI has developed a database built from a vast array of ESG metrics and signals, that also covers the investible universe of listed securities in some breadth. When producing a client report, these bottom-up metrics are aggregated to provide a portfolio-level score or rating. MSCI, like other ESG rating providers, assigns weightings to each metric or signal, depending on its view of the significance of each at the sector or industry level. The metrics vary across vendors at the security level, and because the vendors use different weightings and methodologies, the portfolio scores will also differ. We don't consider there is one 'source of truth' here when it comes to commercial ESG ratings. Each database or platform will have its own relative strengths or weaknesses, and this could depend on the context or use case.

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Comparing the two approaches

To summarise their main features, we highlight some of the key characteristics of Frontier's manager ESG rating approach and those of security-level ESG rating systems such as MSCI's.

Table 1: Rating methods - key characteristics

Ratings provider	Methodology	Assessment style	Time basis	Alignment to investment objectives
MSCI	Bottom-up (security level)	Quantitative	Historical, discrete timepoints	Agnostic to product objectives/risk management. Focus is at company level.
Frontier	Top-down (whole-of-portfolio lens)	Qualitative/wholistic	Forward-looking	Investment objectives are paramount. Risk management important.

Comparing the two approaches – in practice

For our case study, we compared some international equities products with differing Frontier ESG ratings, to the portfolio-level MSCI ESG scores for the managers' respective products. This showed a direct commonality that a layperson might intuitively expect doesn't always apply.

We selected a small peer group of products without past expectations of what their MSCI ESG scores would look like. Table 2 provides an outline of the product characteristics, noting all of these have been rated at least Buy or Neutral Plus by Frontier.

This indicates we have strong overall conviction all of these products will deliver on their stated objectives. However, our ESG ratings (being one component of their overall ratings) vary materially among them (ESG is one of six criteria we use in assessing an overall rating).

Table 2: Product characteristics

Label	Style	Objective	No. Stocks (approx.)	Frontier rating	ESG rating (1-5)
Product A	Value, fundamental	2% p.a. alpha, 5 years rolling	30-60	Buy	2 (slightly behind peers)
Product B	Core, fundamental	2.5 % p.a. alpha, 5-6% T.E., 10 years rolling	200-225	Neutral Plus	2 (slightly behind peers)
Product C	Core, fundamental	1 % p.a. alpha, 3-7 years rolling	20-40	Buy	4 (slightly ahead of peers)
Product D	Value, quantitative	2-3% p.a. alpha, 5% T.E, 10 years rolling	150	Buy	5 (a leader)

The MSCI ESG scores (out of a maximum ten) for these products were measured at 31 December 2023. We were cognisant this comparison was at a specific point in time, so we repeated the process at time intervals over a five-year period and found the relative scores across this peer group stayed broadly the same.

The analysis provided the high-level results shown in Table 3

Table 3: MSCI ESG scores versus Frontier ratings					
Label	Frontier ESG rating	MSCI score agg	MSCI score - E	MSCI score - S	MSCI score - G
Product A	2	6.99	6.7	4.7	5.9
Product B	2	6.94	5.6	4.9	6.0
Product C	4	6.69	6.9	4.6	5.5
Product D	5	6.58	5.6	4.9	5.7

For this particular group of peers, the MSCI aggregate ESG scores for managers with high Frontier ESG rated products were lower compared to their peers with low Frontier ESG rated products (which had higher MSCI aggregate scores).

Some example observations can be made about these particular results:

- Products A and B have higher (G)overnance scores under MSCI despite their Frontier ESG ratings overall being low. When rating Product A, Frontier noted governance is an important part of the manager's evaluation of companies. This is perhaps reflected in the high MSCI G score here.
- Product A has relatively concentrated holdings which can make this effect more accentuated.

Ultimately, the higher MSCI scores for Products A and B are largely an outcome of their sector and stock exposures at a point in time, as determined by the managers' underlying investment processes. While ESG may have played some role in informing portfolio construction in each instance, it is unrealistic to expect a primary driver was for the manager to intentionally achieve a certain level of MSCI ESG scoring.

By the way, we do not suggest in any way that the 'inverse' relationship between Frontier ESG ratings and MSCI ESG scores we observe in our small case study holds across all products either. Rather, we emphasise clients should not expect a standing causal relationship between the two data points. Neither do we believe such an expectation is constructive when selecting asset managers.

Reflections

Context is critical

To Frontier, an industry-leading ESG integration approach for an asset manager does not equate to naively tilting its portfolio to higher ESG rated securities, or even having an investment style which leads to a higher ESG score for the overall portfolio. For example, we know managers that have a quality-style bias tend to have portfolios which score highly via MSCI. Does this mean quality-managers are inherently better at ESG integration compared to say value managers? We argue not - although quality-style managers might disagree with us!

Instead, we seek asset managers that are able to identify, assess and manage material ESG-related financial risks and opportunities in the context of their specific investment strategy and style. There are many different types of investment strategies. And there are returns to be earned across any of these by engaging asset managers able to identify and price attractive investment opportunities in their areas of expertise. The pricing of these investments should account for any material ESG risks or opportunities, and it is this capability which is at the heart of Frontier's ESG rating approach.

Understand the underlying methodologies

Because of MSCI's ESG rating methodology companies with higher greenhouse gas emissions generally scored lower on the (E)nvironment dimension than lower emitting companies. From an investment perspective, does this mean all active asset managers should underweight high emitters and overweight low emitters? Of course not. A skilled asset manager with the ability to accurately incorporate the future earnings implications of each investee company's emissions into its valuation process should be able to make money, even when investing in higher emitters, and despite this being likely to lower the overall MSCI ESG score for the overall portfolio. The manager may also be able to work proactively with the company to reduce operational emissions over time – which may ultimately improve their MSCI ESG score (and real-world emissions) at a later date.

This is not to say the methodologies of rating platforms such as MSCI are somehow flawed, merely that it is important clients have a working understanding of how these ESG ratings are derived (see Table 1) and how they can realistically be utilised.

Think through your use case(s)

Interestingly, some managers argue security-level ESG ratings provide an opportunity to generate returns. One basic thesis is that by buying companies currently rated low, but which have demonstrable tailwinds that will likely lead to ESG improvement going forward, the manager can effectively capture a 'value' opportunity as the market gradually recognises improvement in a higher stock price over time. We don't seek to explore this idea deeply as part of this paper, but we think it is a notable example of exploiting a deeper understanding of the methodologies around such data in an investment context.

We can of course, offer several examples where the Frontier ratings and MSCI scores indeed show stronger 'commonality'. While this may be reassuring to investors who actively seek to achieve favourable ESG outcomes through investing in managers that effectively integrate ESG considerations into their process, such alignment does not necessarily imply a causal relationship.

The results illustrated in this brief case study shouldn't lead to alarm, despair or confusion, but hopefully enhance client confidence through better understanding. From an investment perspective, we absolutely would not support a course of action where a product is divested solely because the ESG scores based on a data vendor such as MSCI are lower than expected or lower than for another comparable product. Instead, we would suggest this scenario can lead to an interesting dialogue with the manager on how some of the holdings are justified in a wholistic sense but also when an ESG lens is applied.

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The final word

While deliberately limited in scale, we hope this analysis highlights the importance for all clients to understand the two approaches to deriving ESG ratings are based on different methodologies and serve different objectives.

We strongly suggest they can be seen as quite complementary to each other, and this is of course why we offer clients easy access to both.

We maintain the view that the wholistic process Frontier undertakes to evaluate and monitor products on ESG is useful for product selection, subject to broader portfolio considerations. But having access to a third-party ESG rating and reporting tool such as MSCI's can also be very useful, for example, in testing and querying the manager's responsible investment activities over time. It can also provide some oversight as to whether there are any undesirable exposures being adopted by the manager. And this oversight can be extended to the total sector configuration to examine what degree of overlap or offsetting there is in relation to ESG exposures as specified by certain factors or metrics.

So, what can we take away from the brief exploration of these results and the resultant considerations?

- A wholistic and rigorous rating process is essential for selecting and monitoring products with a view to ESG integration.
- Investors should consider the broader investment objectives of the product when assessing the ESG credentials of the manager and monitoring ESG exposures at various points in time.
- This rating process can be complemented by ESG (and carbon) reporting which is built from bottom-up exposures, provided by a credible data platform. The reporting results can be readily compared across products and provide guidance on total portfolio exposures. ESG reporting can provide useful information to stakeholders and can also provide some assurance toward regulatory requirements (such as the forthcoming Australian Sustainability Reporting Standards disclosures).

Ultimately, the information and analysis available regarding ESG considerations should enable a focus on those elements that are decision-useful for a particular investor. The specific elements pertinent here will depend on the representations at the product and total fund level, while these in turn will be linked to the expectation of stakeholders, primarily beneficiaries/members.

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Next steps

Frontier will continue to analyse ESG data as part of our manager research efforts so clients can expect their portfolios evolve in line with industry developments and expectations.

We have focussed our analysis in this paper on broader ESG ratings. While our comments also cover climate change at a high level, given that issue is a key pillar in our selection and evaluation of products, we will also extend this analysis to focus on climate change consideration in the future. That is, we will illustrate some results with a comparison of our own climate change assessments (part of the broader ESG scorecard) with carbon/climate reporting from a commercial ESG database in a future paper.

Learn more

We hope you found this paper insightful. If you have any questions or would like to discuss Frontier's ESG assessment approach, along with other third-party ESG rating providers, please don't hesitate to reach out to your consultant or the Responsible Investment Team.

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