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# Active- vs passive-fund ESG approach:

## Does an ESG rating matter?

### Highlights

- Companies should strive for meaningful sustainable development instead of chasing backward-looking ESG ratings.
- ESG ratings matter to passive-fund investors, tracking bespoke indices.
- Investors will look beyond ratings when assessing ESG performance.
- Knowing the ESG approach of your investor will help inform corporate strategy.

### Executive summary

Environmental, Social, and Governance ratings have become a key focus for companies and investors. By achieving good ESG ratings, a company can receive positive market recognition. As a result, companies now tend to spend more time and effort on improving ESG ratings in order to attract investors.

ESG ratings are relevant to passive-fund investors tracking bespoke indices. But not all investors rely on ESG ratings. Active-fund investors are more likely to exercise active ownership through direct engagement with companies on ESG topics.

A better understanding of investor ESG approach will help companies formulate ESG strategy and create meaningful sustainable development instead of chasing backward-looking ratings.

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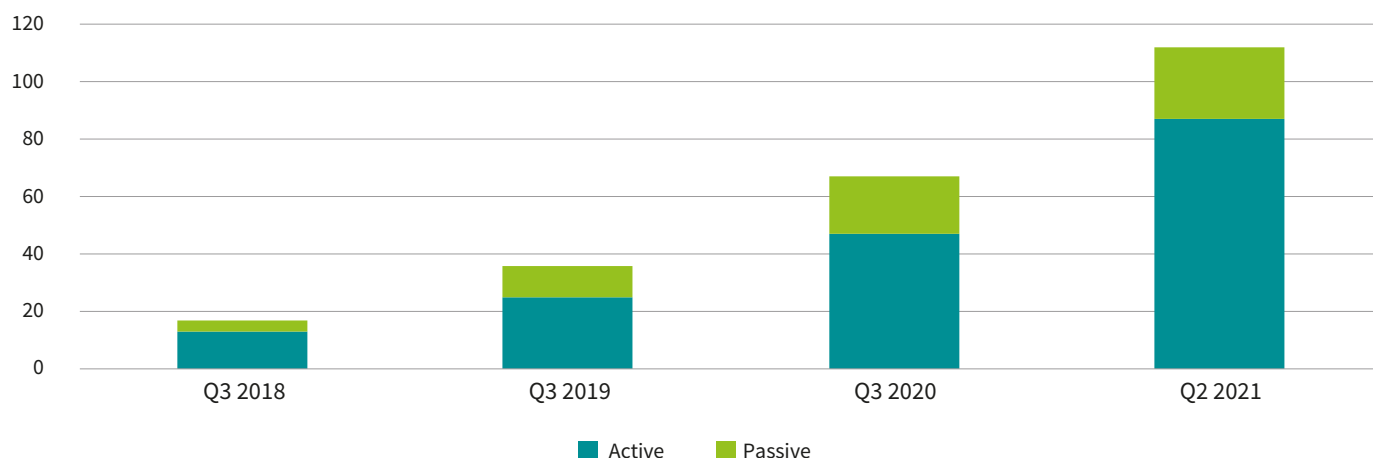
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## 2021 sustainable fund trends

Global sustainable fund assets grew 12% on the year to USD 2.24 trillion as of the end of June 2021. Europe accounted for 81% of overall sustainable fund flows<sup>1</sup>.

European sustainable fund flows (USD Billion)



Meanwhile, sustainable fund assets in Asia totaled more than USD 63 billion. Japan and China continue to dominate the space and account for USD 26.8 billion and USD 24.7 billion respectively, followed by South Korea (USD 5.5 billion) and Taiwan (USD 3.2 billion)<sup>2</sup>.

## Know your ESG ratings

ESG Rating Agency	Rating Scale	Coverage	Methodology
MSCI	AAA-CCC	14,000 equity and fixed-income issuers	<ul style="list-style-type: none"> <li>• Performance-based rating system</li> <li>• Looks at 37 key ESG issues</li> </ul>
Sustainalytics	Score out of 100	40,000 companies globally	<ul style="list-style-type: none"> <li>• Risk-based scoring system</li> <li>• Assesses 70-90 management indicators with maximum 10 material ESG issues</li> </ul>
S&P Global ESG Score	Score out of 100	7,300+ companies globally	<ul style="list-style-type: none"> <li>• Performance-scoring system</li> <li>• 1,000 data points with nearly 30 different criteria</li> </ul>
RepRisk	AAA-D	180,125 companies globally	<ul style="list-style-type: none"> <li>• Risk-based rating system</li> <li>• Comprises 28 ESG issues with 75 additional topic tags</li> </ul>

ESG rating agencies vary by rating system and methodology. They are ideal for investors getting familiar with ESG and provide an overview of a company's performance in this area.

However, ESG ratings may not provide the complete picture. They are generally based on public disclosures, which vary in quality and reporting framework. Meanwhile, as touched on above, there is a lack of consistency in terms of methodology, measurement, and definition across ESG rating agencies.

1. Global Sustainable Fund Flows: Q2 2021 in Review, [global-esg-flows-q2-final.pdf](https://www.morningstar.com/global-esg-flows-q2-final.pdf) (morningstar.com)

2. Asia Sustainable Assets, <https://www.morningstar.hk/hk/news/214092/asia-sustainable-assets-hit-new-highs.aspx>

## Four steps to understanding your investor's ESG approach

ESG approach varies by investor. Individual approach determines how an investor implements ESG ratings and engages with companies.

There is guidance companies can follow to better understand ESG approaches overall. These four steps provide insight and can help guide your ESG strategy.



**Step 1:** Identify reporting gaps when benchmarked against key reporting standards used by global investors.



**Step 3:** Analyze the indirect impact of ESG ratings and key ESG issues of concern to your top investors.



**Step 2:** Based on the latest shareholder structure, evaluate the direct impact of ESG ratings on your holdings.



**Step 4:** Conduct peer analysis on exchange-traded Fund (ETF) investor holdings to help identify ESG-themed indices and ETF constituents.

## Active- vs passive-fund ESG approach

Passive funds are employed by a wide range of investors as they cost less to run than active funds. ESG ratings will have more direct impact on the passive funds that track a particular bespoke ESG index.

Active funds are actively managed by portfolio managers. Unlike passive funds, active-fund managers are more likely to engage with a company directly on material ESG risks and opportunities. In addition to this, active-fund managers can choose to exit if investee companies make no ESG improvements.

## Investor case study: Active vs passive ESG approaches at adidas

Norges Bank Investment Management (Norges Bank) and The Vanguard Group (Vanguard) are adidas's top investors. The former investor is driven by an active investment style, while the latter is known for adopting a passive style. Their different investment styles are mirrored in their ESG approaches.

Norges Bank has set expectations for a company to follow based on nine ESG topics and UN Sustainable Development Goals. For example, the investor expects companies in the plastics value chain to have strategies that address the transition toward a circular economy. The recent effort at adidas to release fully recyclable shoes is a factor Norges Bank would consider when evaluating the company's ESG performance.

Vanguard holds adidas shares through a variety of funds, mostly index. Most of those index funds do not track ESG indices; ratings may not have much influence. Vanguard's stewardship team would likely engage with adidas to understand how the company addresses material ESG risks. If adidas fails to address and manage these risks, the investor would likely vote on relative-fund proxies to ensure the company acts and protects shareholder value.

Bottom line, adidas need to understand their top investors' ESG criteria before formulating an ESG strategy.

## Helping to Tell Your ESG Story

IHS Markit understand the importance of ESG storytelling for a company: a good story founded on good-quality and relevant quantitative data will resonate with different stakeholders, engage them and in turn drive change.

We offer diverse ESG advisory solutions to help companies tell compelling ESG stories to the right audience.



### **ESG Tutor - ESG Reporting support in line with ESG rating requirement**

Establish key indicators that are material to issuers and relevant rating agencies



### **ESG Outreach and Engagement – Investor Relation Focus/Investor Communication**

Provide advisory on key messages to deliver a concise and coherent ESG strategy to investors and other stakeholders for AGM/EGM preparation



### **ESG Capacity Building - Internal**

Provide training session on selected indicators with Investor Relation team, key executives and selected workforce to better understand ESG and its impact



### **ESG leadership - Strategy Refine and Investor Engagement/Advocation**

Provide advice on the key messages for ESG strategy, develop roadmap to set relevant ESG targets in line with international best practices and global requirements. Develop investors ESG DNA

For more information on ESG Unlock, contact us at: [DL-ESG-Team@ihsmarkit.com](mailto:DL-ESG-Team@ihsmarkit.com)

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