WOULD YOU MIX RED AND WHITE WINE IN A GLASS? NO. WHY ARE WE DOING THAT WITH ESG?

In summer 2020, reports emerged about the supply chain of UK-based fast-fashion retailer Boohoo. Workers in a supplier's factory – also based in the UK – were reportedly being paid well below minimum wage and exposed to substandard conditions.

Despite the allegations, the retailer's stock was held by a handful of funds carrying an "ESG" label. Indeed, the stock also scored highly in the ESG scoring system of at least one major index provider.

The episode shows the pitfalls when using so-called ESG ratings. In the wake of the incident, critics bemoaned the pseudo-science that goes into these scoring systems, noting they are simply not granular enough and, at times, lack the application of simple common sense. It was also reported that even some entities making use of detailed research gave the company a high ESG rating – the faults in the supply chain being outweighed by other factors, such as the retailer's strong job creation.

Common sense is certainly valuable when assessing corporates' sustainability profiles. So too are detailed data sets, now much more widely available than thirty years ago when ESG scores first started to emerge.

It's important at this juncture to address the difference between "ESG data" and "ESG ratings". The former refers to extra-financial information that can be used to gain insight into a company's sustainability practices and revenue streams. The latter is a subjective score, at times constructed using an opaque methodology.

At Impact-Cubed we see a huge value in ESG data – we've distilled sustainable investing down to 15 dimensions to address corporate entities. For sovereign entities, we've settled on

29 dimensions. Each of these dimensions is important for an investor. Blending them together to create a subjective "ESG score" dilutes them all. It's akin to mixing red and white wine in your glass.

In an age where technology allows for data to be gathered on thousands of securities, assigning subjective ESG letter grades is outdated and ripe for disruption. It also doesn't deliver what investors are often looking for – the knowledge that their money is making an impact. ESG ratings don't show investors how their capital contributes to sustainable development, rather they indicate the "sustainability risk" of an individual corporate or country. On the other hand, detailed information gives clarity to stakeholders on the impact of their investments.

Instead of making a faux-rose in our wine glass, let's take advantage of technology to harvest ESG data more efficiently and make it accessible to investors in a way that actually supports their decision-making process. In doing so, we will also create positive impact for society- not just avoid ESG risk.

ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customized sustainable investing.

You can find out more about our data and portfolio models at www.impact-cubed.com.