Exchange traded funds

Companies with good ESG scores pollute as much as low-rated rivals

The finding holds true even when researchers looked only at the environmental part of the metric

Mixing social or governance ratings with carbon intensity typically creates portfolios than are less green, researchers said © AP

Steve Johnson JULY 31 2023

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Companies rated highly on widely accepted environmental, social and governance metrics pollute just as much as lowly rated companies, research has found.

This perverse lack of correlation holds even if companies' carbon intensity — their carbon emissions per unit of revenue or market capitalisation — is compared purely to their environmental rating, according to Scientific Beta, an index provider and consultancy.

"ESG ratings have little to no relation to carbon intensity, even when considering only the environmental pillar of these ratings," said Felix Goltz, research director at Scientific Beta. "It doesn't seem that people have actually looked at [the correlations]. They are surprisingly low."

"The carbon intensity reduction of green [ie low carbon intensity] portfolios can be effectively cancelled out by adding ESG objectives."

The findings come amid strong demand for ESG investment, with "sustainable" funds globally attracting net inflows of $49bn in the first half of this year, according to Morningstar, while the rest of the fund industry saw outflows of $9bn.

Goltz and his colleagues looked at 25 different ESG scores from three major providers: Moody's, MSCI and Refinitiv.

They found that 92 per cent of the reduction in carbon intensity that investors gain by solely weighting stocks for their carbon intensity is lost when ESG scores are added as a partial weight determinant.

Even just using environmental scores, rather than the whole panoply of ESG, "leads to a substantial deterioration in green performance", they found.

Worse still, mixing social or governance ratings with carbon intensity typically creates portfolios than are less green than the comparable market capitalisation-weighted index, the researchers noted.

"On average, social and governance scores more than completely reversed the carbon reduction objective," Goltz said.

He offered a simple explanation for this, namely that "the correlation between ESG scores and carbon intensity is close to zero [at 4 per cent]. The two objectives are unrelated and are therefore hard for investors to simultaneously achieve."

"It can very well be that a high-emitting firm is very good at governance or employee satisfaction. There is no strong relationship between employee satisfaction or any of these things and carbon intensity," Goltz argued.

"Even the environmental pillar is pretty unrelated to carbon emissions," he added, with this rating partly determined by factors such as a company's use of water resources and waste management practices.

Keeran Beeharee, vice-president for ESG outreach and research at Moody's, agreed that ESG investment does not necessarily help an investor create a low-carbon portfolio, or any other specific goal.

"[There is a] perception that ESG assessments do something that they do not. ESG assessments are an aggregate product, their nature is that they are looking at a range of material factors, so drawing a correlation to one factor is always going to be difficult," Beeharee said.

"In 2015-16, post the SDGs [UN sustainable development goals] and COP21 [Paris Agreement], when people began to really focus on the issue of climate, they quickly realised that an ESG assessment is not going to be much use there and that they need the right tool for the right task. There are now more targeted tools available that look at just carbon intensity, for example," he added.

A spokesperson for MSCI ESG Research said its ratings "are fundamentally designed to measure a company's resilience to financially material environmental, societal and governance risks. They are not designed to measure a company's impact on climate change."

Its environmental pillar, for example, looks not only at a company's past carbon emissions, "but also at its plans to curb emissions in the future, its investments to seize opportunities related to clean technology, and its management of biodiversity and nature-related risks."

Refinitiv said that "while very small, the correlation found in this study isn't surprising, especially in developed markets, where many large organisations — with focused sustainability strategies, underpinned by strong governance, higher awareness of their societal impact and robust disclosure — will perform well based on ESG scores, in spite of the fact that many will also overweight on carbon".

Hortense Bioy, global director of sustainability research for Morningstar, also thought the findings were "not completely surprising".

However, she believed the research's focus on the trade-offs in sustainable investing was "helpful".

"Investors need to be aware of all the trade-offs. It is not simple," Bioy said. "In this case, investors need to think carefully about which aspects of sustainability they would like to prioritise when building portfolios: carbon reduction or a high ESG rating."

This raises the question as to whether the concept of ESG can really work as a mass market product, given that different investors will have different priorities.

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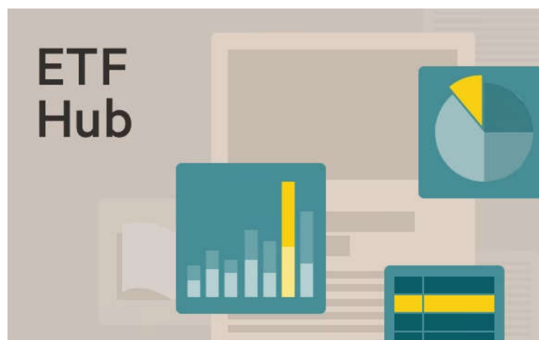

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"Large investors want to do something customised. It's a real issue for collective investment schemes like ETFs and mutual funds," Goltz said. "Even if you have strong ESG considerations you might actually disagree with some of the ESG issues", such as restrictions on the production of certain types of weapons.

And with new metrics, such as biodiversity, steadily being added into the ESG equation, this problem may be becoming worse, Goltz believed.

"If you add more unrelated criteria you are not going to perform well on all of them, so you have to think about your priorities. By adding too many you are losing the focus," he said.

"If you are interested in reducing the carbon intensity of your portfolio, you are going to get that only by focusing on the carbon intensity, [otherwise] you are very quickly going to be getting green dilution."

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