Managing corporate controversies: the role of ESG ratings

High profile corporate controversies are regularly used to highlight the value of ESG analysis. Volkswagen's emissions scandal, Enron's fraud and BP's Deepwater Horizon oil spill each appear to provide tantalising examples of the significant losses that could potentially have been avoided through a better understanding of company practices. Our analysis suggests investors hoping conventional ESG ratings will help to identify these problems before they break are likely to be disappointed (Figure.1):

1. **ESG ratings have shown no clear predictive value.** Better-rated companies appear slightly more likely to experience controversies than worse-rated companies. This suggests that tick-box indicators of company sustainability are ineffective measures of controversy risk.
2. **But, ESG ratings have reacted to controversies.** On average, ratings have fallen by a full rating notch in the few months after a controversy becomes public. Most ratings include corporate controversies in their calculations, and while this mitigates the reputational risk of having high ratings for challenged companies, it disguises their limited predictive power.
3. **Past controversies are a bad guide to future controversies.** We find no meaningful relationship between the number of controversies a company has faced and the likelihood it suffers a future controversy. Ratings that rely heavily on past controversies therefore risk undermining their own effectiveness.

One of many inputs

This does not mean third party ESG ratings have no value. Instead it underlines the importance of understanding what they are and how they should be used. We use information from several external ESG research firms, but only ever as one input into our own company assessments to be questioned, examined and built on.

We outlined our concerns about the use of ESG ratings to assess portfolio sustainability in 'Painting by Numbers ' (May 2016). The conclusions here expand on some of these concerns: principally that ESG ratings flatter investors who sell stocks after controversies emerge and penalise those who invest the time to evaluate each situation and buy shares when they conclude risks are overblown.

The value of ESG integration

To us, effective ESG integration means examining a company's ESG performance and incorporating that analysis into investment decisions rather than outsourcing that analysis to third parties. Moreover, effective ESG integration is not just about preventing large downside controversy risks. Rather, the key value of examining business model sustainability lies with the insight it can bring to future growth.

Figure 1: MSCI company ratings and their respective changes pre- and post-controversies.

Name	MSCI pre event	MSCI change	MSCI post event
BHP Billiton	A	-1	BBB
Volkswagen	BBB	-3	CCC
Toshiba	AAA	-3	BBB
Olympus	AAA	-6	CCC
Valeant	CCC	0	CCC
Siemens	AAA	0	AAA
Tesco Plc	A	0	A
Compass Group	A	-1	BBB
Carnival	BB	-2	CCC
BP	AA	-3	BB
Barclays	A	-3	B
Comcast	B	-1	CCC
Costco	BBB	-3	CCC
Dixons Carphone	BBB	-1	BB
Lloyds	BBB	-3	CCC
Vodafone	AA	1	AAA

Average rating pre- and post-**controversy** 3.69 → +1.06 → 4.76

Average rating change with **no controversy** 4.06 → -0.02 → 4.04

Source: MSCI, Schroders. Ratings adjusted as to numbers as follows: AAA=1, AA=2, A=3. BBB=4, BB=5, B=6, CCC=7.
Source: Schroders as at 31 January 2017.