

What is an ESG Score? How ESG Works and Finding ESG Investments

Picking an investment based on ESG standards can take time and effort. That's because there is no singular ESG scoring system for all companies – each rating agency measures each company by its own standards.

In this article, we'll review what makes up an ESG score, some of the largest ESG rating agencies, and the inherent problems we still face in using these metrics to gauge a company's actual risks and opportunities across the domains of environmental, social, and governance standards.

Key Takeaways

- ESG scores are not standardized. Individual rating agencies calculate them, so they vary greatly.
- ESG scores are typically assigned a numerical value from 1 –100 or 1 –10. Some agencies also use a letter grading system.
- ESG scores are relative, which means that if a company is outperforming its peers in the same industry, it could have a high ESG score without being particularly beneficial for the environment or incorporating substantial diversity, equity, and inclusion (DEI) initiatives.

What is an ESG score?

ESG scores rate companies according to three categories that involve the company's business opportunities and risks. Those

categories are environmental (E), social (S), and governance (G).

ESG scores from most agencies range from 1 – 100. The higher the number, the better the score. Some agencies use different number scales. For example, one of the largest rating agencies, MSCI, uses a scale of 1 – 10.

Some rating agencies will then categorize each company in terms of letter ratings, with AAA being the best and CCC being the worst.

How are ESG Scores Calculated?

The factors that go into each ESG score and how they are weighted vary between rating agencies. This is extremely important to remember, as not every agency will weigh metrics according to your investing values. You may have to shop around to find the rating agency that best matches your investing philosophy.

For example, if you're particularly interested in companies with clean energy initiatives, look into a rating agency's system to ensure it values that highly in its scoring.

In general, though, here are some of the factors that rating agencies consider when calculating ESG scores.

Environmental metrics

Metrics used to establish an environmental score can vary from agency to agency. As an example, MSCI ESG scores typically factor in the following:

- **Climate change:** This can include the company's carbon footprint and efforts to reduce or offset carbon emissions.
- **Natural capital:** This category looks at companies' use of natural resources, such as water sources, raw

material sourcing, and efforts to support biodiversity through land use.

- **Pollution and waste:** In this category, MSCI looks at electronic and toxic waste and how a company manages packaging materials. In May of 2022, the S&P 500 ESG Index kicked Tesla off because of violations of the EPA's Clean Air Act and its handling of waste in California.
- **Environmental opportunities:** Environmental concerns aren't only an area for restriction or risk; they can also be an opportunity for simultaneous economic growth. Things like green building practices, renewable energy, and clean technology can attract new investors as they look toward tomorrow's economy.

Social Metrics

Social metrics look at how well the company manages its relationships with stakeholders. This can include paying workers fair wages, a corporation's impact on the communities where it operates, and holding business partners in its supply chain accountable to standards similar to the ones the company sets for itself.

For example, the production of cashmere sweaters requires retailers to work with both farmers in places like Mongolia and weavers in other countries. Many cashmere producers now clarify on their website that they work with third-party organizations to ensure the farmers' well-being and fair wages. An ESG rating agency might look for certifications like this to evaluate a company's social metrics.

Governance Metrics

Corporate governance is the third category and encompasses diversity, equity, and inclusion (DEI) principles, business ethics, executive compensation, and tax transparency, among

other factors.

For example, a company with a board composed of both men and women – especially if those men and women are of diverse racial and ethnic backgrounds – is likely to score higher in governance metrics than a board composed primarily or entirely of white men.

Another critical aspect of the governance category is lobbying and political contributions. If a company invests in political parties pushing legislation considered environmentally damaging or socially regressive, it's more likely to be scored lower. Because of this, it isn't surprising that ESG investing has become a new battleground for a culture war – more on that below.

What is a Good ESG Score?

When agencies calculate ESG scores in terms of numbers, they can fall into the category of poor, average, good, or excellent. For rating agencies that use a scale of 1 – 100, the tiers look like this:

- **Excellent:** A score of over 70.
- **Good:** A score between 60 and 69.
- **Average:** A score between 50 and 59.
- **Poor:** Scores below 50.

Once they calculate the ESG score, the rating agency may assign a grade according to a letter system. While MSCI isn't the only agency rating ESG investments, they are one of the largest. Here is how they implement the lettering system:

- **AAA or AA:** These letter designations represent companies that are industry leaders in ESG standards.
- **A, BBB, or BB:** These letter designations represent

companies that align with the industry average when meeting or setting ESG standards.

- **B or CCC:** These companies need to catch up to industry norms regarding ESG standards.

Who Calculates ESG Scores, and How Do I Find One That Meets My Investing Goals?

MSCI is one rating agency that deals with ESG investments, but several others exist. Here are some of the largest agencies that release ESG ratings and examples of investors their ratings are best for.

- **Comprehensive:** MSCI, S&P Global, and Sustainalytics all weigh environmental, social, and governance issues fairly equally. Even so, significant discrepancies exist between each agency's rating system.
- **Environmental:** If your primary concern is climate change, you may want to turn to ratings from the Carbon Disclosure Project (CDP). Companies can only get a CDP rating if they respond to a survey requested by a shareholder. As a shareholder, you can put in such a request.
- **Governance:** Institutional Shareholder Services (ISS) Governance QualityScores ranks companies according to the governance portion of ESG standards.

Potential Problems With ESG Scores

ESG scores are not standardized across rating agencies. As we discussed, three of the largest comprehensive ESG rating agencies – MSCI, S&P Global, and Sustainalytics – have significant discrepancies between their company ratings, even

though they measure across similar domains.

ESG scores can sometimes be misleading. You might be surprised to learn that ExxonMobil – one of the world's largest oil and gas companies – is on the S&P 500 ESG Index. There are a couple of reasons for this.

The first is that ESG scores measure companies against others in their industry. Because Exxon scores well compared to other oil and gas companies, it made it on the list.

Another is that companies like Exxon can aim to appear carbon neutral, not necessarily by reducing emissions but by pledging to reduce emissions in the future or by purchasing carbon offsets.

Also, ESG rating agencies usually measure direct carbon emissions when assessing carbon footprint. This means the agency won't consider emissions from the use of a company's products. Under this policy, a company like Tesla doesn't get sufficient credit for its low-emissions products, while a company like ExxonMobil can get away with having relatively environmentally damaging products.

For an example of inconsistencies among rating agencies, you can see that ExxonMobil gets a D-score from InfluenceMap despite being included in the S&P 500 ESG Index.

In these ways, companies can manipulate ESG ratings. They appear more environmentally or socially responsible than they are because they are doing better than others in an already problematic industry.

Recent Opposition to ESG Investing

ESG investing has become part of a recent culture war waged primarily by Republican lawmakers. The arguments vary but mainly focus on private investing groups focusing more on appearing socially conscious instead of making their investors

a profit. Conservative politicians have also argued investing in ESG-friendly companies is a kind of betrayal of investors' values.

Earlier this year, conservative lawmakers in Kansas and Indiana dropped anti-ESG legislation because representatives of the two states' pension systems opposed it. In both cases, the pension system anticipated billions of dollars of loss over the next ten years if the state government passed the anti-ESG legislation.

There are legitimate criticisms about the rules for assigning ESG scores and the lack of standardization among agencies. However, whether the widespread conservative criticism of ESG investing is being made entirely in good faith is suspect.

It seems inevitable that with a populace increasingly engaged in fighting climate change and supporting progressive social issues, investors will look for an avenue to invest in companies supporting similar causes. The ability to do so is a natural feature of a free market.

The Bottom Line

You'll likely come into ESG investing with noble intentions. But prepare yourself, measuring a company's impact, risk, and growth potential is tricky. There are no standard, agreed-upon metrics to evaluate any company's ESG efforts. Even if there were, the rating agency's values might not align with your values as an investor.

That doesn't mean ESG investing is not an effort worth pursuing. You can research each rating agency's metrics to decide which aligns best with your values. You can also look into groups like hedge funds that focus on investing in ESG companies.

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