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SOLACTIVE
German Index Engineering

Does the world need another ESG index?

Guest Contribution

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Truvalue Labs

Two secular investment trends are the ascendance of ESG and the growing dominance of passive investing. ESG indexes are at the nexus of these two movements and are increasingly recognized as cornerstones of ESG investing.

A third trend is the transformative impact of technology on multiple facets of the investment process. This is as true in ESG research as it is in trading, portfolio management and risk analysis. Artificial intelligence (AI), satellite data and sensor data are revolutionizing data collection and analysis and will shape the future of ESG research and investing.[1]

With the recent launch of the Solactive Truvalue ESG United States Index[2], these three trends are captured for ESG investors for the first time. The index is part of the Solactive Truvalue ESG Index Series, which uses Truvalue Labs metrics to select companies based on their ESG scores after excluding oil, gas and coal, utilities and tobacco. The Index shows annualized outperformance of 2.05% since inception in February 2008, 2.88% over the past 5 years and 8.39% over the past year[3], a product of the ESG selection process based on Truvalue Labs data and industry screens.

Why ESG indexes matter

A good benchmark is representative of a market or strategy, transparent in its construction and investable. i.e., liquid with low turnover, and capacity to support an appropriate scale of assets. Additionally, ESG benchmarks define the characteristics of an ESG strategy in relation to the underlying market.

So ESG indexes define particular strategies, offer a definitive record of the financial dimension of ESG portfolios (risk, return, fundamentals) and measure their ESG characteristics. And of course, they are used in passive investments such as ETFs, mutual funds, institutional accounts and structured products. Ultimately, ESG indexes matter because they define and measure how ESG investment strategies diverge from the underlying market.

There are a wide range of approaches to ESG, so there are multiple ESG strategies. While ESG fund managers have been criticized for the elasticity of the term, it is worth noting that there are also multiple standards for defining and measuring traditional investment factors such as value. But there are better and worse representations of ESG strategies, which ultimately depend on the data used to construct the benchmarks.

Addressing the shortcomings of ESG research

This last point brings me to why the world needs more ESG indexes. While ESG indexes offer transparent, rules-based exposure to ESG signals, they are only as good as the data inputs and methodologies. As sustainable

[1] ESG Research in the Information Age – AI, Unstructured Data, and the Future of ESG Investing.
[2] Solactive Truvalue ESG United States Index
[3] As of August 26, 2020.

investing grows in popularity, ESG research has come under scrutiny over concerns about its timeliness, transparency, subjectivity and salience.

Truvalue Labs' processes and data are responsive to each of these concerns.

- **Timeliness.** Analyzing more than 115,000 sources in 13 languages with natural language processing and machine learning, Truvalue Labs' company scores are updated in real-time as new information is processed. Their scores always reflect the most current information available, rather than forcing clients to wait up to a year before updating a rating.
- **Transparency.** Truvalue Labs uses the Sustainable Accounting Standards Board's (SASB) materiality framework, not a proprietary framework. Developed in consultation with industry professionals, the details are publicly available on SASB's website. For transparency on what drives its scores, Truvalue Labs provides clients with access to the relevant articles and documents.
- **Subjectivity.** Truvalue Labs' process avoids the potential bias of human analysts and from company reported information.
- **Salience.** Truvalue Labs' scores reflect a Dynamic Materiality[4] process that identifies the most material issues for stakeholders of each company based on stakeholder perspective. This gives investors insights into the ESG issues that matter most at each company. Other rating agencies use models based on prior assumptions about which issues are material.

Since traditional ESG raters apply a uniform model across each industry, they may miss the emergence of company- and industry-specific material issues. Consider Wirecard, which Truvalue Labs scored in 14th percentile of the Consumer Finance industry at the time its scandal broke because of Business Ethics concerns.[5] Several traditional rating agencies gave the firm an average rating based on models that do not feature Business Ethics as a KPI for Consumer Finance. The *Financial Times* called out ESG rating agencies and ESG fund managers for missing the signals on Wirecard.[6]

Better Beta[7]

So, the world needs another ESG index if new data affords us the opportunity to create better benchmarks.

Indexes are "proof of concept" for ESG investing, measuring and documenting the financial and sustainability impact of an ESG strategy in a consistent, disciplined way. And it's logical that better ESG data would lead to a

[4] Dynamic Materiality: Measuring What Matters

[5] Truvalue Labs Research Brief. Wirecard AG. Tremors Before "The Big One": Timely ESG Signals Warn Investors. June 29, 2020.

[6] Financial Times. Did ESG investors pass the Wirecard test? July 1, 2020.

[7] This concept is touched on in The Third, System Stage of Corporate Governance: Why Institutional Investors Need to Move Beyond Modern Portfolio Theory

better ESG index. Therefore, it's critically important for the continued advancement of ESG investing that the research – and products based on it – are as credible as possible.

Judging by fund flows, investors responded to COVID-19 with affirmation for ESG, continuing the pre-pandemic trend. According to Morningstar, there are now $250 billion in sustainable funds.[8] As professionals and practitioners, we should reward that trust with the best products and best practices. Since AI technology enables us to generate more timely, consistent and relevant ESG analytics, we owe it to investors to use that information to construct more precise ESG benchmarks.

About the Author:

Thomas Kuh, PhD is an industry expert with decades of deep expertise in ESG indices and ESG research. As **Head of Index at Truvalue Labs**, he creates benchmarks for implementing ESG investment strategies and licensing indices for ETFs, mutual funds and institutional accounts.

References

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[5] Financial Times: "Did ESG investors pass the Wirecard test?"

[6] Hawley, James & Lukomnik, Jon. (2018): "The third, systems stage of corporate governance: Why institutional investors need to move beyond modern portfolio theory."

[7] Morningstar: "Passive Sustainable Funds: The Global Landscape"

[8] Morningstar

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