MATERIALITY MATTERS

Targeting the ESG issues that impact performance – the material ESG score

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ABSTRACT

Russell Investments has developed a new way to measure a company's ESG (environmental, social and governance) score. Drawing from the metrics developed by industry leaders Sustainalytics and SASB (Sustainability Accounting Standards Board), our new material ESG score identifies and evaluates only those issues that are financially important to a company.

The new material score allows us to differentiate between companies in a way that the traditional aggregated ESG score does not facilitate. We can now distinguish between companies who score highly on ESG issues that are financially material to their business, from those who score highly on issues that are not financially material to their business. Our evidence suggests that the Russell Investments material ESG scores are better predictors of return compared to traditional ESG scores.

Bottom line: Not all ESG issues matter equally

The relevance of ESG issues varies industry to industry, company by company. For example, fuel efficiency has a bigger impact on the bottom line of an airline than it does for an investment bank. So, rather than adopt a one-size-fits-all approach, we have worked to develop a new ESG scoring system that is specific or truly material to a company and their profitability.

Why? We have found that traditional ESG scores are composed of a large number of issues that are not material. Specifically, for 66% of all securities in the Russell Global Large Cap Index universe, less than 25% of the data items in the traditional score are considered material.

So, to generate our new score, we have leveraged the traditional ESG scores provided by the data provider Sustainalytics alongside the industry-level materiality map developed by SASB. Then we asked ourselves, can this new score be used as an ESG signal for investment decision making?

New material score methodology

Identifying which ESG sub-categories are material, and which are not

Traditional ESG scores such as those used by Sustainalytics are constructed for a variety of financial and non-financial uses. This means that a company may receive an ESG score based upon issues that are not actually financially relevant to them. So, to help us identify which of the 145 Sustainalytics sub-categories are indeed material, we used the SASB materiality map as a guide. Those subcategories that were not considered relevant to the 30 material issues identified on the SASB map were deemed immaterial and placed out of scope for each industry.

Constructing the new material scores

To construct the new scores, we first standardised the overall traditional score for each of the 145 sub-categories. Then, we aggregated the scores of the sub-categories that had been identified as material before calculating the final material scores and scaling them into a range between 0-10; where higher scores represent stronger outcomes.

Putting the new score into context—success, purpose and application

Looking at the correlational relationship between traditional and new

Russell Investments' scores offer something extra and above that of the traditional scoring approach.

To assess the success of our research, we sought to determine whether the Russell Investments scores offer some thought-provoking results to the industry, i.e. was the research useful? Do the scores have purpose? And do they have practical application?

We used correlation metrics to help answer this question in order to understand the extent that our new material ESG scores resemble the traditional ESG scores. A very low or negative correlation between traditional and new would be surprising, if not outright concerning, given that the data used to construct our scores is a subset of the data typically used by traditional scores. A very high correlation would suggest there is little purpose to developing and using our new material score.

At roughly 65% correlation, our new material scores are indeed positively correlated—but, meaningfully different—from the traditional scores. This indicates that the Russell Investments scores offer something extra and above that of the traditional scoring approach.

Materiality and company performance

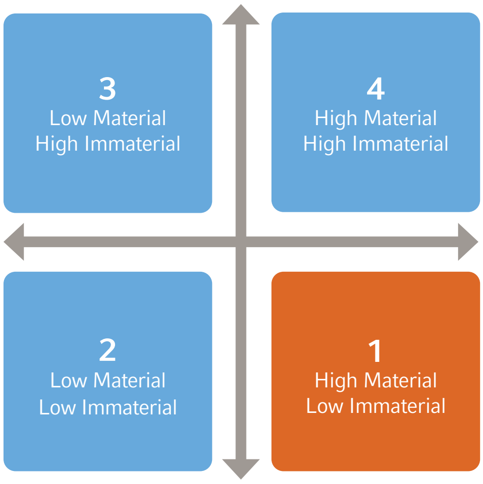
At Russell Investments, we believe that a sound awareness of ESG factors and a robust process can help to deliver strong investment returns and meet objectives over the long-term. In light of this, the next obvious question is: Can materiality help to deliver strong performance?

Khan, Serafeim, and Yoon (2016)

A recent study in 2016 by Khan, Serafeim, and Yoon (KSY) shows that companies with strong performance on material ESG topics outperform companies with poor performance on material topics. The figure below shows the relative returns of companies that had high performance in material issues and low performance in immaterial issues. High performance on material issues led to higher alphas than low performance (quadrant 1 vs. 2 and quadrant 4 vs. 3).

Interestingly, after controlling for high performance in material issues, a portfolio of companies scoring low on immaterial issues generated higher alpha than the portfolio of high performance on immaterial issues. In other words, spending resources on immaterial issues appears to have been value detracting. This further supports our view that differentiating between material and immaterial issues matters from an investment perspective.

Mapping of performance of both material and immaterial categories. (Khan, Serafeim, and Yoon, 2016), US Large Cap Universe, 1991 - 2013



Four-factor alphas (1991-2013)	Annualised alpha	Difference in alphas
1 - High Material, Low Immaterial	6.01%	
2 - Low Material, Low Immaterial	-2.90%	8.90%***
3 - Low Material, High Immaterial	0.60%	5.41%***
4 - High Material, High Immaterial	1.96%	4.05%**

Source: Russell Investments. Alphas refer to portfolio returns regressed on four-factor models including Mkt-Rf, SMB, HML, and UMD. ***, **, * refer to significance at the 1%, 5%, and 10% levels respectively.

Can our new material score be used to impact performance?

The study by Khan, Serafeim, and Yoon has many important implications for our research and indicates that spending resources on immaterial issues is potentially value detracting. Going back to our original example, learning that fuel efficiency is a poor signal for future outperformance of an investment bank does not imply that the same is true for an airline. This explains why using fuel efficiency as a signal across a universe could lead to inconclusive results, even though it may be a valid signal for a subset of the universe.

In an effort to evaluate whether our new scores can indeed be used as a return indicator, we back tested them between December 2012 and June 2017 on a wider indicator than KSY used—the Russell Global Large Cap Index. This test found that material issues are indeed a promising signal for informing investment decisions based on ESG performance. Investors could potentially gain an additional 22 basis points (versus using the traditional ESG score) by refining stocks to those that have higher material ESG characteristics.

Material and Immaterial ESG Issues (RGI Global LC, Dec 2012-June 2017)

Annualised Differences in four-factor alphas (High – Low Quintiles)	
Material ESG Issues	1.19%**
Immaterial ESG Issues	0.30%
Traditional ESG Score	0.97%*

Source: Russell Investments. Alphas refer to high minus low portfolio returns regressed on four-factor models including Mkt-Rf, SMB, HML, and UMD. ***, **, * refer to significance at the 1%, 5%, and 10% levels respectively.

Consistent with KSY, we found that the difference between high and low performers on material issues is larger than immaterial issues or the traditional scores. This suggests that material issues are the most promising signal among those we consider here for informing investment decisions based on ESG performance. The difference in alphas is statistically significant for material issues, but not for immaterial issues.

So, does materiality matter? Yes.

Industry bodies and Russell Investments aligned

Industry bodies such as the Task Force on Climate-related Financial Disclosures (TCFD) and the United Nations-backed Principles for Responsible Investment (PRI) actively promote and recommend that companies need to focus more on the material ESG issues that directly affect their bottom line. With the help of SASB's industry-level material map and data from Sustainalytics, we have been able to do just that, and construct a new ESG score that focuses solely on material issues.

Russell Investments material ESG scores are better predictors of return

Ultimately, our new score allows us to differentiate between companies in a way that the traditional score does not facilitate. We can now distinguish between companies who score highly on ESG issues that are financially material to their business, from those who score highly on issues that are not financially material to their business. Our research suggests that the Russell Investments material ESG scores can provide insights beyond traditional ESG scores.

Ongoing research to ensure robustness and risk management

We will commence use of the material ESG score in the Russell Investments' Decarbonisation Strategy as part of our ongoing integration of the score. We believe that the Russell Investments' material ESG score represents a strong development in our understanding of ESG performance drivers. Today, the scores are being used and measured in our research databases to help us chart further progress. We are in the early stages of development and further research is required to determine the integration of the Russell Investments' material ESG score throughout our investment process.

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