Hold the Ratings: ESG Funds Outperform If They Use More Data

The creator of active shares has debuted a new metric, active ESG shares, that measures how much a manager leans on ESG scores from third-party providers.

By Brian Ponte | March 10, 2023

Actively managed environmental, social and governance-focused funds that consider more than just third-party ratings tend to outperform such funds that lean heavily on the scores, new research shows.

The creator of the active shares metric published a paper in late January describing a new score, active ESG share, which measures the degree to which portfolio managers use ESG information and compares the ESG ratings of a fund's holdings to the ratings of its benchmark.

The goal of active ESG share is to measure whether a manager actively uses a variety of ESG information or simply favors stocks with high ESG ratings, according to the paper, written by University of Notre Dame professors Martijn Cremers and Rafael Zambrano, and University of Arkansas professor Timothy Riley.

The report analyzed actively managed funds that are labeled as ESG.

The metric is reminiscent of the active share figure, which measures how actively managed a mutual fund is, by comparing its holdings to its benchmark. Active share was introduced in 2006 by Cremers and quantitative researcher Antti Petajisto.

The January paper shows that funds with a high active ESG share – that is, funds that appear to lean less on ESG ratings and benchmarks – tend to outperform those that simply select securities with high ratings. Funds that hold stocks that carry significantly different scores from different ESG ratings providers tend to perform best.

Active ESG share factors in whether managers deviate from ESG benchmarks by selecting stocks with low ESG ratings, either because the manager believes that the score will improve or that the rating itself is inaccurate, Cremers said.

The fact that ratings for the same company can differ from major providers is a "huge challenge" for managers of ESG funds, Cremers noted. However, the best-performing ESG funds are those that invest in securities that have ratings that differ from provider to provider. The report uses data from MSCI, TruValue Labs and Kinder, Lydenberg, and Domini.

“When people in the market disagree, well, then you need an expert to figure it out,” Cremers said. “Managers that are most active in the ESG dimension tend to do better in the future and that is especially true if they tend to focus on those stocks.”

The average active ESG share for a fund is about 15%, the paper notes, and scores extend to the mid-20s. The higher the score, the more likely it is that funds hold low-scoring or disputed stocks.

Funds with the highest active ESG share scores include the $4.8 billion Parnassus Value Equity Investor Fund, which has a score of 25%; the $1.1 billion TIAA-CREF Social Choice Low Carbon Equity Fund, with 22%; the $39 million Trillium ESG Small/Mid Cap Fund, with 26%; and the $36 million Cromwell Tran Sustainable Focus Fund, with 25%.

The Parnassus Value Equity Investor Fund had net returns of 15% during the three-year period ended June 2021, Cremers’ data shows, and 14% during the trailing five-year period. It beat its stated benchmark over both periods. The index returned 11.5% over the same three-year period and 10.2% over five.

“We use the data providers as a source of information, but then we go much beyond that, and do our own level of analysis and due diligence,” said Robert Klaber, portfolio manager and director of ESG research at Parnassus. “And so the way we approach it, is we focus on the three to four most material ESG factors pertaining to the company sector and we evaluate how the company performs on those ESG factors.”

Parnassus’ proprietary research led the firm’s portfolio managers to pick, for several funds, Veeva Systems, a leading life sciences software company, Klaber said. Veeva had received a low ESG score by a leading ratings provider because of its employee satisfaction, he noted. He declined to name the provider.

“When we did our due diligence, we realized that, in fact, this company is one of the most desirable places to work in software in the Bay Area,” Klaber said. Parnassus’ research was based in part on interviews with Veeva employees, who spoke positively of their workplace, he noted.

The TIAA-CREF Social Choice Low Carbon Equity Fund, meanwhile, returned 16.2% over the three-year period ended June 2021, and 14.8% over the trailing five-year period, the data shows. Its benchmark, meanwhile, returned 14.9% and 14.4% over the same periods.

“Our investment process for the Social Choice Equity suite, as an example, is designed to drive exposures to companies that best manage material environmental and social risks, while also demonstrating strong governance controls,” a company spokesperson said.

The Trillium ESG Small/Mid Cap Fund had net returns of 13.2% and 12.6% over the same three- and five-year periods, respectively. Comparatively, its benchmark returned 12.9% and 12.8%, respectively, over the two time periods.

Trillium uses a proprietary sector- and industry-specific materiality assessment and benchmarking framework within its analysis of companies.

“Trillium’s ESG research uses inputs from multiple data sources and extends well beyond the raw data and ratings provided by third-party financial providers,” said Mitali Prasad, portfolio manager and analyst of the fund. Such information includes in-house research and datasets, as well as governmental websites and non-government organizations, she noted.

“Each company is evaluated against their peer set, scored, and monitored on an ongoing basis to account for any material changes that might arise,” Prasad said.

And the Cromwell Tran Sustainable Focus Fund returned 16.2% over the same three-year period analyzed, beating its benchmark by 2.8 percentage points. Over the five-year period, the fund returned 15.6%, or 2.2 points better than the index.

Cromwell augments the ESG data it receives from the ratings agencies with an internal ESG framework, said Quoc Tran, investment chief of the fund’s subadvisor, Tran Capital Management.

A shortcoming of using ESG scores is that many ratings providers equate good disclosure with good ESG practices, even if the actual business is harmful, Tran said. For example, some tobacco companies have high ESG scores, he noted.

Overall, high active share and active ESG share deviate from their benchmarks, which could potentially lead to funds' underperforming as well as overperforming, said Alyssa Stankiewicz, associate director of sustainability research at Morningstar.

“They seem to suggest that managers on ESG funds are more knowledgeable about the ESG data, but is the appropriate takeaway there that ESG is a specialized knowledge set?” Stankiewicz said. “Or just that a fund manager is likely more able to drive outperformance using a data set if the data are central to the investment process?”

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Active Share measures the percentage of stock holdings in a fund that differ from a benchmark. **ESG** refers to environmental, social and corporate governance. **Price to earnings** (P/E) is the market price per share divided by earnings per share. The **S&P 500 Index** is a capitalization-weighted index of 500 stocks. An investment cannot be made directly into an index.
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