What Makes a Better Company? ESG and ESG Ratings

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Abstract. Nowadays, all sectors of society and companies at all levels attach increasing importance to ESG. ESG can bring value to enterprises besides economy and make great contribution to society and environment while helping enterprises to manage their internal affairs well. Therefore, exploring the magic of ESG has become a work that cannot be ignored. Through research on Parnassus and MSCI, this paper finds that ESG rating system is established through a large number of measurement standards, and how ESG helps companies develop requires a complex and complete process.

Keywords: ESG, ESG Ratings, Environmental, Enterprises

1 Introduction

Since the new century, with the whole progress of human society, people's social responsibility is heavier, at the same time, the concept of sustainable development and green development gradually wins support among people. Social demand for enterprise is not only in economic or corporate governance, enterprises in the field of environmental and social performance received extensive attention of the society from all walks of life.

The concept of ESG first appeared in the 1980s and was officially proposed in a research named Who Cares Wins [1] in 2005. In this concept, E is environmental, and it focuses on the impact of the company on the environment, for instance, environmental policy, emissions, climate impact and water management are all concerned. S is social, just as the word implies, some social problems are paid much attention to, such as labor relations, consumer protection, workforce diversity and product safety and quality. Similarly, G is governance, in this respect, a company's internal management and operations are highly valued. Problems like shareholder relations should be handled well.

Following what has been discussed above, it is clear that ESG is a comprehensive investment philosophy that takes environmental, social and governance into consideration. Through ESG, investors are able to better evaluate investment behaviors and company's contribution to society and the environment.

Additionally, ESG ratings is also an extremely important approach. ESG ratings make it relatively easy for investors to make judgments on non-financial information

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of companies, and researchers increasingly rely on ESG ratings for qualitative analysis and empirical analysis.

So the research is trying to figure out some questions: Why more and more companies emphasize ESG? How do ESG ratings work? How ESG influences the company's development?

To answer these questions, the author data and reports from some listed companies and analyzed them. Besides, a lot of references were also made.

The author chose MSCI to analyze how do ESG Ratings work? What are the features and benefits? What approach does it take? What does it offer? Also, the author took Parnassus Investments as an example to introduce how a company can implement its ESG concept into the actual investment process. Therefore, it is predicted to have a more comprehensive and in-depth understanding of ESG and its related content.

2 Overview of ESG and Key Participants

To figure out why more and more people emphasize the importance of ESG, it is necessary to understand what ESG is thoroughly and who is involved in it. As the author talked above, ESG pays more attention to the E, S and G dimensions, while weakening the company's financial performance. While the overall direction of ESG in China and Western countries is basically the same, there are some differences [2]. Compared with western developed countries, China's ESG investment started relatively late and has a small scale. In addition, as China's ESG information disclosure standards are not enforced, the quantity and quality of disclosure are low, so China's ESG could be described as concept-oriented and fail to form effective management [3]. As a comparison, western ESG disclosure data is more comprehensive and complete, and its governance is relatively standardized. ESG investment strategy has also developed earlier, and has formed a better echelon of ESG investment targets. Parnassus is the largest, earliest and best performing of the top 20 ESG strategic public funds in the world, and Parnassus is taken as an example in the article.

Then the author studied some key participants in the secondary market. They are stock exchanges, listed companies, rating organizations and venture capital firms. There are a lot of organizations and companies like MSCI, Parnassus Investments, Thomson Reuters Corporations and so on. Much systematic work has been done around ESG by them. Of course, they are doing different work around ESG in the secondary market. For instance, the stock exchange can provide advice for the proper flow of investment. Also, the stock exchange facilitates the free flow of capital and can offer update about profitability and development of securities issuing companies through daily information on listed companies. So that social funds flow in the direction where they are most needed and most beneficial. At the same time, it is impossible for any regulations or rules to be perfect, and sometimes trading rules may not be effectively implemented. Therefore, it is one of the important responsibilities of exchanges to supervise all kinds of behaviors that violate the fairness principle and trading rules, so that trading can be carried out fairly and orderly.

To conclude, ESG concept can bring great value to enterprises and make them operate efficiently. In addition, ESG can point out a more forward-looking path for enterprises and make greater contributions to society. Other relevant participants, including rating agencies, are to optimize the indicators and content of ESG and ultimately achieve the purpose of promoting social progress.

This explains the growing emphasis on ESG.

3 ESG Ratings: Take MSCI as an example

In this part, the author will figure out the question: How do ESG Ratings work?

As mentioned above, ESG ratings make it relatively easy for investors to make judgments on non-financial information of companies, and researchers increasingly rely on ESG ratings for qualitative analysis and empirical analysis. There are a number of companies or organizations that do rating work, such as Morgan Stanley, KLD Research and Analytics, Thomson Reuters Corporation [4].

Under normal circumstances, ESG evaluation system takes E, S and G as the core and sets hundreds of indicators around ESG to form a complete system and judge the development level of a company on ESG, and then provide useful advices.

ESG is more based on the perspective of practical operation, it provides a more comprehensive, more perfect evaluation framework. And it has been clear about the matters should pay attention to during enterprise production, investment and development direction of the company. It not only can better analyze enterprise implementing the green development idea, but also can evaluate the enterprise sustainable development ability. In addition, investors can use ESG data ratings to help them make more sound investment decisions.

Now shifting the content to MSCI ESG Ratings.

MSCI hope to provide the society with a very comprehensive and perfect ESG ratings system, so as to help reduce the risk in the process of investment. That is to say, without the help of the ESG ratings system, some hidden risks can be easily overlooked, and it may give rise to extremely bad consequences.

MSCI has a huge scale for ESG research, including over 200 analysts, 1500 ESG Equity and Fixed Income Index and 1700 ESG Research Client Worldwide.

MSCI ESG Ratings' key features and benefits are as follows.

MSCI has created a dynamic model so that every new and trivial risk could be detected as soon as it emerges. Additionally, they update and check the model frequently so as to ensure the accuracy of the model. In order to make the model consistently valid and accurate, it must rely on a large amount of data, MSCI collect data from their clients and researches from society. Specifically speaking, MSCI ratings system covers over 8000 companies. Therefore, we can draw a very basic conclusion: the strategy or approach needs to be universal and can keep up with the industry.

A model or a rating system should be designed as a considerate tool so that the result could be accurate and persuasive. To be specific, it must take as many useful factors or metrics as possible into consideration, such as board, ownership and so on.

The accumulation of data over the years helps to gain insights and analyze solutions to some key problems, while adjusting the weight of indicators based on the importance of indicators reflected in different data.

The 21st century is the age of science and technology, in any aspect of the work cannot lack the help of science and technology. In the face of such a large amount of data, it is difficult to rely on human resources alone, so ESG data analysis naturally needs AI. It is never exaggerating to say that AI is of tremendous significance to contemporary society. With the help of AI, we are able to validate data efficiently. Also, data should be daily updated and checked, and it also requires the help of artificial intelligence. The author took MSCI as an example, MSCI monitors over 3,000 media publications and daily updates of public files in order to guarantee effectiveness and timeliness.

In respect to data collection, MSCI does not use questionnaires but collect and standardize public data, and most data are from company disclosure documents and thousands of media sources. Besides, alternative data about government included.

Before rating, the team would make an exhaustive evaluation. Every important issues would be scored by specific standards. Also, the team would monitor the controversies and events daily and update them weekly.

After all the preparations have been made, MSCI team performs the final ESG ratings. They produce reports on ESG ratings by assigning weights to different indicators and how risks or issues are scored on those indicators. Additionally, these ratings would be checked by market or committee.

MSCI is able to provide rich feedback to clients after the entire ESG rating process is completed, such as Company, Industry & Thematic Reports, Portfolio Analytics, Data Feeds and Indexes.

The ESG rating of China Securities Index provides the answer to the question of which of the three dimensions constituting ESG has the most significant effect on enterprise value enhancement [5]. In the study of ESG rating of HuazZ, the coefficient of G was the largest (0.074), followed by the coefficient of E (0.052), and the coefficient of S was the smallest (0.035). It can be seen that good corporate governance is of great help to the improvement of corporate value. Compared with corporate governance, the effect of the other two factors is limited. The possible reason is that undertaking environmental and social responsibility will not only produce direct costs, but also indirect costs by occupying enterprise resources and crowding out other projects, thus reducing the competitive advantage and enterprise value [6].

In addition, data show that companies with higher ESG ratings are more resilient to sudden and adverse environmental changes [7-8].

4 Detailed operation process of ESG: Take Parnassus as an example

The author took Parnassus Investments as an example to introduce how a company can implement its ESG concept into the actual investment process. As an investment management company founded nearly 40 years ago, Parnassus has long insisted that environmental, social and corporate governance performance be taken into consideration. A good evaluation system with solid fundamentals and plenty of indicators is of great importance to accurate analysis and also, it is beneficial to create more chances. When making decisions, Parnassus tend to complicate matters and consider as many aspects as possible to ensure that as many risks and problems as possible are identified and addressed in a timely manner. By doing so, not only can bigger problems be prevented, but also greater investment and income at the social level can be generated.

1Parnassus' overall ESG implementation process includes the following aspects: ESG Guardrail, ESG Research in Security Selection, Monitoring the ESG Profiles of Holdings, Making an Impact with Engagement and Proxy Voting [9].

4.1 ESG Guardrail

Parnassus Investments' ESG research process begins by creating a list containing companies that fail to meet the ESG criteria established by Parnassus itself. Parnassus Investments takes a systematic approach, removing ESG's worst-performing companies from its portfolio. The restricted list includes two categories of controversial corporates: those have been judged as unqualified for investment due to non-standard management or other factors, and companies that do not meet the company's exclusion screening. Specifically, corporates that gain over 10 percent of their revenues from alcohol, weapons and other detrimental aspects are excluded from their prospectuses. Parnassus Investments claimed that companies such as alcohol manufacturers are unable to provide a positive contribution to society.

4.2 ESG Research in Security Selection

After being screened from the restricted list, any company not on list can be qualified for more in-depth ESG and comprehensive research. Analysts leverage the expertise of Parnassus' dedicated ESG management team throughout ESG's evaluation of latent holdings. Also, the analyst leads research on company-specific ESG risks, while the ESG management team is responsible for the all-important risk research department.

4.3 Monitoring the ESG Profiles of Holdings

Analysts regularly review and update holders' initial research reports, and each held ESG risk document is checked at least every year, and even more frequently if disputes arise. In particular, the five riskiest companies in each strategy will receive additional attention from analysts and management teams.

4.4 Making an Impact with Engagement

Parnassus Investments owns a large number of shares in the company, providing the opportunity for Parnassus investors to be heard by a lot of most powerful companies all over the world. Establishing a positive relationship between spending and management is an effective way to affect corporate change. While investment firms such as Parnassus continue to prove themselves capable of providing valuable advice, many others will try to come for help.

4.5 Proxy Voting

Parnassus claims that ESG investors could add the long-term value of the company in their portfolio by ensuring that their proxy vote is in their interests as shareholders. Proxy voting plays an irreplaceable role in Parnassus' participation strategy, particularly its guidelines for voting and transparent voting records.

5 Conclusion

Through the full text of the exploration and analysis, the author have been able to have a basic and relatively comprehensive understanding of ESG. ESG can not only bring economic benefits to the enterprise, but also help the enterprise make great contributions to the society and the environment. With its unique way of thinking, ESG points out a very forward-looking way for the enterprise, which can always make the whole enterprise full of energy. There is a significant positive correlation between ESG information disclosure and enterprise value. Compared with before the policy release, ESG information disclosure plays a role in promoting enterprise value after the policy release; The promotion effect of ESG information disclosure on the value of manufacturing enterprises is mainly reflected in non-state-owned manufacturing enterprises with a high degree of marketization [10].

In terms of ESG rating, it can be seen from the case analysis of MSCI that a complete rating system usually needs hundreds of indicators as measuring standards. The more comprehensive the indicators are, the more objective and accurate the evaluation results will be, thus having higher reference value. Client companies and investment companies can use the results of ESG ratings to adjust their operational details, corporate goals or concepts in real time and appropriately, so as to achieve better development.

From Parnassus, it can be seen that ESG is much more than just the three words. Integrating ESG research into the investment process allows companies to identify material risks and opportunities that may otherwise be overlooked. This comprehensive analysis of fundamental and ESG attributes in tandem results in a more complete view of company prospects, which may also help reduce portfolio volatility and manage downside risk.

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