ESG Ratings Agencies – Opportunities for a Small and Mid-Cap Investor

Chelverton's investment processes are designed to capture the valuation inefficiencies prevalent in the small and mid-cap company segment.

Currently we see abundant value within our stock universe as the historic small and mid-cap discount is stretched by macro factors. However, as we wait for these macro factors to improve, Chelverton have been focussing on value-enhancing engagement, prompting this ESG bulletin.

We believe the recent change in MSCI's ESG Fund Rating methodology, removing the ESG momentum factor, may create an opportunity for us given our investment focus on unrecognised value and our engagement focus on encouraging and supporting improved ESG management and reporting capabilities amongst our small and mid-cap holdings.

However, before discussing this change it is helpful to consider the context:

There is a recognised large-cap bias in the ESG ratings awarded to companies by external ratings agencies. In our view, this bias compounds with other pricing inefficiencies to add an additional dimension of unrecognised value that we seek to target through our investment processes.

The chart below highlights the large cap bias of various ESG ratings agencies.

Source: LaBella et al. (2019) cited by Klement, February 2021

As the importance of ESG management increases, we believe the bias is constraining market efficiency for a combination of reasons:

- Small and mid-cap companies remain significantly under-researched by ratings agencies, yet research highlights that asset managers running sustainability-focussed strategies frequently use agency data as a stock universe filter, meaning the absence of a rating is a problem[1].
- Where agencies do research smaller companies, assessments tend to reward the number of ESG data points reported, discriminating against lean small companies with less reporting resources, leading to relatively lower ratings. Again, research highlights that asset managers running sustainability-focussed strategies frequently filter out or limit exposure to perceived

[1] EU Commission Study on Sustainability Data file:///C:/Users/sdc/Downloads/study%20on%20sustainability-related%20ratings%20data%20and%20research-EV0420315ENN%20(2).pdf

'laggards' (those with the poorest ratings), creating a problem for small company inclusion within the available stock universe[1].

Consequently, we speculate that poor quality ESG ratings may compound with poor universe coverage to leave ESG management strengths inadequately recognised within the small and mid-cap segment.

Chelverton have been targeting this issue through their annual Engagement Plan(s) for a number of years now, as a value-enhancing exercise. We have been writing to committed holdings regarding how to improve ESG management and reporting capabilities via improved risk identification and the adoption of recognised frameworks and standards that enable fairer assessments. We offer support to smaller companies in their development of ESG management and reporting capabilities, working to unlock the value of hidden ESG strength within our companies wherever we can.

MSCI's decision to remove an adjustment factor from their ESG Fund Rating methodology resulted in the whole MSCI fund universe being moderated downward at the start of this year.

The adjustment factor aimed to include a fund's exposure to positive or negative ESG trends and laggards within the fund ESG rating. However, the factor had resulted in an upward drift in ratings over time, as funds have been exposed to more positive than negative trends in recent years, and have limited exposure to laggards due to limit and exclusion policies, as discussed.

At Chelverton, the changes generated interest and reflection.

Prior to the change the rated proportions of Chelverton funds were all in MSCI's Leader category i.e., AAA or AA rated.

Post the change the rated proportions of Chelverton funds were moderated downward along with all other funds, but have since returned to an improving trajectory.

Three funds again sit in the Leader category, rated as AA (category band includes AAA and AA ratings), and one sits at the top of the Average category, rated as A (category band consists of A, BBB and BB ratings)[2]

The changes highlight a number of important considerations:

Firstly, despite the discussed rating constraints experienced by small and mid-cap companies, our holdings are generally well-rated by MSCI where an ESG rating exists. The removal of recognition of strong ESG management momentum – which we look for, encourage, and support, as an indicator of sustained competitive advantage in our companies - has not detracted from the underlyingly assessment, despite the factors that create the large cap ratings bias.

Secondly, we consider the removal of the adjustment factor presents us with an enhanced opportunity given our process focus on ESG management momentum within an agile, under-researched stock universe adapting to required change at pace.

Chelverton UK fund managers do not pillar score the companies they select. Instead, the managers look for proportionate and/or improving ESG management focus and reporting capabilities as an investment quality indicator, working to encourage and support improvements wherever relevant.

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[2] CAM internal ESG risk reports, Q2 2023.

European Select Fund managers do pillar score using the aggregate score to adjust the discount rate applied to cash flows projections where appropriate. The managers similarly work to support and encourage ESG management and reporting improvements amongst their small and mid-cap holdings.

As responsible investors our annual Engagement Plan, now in its third year, has evolved to embrace the concept of double materiality. Double materiality focuses not just upon the sustainability issues that are directly material to a company's financial performance, but also on the systemic issues that are considered the responsibility of all market participants to manage in the long-term interests of wider stakeholders.

We are actively engaging with committed holdings on climate change, nature protection and restoration, and diversity, equity and inclusion, and the importance of including meaningful ESG targets in executive remuneration packages.

We will continue to encourage and support the ESG management and reporting trajectory of our companies to help ensure the efficient allocation of capital to this important market segment, which has consistently outperformed larger peers over the long-term. Small and mid-cap companies undoubtedly sit at the heart of the global economy, within supply chains and serving the needs of consumers, and they have a central role to play in delivering a more sustainable future.