OWL ESG

THE GOLD STANDARD FOR ESG DATA & ANALYTICS

THE COST OF BAD ESG DATA

Ranging from missed opportunities to potentially significant harms, the pitfalls of unreliable ESG data present an unacceptable risk.

- Massive amounts of capital will drive ESG growth over the next few years, as a younger generation of investors prioritizes corporate responsiveness and impact investing.
- Today, a staggering amount of ESG data is stale, subjective, or inaccurate, and data vendors lack either the structure or resources to address this at scale.
- Manual research to correct inaccurate data is an expensive and slow part of daily operations for many investors. In the future, it will be prohibitively resource intensive.
- The cost of relying on bad data will ultimately be even greater, as investors are subject to regulatory, financial, and reputational harms.

The market has dictated that environmental, social, and governance (ESG), or sustainability, is more than just a sales tool or talking point. Being responsive to ESG issues fosters good corporate stewardship and is paramount for companies and their investors alike. The impact of ESG factors is second only to financial returns in driving investment decisions, and corporate management is responding accordingly.

A new generation of investors considers ESG metrics to be a non-negotiable component of their decision-making process, and they are raising expectations for robust disclosures and meaningful actions on the part of companies that wish to earn their trust and their dollars. As the link between improved sustainability and financial returns grows stronger, so does the prominence of ESG data for asset owners and investment managers who are pursuing strong risk-adjusted returns.

Further, meaningfully incorporating sustainability into corporate planning signals to investors that management is committed to developing thoughtful long-term strategies, an essential attribute in upholding shareholder value. Companies that prioritize ESG considerations are attracting new customers and increasing “stickiness” among existing customers. Integrating ESG factors into a corporate strategy also demonstrates that management is flexible and can adapt to changing market expectations and market conditions, now and into the future.

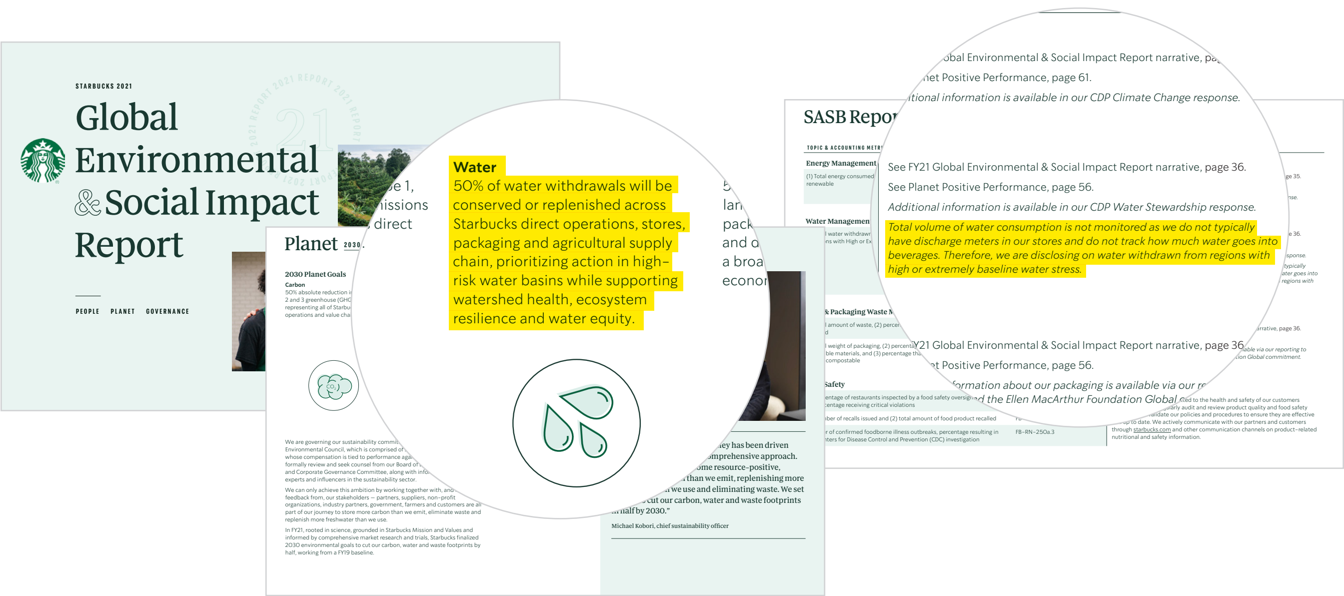
Investment firms, wealth managers, asset owners, and the entire investment ecosystem have embraced the ESG market, with ESG assets expected to reach around $50 trillion by 2025, approximately one-third of total assets under management globally. This is in addition to the $70 trillion of wealth that a new and impact-conscious generation of retail investors will inherit over the next decade, in a space that has seen more than 100 percent growth in ESG assets managed in the last five years. Having accurate and updated ESG data to inform investment decisions is essential, with the same degree of accuracy that we have come to expect from reporting on EBITDA or EPS.

BAD DATA IS THE NORM

Nonetheless, the market continues to rely on ESG data that is incorrect, outdated, subjective, inconsistent, and often all of the above. An independent analysis of data obtained from 15 of the largest ESG data vendors found that 60 percent of that data was incorrect or outdated. A separate analysis of ESG data from eight of the largest providers revealed as much as 50 percent variability in their reporting of select metrics.

The lack of reliable ESG data is one of the worst-kept secrets in the investment world, and complaints about stale, inconsistent, and inaccurate data are common among asset managers who seek to include sustainability as part of their investment considerations. In fact, surveys have shown that over 60 percent of asset managers consider data challenges to be a main obstacle in adopting ESG investments.

Providers contend with several factors when collecting and selling their ESG data, which has led to the current situation. With no consistent regulatory standards for disclosures, corporate ESG reporting is often sparse, incomplete, and idiosyncratic, with different metrics reported and promoted in a way that reflects each company's interpretation of data and terminology. In addition, collecting tens of thousands of individual data points is resource-intensive and time-consuming. Business models based on human data collection require significant head count, which is expensive and fails to solve the problem of human fallibility and time limitations.



As one solution, some prominent ESG data providers developed ratings systems using the data they collect. While selling these ratings offsets the cost of data collection, the ratings themselves are only as useful as the data from which they are constructed. This means that, on top of the separate and non-trivial problem of the subjectivity involved in creating the ratings, they are wildly unreliable.

ESG's rise as a prominent consideration in strategic decisions for companies is relatively new, and the market is still adjusting to demands surrounding ESG data. Better quality data is obviously something any serious investor craves, ESG and otherwise, a fact so intrinsic to investing that it is at the root of accounting standards and insider trading laws and drives trading algorithms.

ESG data vendors will find that clients are increasingly scrutinizing the quality of their data, and choosing providers based on data accuracy and timeliness. Vendors whose business model prioritizes core data quality and accuracy, with processes that ensure the data is not stale, will be market leaders positioned to take full advantage of the seismic shift toward responsible investing and its extraordinary impact on related corporate decision-making.

DATA QUALITY DRIVES FINANCIAL OUTCOMES

In contrast, bad ESG data will exact an increasingly heavy toll, dragging down those who rely on it. This problem will be exacerbated by the growth in ESG reporting, both as an expectation and a regulatory requirement. As more metrics are reported by more companies, the investment community will face a choice between trusting data vendors or hiring additional staff for quality assurance. The outcome could be bad either way—either an unacceptable increase in staffing costs, or a reliance on an unreliable data vendor that leads to potentially catastrophic decisions.

Investment decisions based on bad data will quickly undermine confidence among investors who are seeking sustainability as a core principle. It is impossible to confidently invest based on issues such as greenhouse gas emissions or water conservation when the metrics used to analyze them are stale or inaccurate.

Even small differences can have a big impact, especially with reporting evolving so dramatically. An index based on companies in the Russell 3000 that are among the best in terms of adopting an emissions reduction policy and demonstrating progress in achieving their goals would be almost 70 percent different in composition relying on 2021 data compared to 2020 data.

Companies that are reluctant to embrace ESG factors in their strategy are signaling to investors that they are inflexible—a red flag under any market conditions. It also signals an unwillingness or failure to recognize and incorporate long-term risk factors. For example, extraction-based companies that are not planning for potential stranded carbon assets in regulation-heavy countries are asking investors to take a large leap of faith. Investors who hold the stocks (or bonds) of these companies in their portfolios based on bad data around progress toward mitigating this risk expose themselves to huge potential financial harm.

Amendments to the Fund "Names Rule"

U.S. SECURITIES AND EXCHANGE COMMISSION MCMXXXIV

SEC Proposes Rule Changes to Prevent Misleading or Deptive Fund Names

FOR IMMEDIATE RELEASE
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Washington D.C., May 25, 2022 —
The Securities and Exchange Commission today proposed amendments to enhance and modernize the Investment Company Act "Names Rule" to address changes in the fund industry and compliance practices that have developed in the approximately 20 years since the rule was adopted. A fund's name is an important marketing tool and can have a significant impact on investors' decisions when selecting investments, and the Names Rule addresses fund names that are likely to mislead investors about a fund's investments and risks. The proposal follows a request for comment the SEC issued to gather public feedback on potential reforms to the rule in March 2020.

Perhaps no asset is more valuable to a company than its reputation within its customer base, and this holds true for investment firms as well. Accusations of greenwashing have already damaged reputations and led to a loss of assets under management for investment managers that cannot support claims about ESG or sustainable funds. As ESG-based investing increases, so will the competition for investors who seek sustainable investment options, and a firm's reputation in this arena will be critical to its success. Even good-faith investments, when based on bad data, will ultimately do significant harm to an asset management firm's reputation.

Regulatory scrutiny of ESG-related reporting is only increasing. Recent changes in U.S. and E.U. reporting requirements are making headlines, with similar discussion occurring across Asia-Pacific markets. Stewardship guidelines are part of the landscape for investors in Europe, and some degree of oversight is likely in the U.S. over the next decade. Meanwhile, indexes that claim to be based on "ESG" but ultimately fail to live up to that claim will garner massive fines and penalties. As the number of these types of investment strategies increases, the data that drives them will be critical in minimizing regulatory risk.

RELIABLE DATA NON-NEGOTIABLE

The market has dictated that ESG is far more than a talking point, and the ability to incorporate ESG considerations and demonstrate results will be make or break for companies and investors alike. Data is the singular fundamental common element in all investment and strategic decisions. ESG data is no exception.

As ESG considerations become ubiquitous across the entire market, having reliable ESG data will create a competitive advantage proportionately. It's no surprise that the market for ESG data is over $1 billion, nor that it is expected to nearly triple in size over the next three years. Good data means investors are able to confidently allocate funds in ways that align with their principles and support their investment goals.

When ESG data is inaccurate, inconsistent, or stale, investors are exposed to financial, reputational, and regulatory risks that will only increase in the size and scope of their potential impact as the ESG investment market grows. Given the amount of money at stake, and the importance many investors are placing on ESG factors in driving their decisions, accepting lower quality ESG data is a risk no rational investor should contemplate.