

## ESG Integration Across the Cap Spectrum



As an investment team managing U.S. equity portfolios across the capitalization spectrum, we experience firsthand the variability among environmental, social, and governance (ESG) data and third-party ratings. We believe that navigating the current ESG landscape requires an active approach to ESG integration and engagement that is thoughtful, independent, and flexible.

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**Portfolio Specialist on  
William Blair's U.S. Growth &  
Core Equity Team**  
Tara Patock, CFA

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As an investment team managing U.S. equity portfolios across the capitalization spectrum, we experience firsthand the variability among environmental, social, and governance (ESG) data and third-party ratings. These differences largely emanate from the absence of a common reporting framework and the fact that companies are in different stages of ESG adoption within their businesses.

We believe that navigating the current ESG landscape requires an active approach to ESG integration and engagement that is thoughtful, independent, and flexible.

## **The State of Sustainability Reporting**

As investors have increased their attention on ESG factors, so too have corporations. We have observed a marked increase in the quantity of data that is available to us as investors. This is most evident among large caps, with 90% of corporations included in the S&P 500 Index issuing sustainability reports in 2019, an increase from 20% in 2011, as seen in exhibit 1.

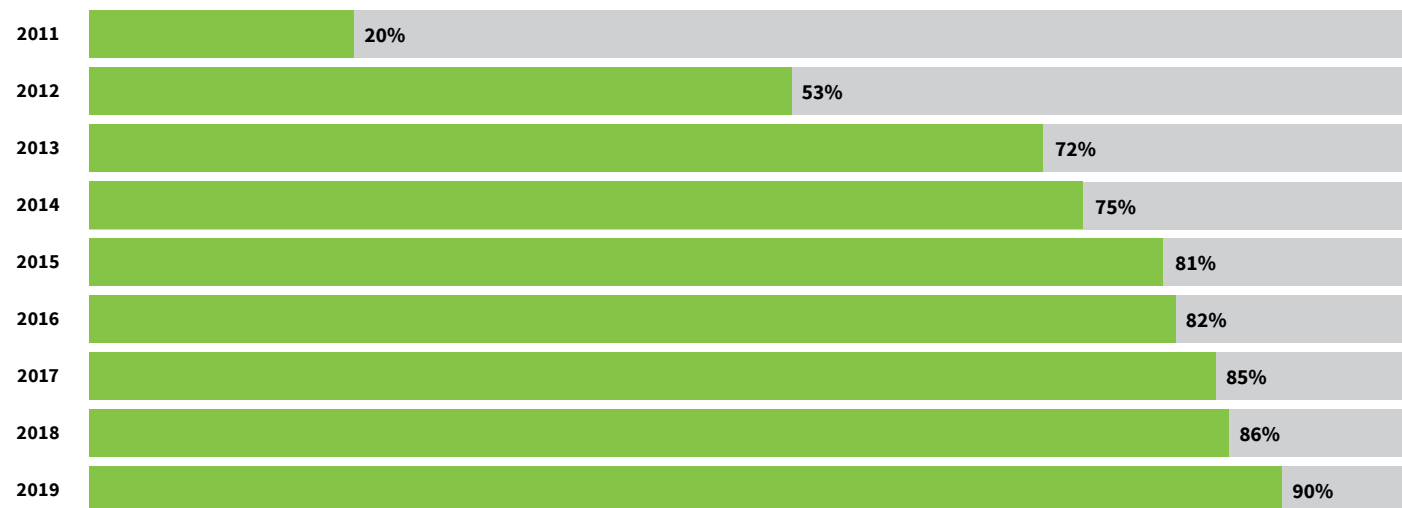
Among the S&P 500 companies, reporting frameworks remained inconsistent. The most common framework cited in 2019 was the Global Reporting Initiative (GRI) disclosure standards, with about half of S&P 500 companies referencing the GRI, according to the G&A Institute. Other reporting frameworks referenced included the Sustainability Accounting Standards Board (SASB), CDP (formerly the Carbon Disclosure Project), and TCFD (Task Force on Climate-related Financial Disclosures). With a lack of unified reporting standards, large-cap companies have been disclosing enormous amounts of information, but much of it is not useful in making investment decisions.

Beyond the use of different reporting frameworks, there is a wide range of company disclosure around sustainability information—from the breadth and depth of relevant ESG data, to the mode of disclosure (e.g., websites, sustainability reports, SEC filings), to the co-mingling of material and nonmaterial metrics. The lack of access to consistent information that is comparable across companies renders much of it, at best, unwieldy to sort through and, at worst, unusable for investors.

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## EXHIBIT 1

### S&P 500 Companies with Sustainability Reporting



Sources: Governance & Accountability Institute, Inc., as of July 2020.

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We have observed a trend toward integrated reporting, which refers to the combination of both financial and nonfinancial information in a single report. Ultimately, we believe this should help focus corporate sustainability disclosure on metrics that are material to understanding a company’s financial condition, operating performance, and/or future prospects. In the meantime, for active large-cap investors, who are faced with a deluge of

information and the task of filtering it down to what matters on a company-by-company basis, this is fertile ground for adding value.

Moving down the market-capitalization spectrum, corporate sustainability reporting is less ubiquitous. Expanding beyond the S&P 500 Index to roughly the next largest 500 companies—as measured by the bottom half of the Russell 1000 Index, which can be described as mid-cap companies—only 39% of companies issued sustainability reports in 2019. One can safely assume the percentage would diminish further for small-cap companies, and our own anecdotal evidence suggests this is true.

Smaller-cap companies are generally in the earlier phases of incorporating ESG factors into company strategy, and correspondingly, tracking and disclosing sustainability information that is relevant to their businesses. Furthermore, even when the business model and sustainability strategy are well aligned, smaller-cap companies often lack the significant resources required to produce sustainability reports.

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Thus, in the small-cap space, active management around ESG issues requires a different approach. We find tremendous value in direct discussions with management teams about these issues and are able to achieve a much deeper level of understanding of company initiatives that are not described on the company website or in a sustainability report.

## Implications for Third-Party ESG Ratings

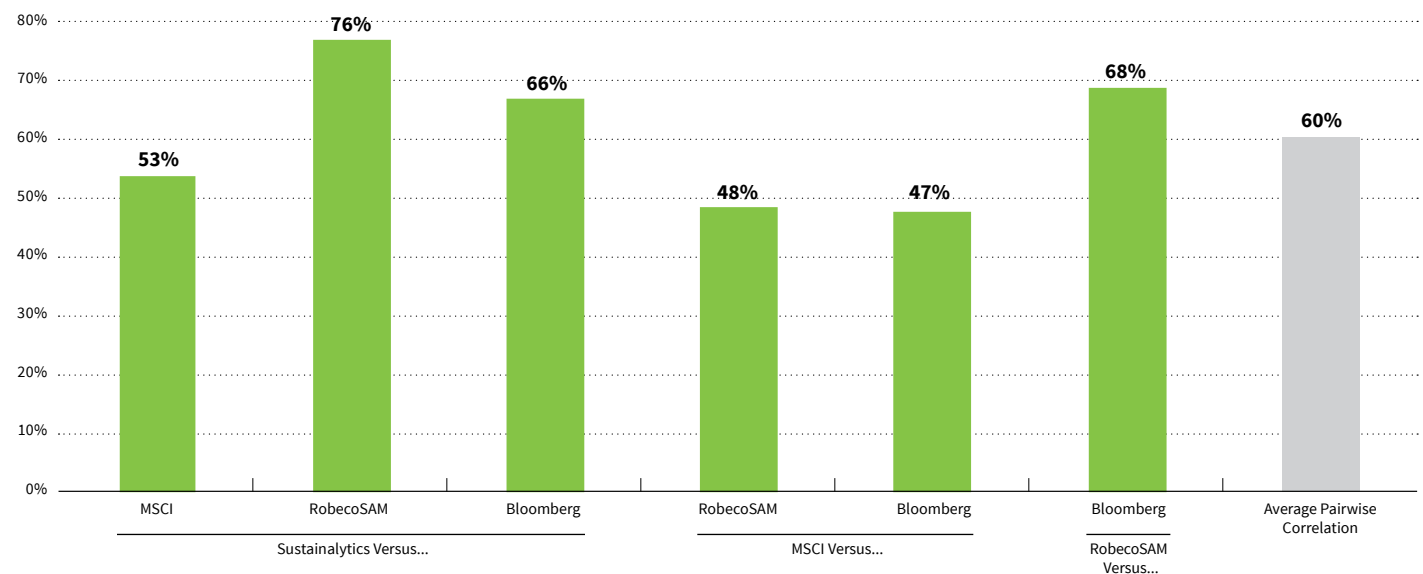
Because the industry has yet to align around a consistent reporting framework, ESG ratings providers focus on different factors, driving inconsistency across ratings. Moreover, due to stark differences in data availability across the capitalization spectrum, ESG ratings broadly skew more favorably toward large caps. This reality necessitates taking a closer look at the ESG characteristics of each company and applying one's own judgment, rather than relying on any single ratings vendor, and reinforces the importance of independent thought in approaching ESG analysis.

To better navigate this evolving landscape at William Blair, we have developed a proprietary materiality framework that informs our qualitative E, S, and G ratings. Our materiality framework is the starting point for company-level ESG research and focuses our analysts on key issues that are likely to be material to long-term financial performance.

Just as investors are focused on different factors when considering sustainability information, so are ESG ratings providers in scoring companies. Given these methodology differences, ESG ratings across different vendors yield inconsistent signals. Analysis from Empirical Research Partners comparing four ESG ratings providers against one another suggests the average correlation of ESG ratings is only 60%, as shown in exhibit 2. This implies that using two different ESG ratings vendors to assess the ESG quality of an individual company, or a portfolio of companies, could lead to very different conclusions. ESG ratings vendors are largely reliant on publicly

### EXHIBIT 2

#### Common ESG Scoring Methodologies Cross-Sectional Correlations



Source: Empirical Research Partners, State Street Global Advisors, Sustainalytics, MSCI, RobecoSAM, Bloomberg, as of 2019.

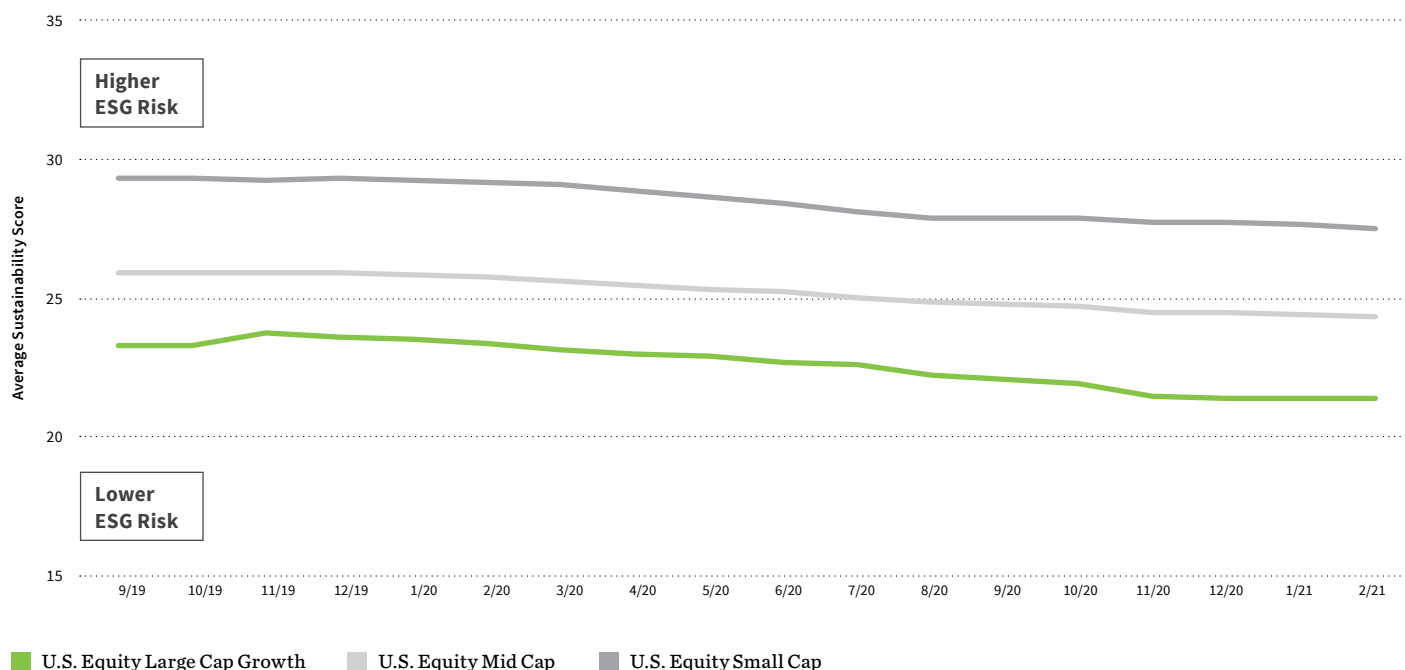
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disclosed, backward-looking ESG data to inform their ratings. Given the above-described differences in data availability across the capitalization spectrum, ESG ratings often favor larger-cap companies simply based on the level of disclosure. As an example of this capitalization bias, consider the Morningstar Sustainability Ratings for mutual funds, for which the global category averages are shown in exhibit 3 below. Sustainalytics company level scores are the basis for Morningstar's fund-level

sustainability ratings. Because larger-cap companies have more resources to dedicate to disclosure and communication of ESG initiatives, larger companies—and the funds that invest in them—generally receive better ESG scores. Thus, the market capitalization skew of a fund under consideration will be a significant determinant of how its sustainability score compares to its relevant universe.

EXHIBIT 3

## Morningstar Sustainability Global Category Average



Source: Morningstar Direct, William Blair, as of March 2021.



# ESG Integration Across the Cap Spectrum

## Engagement: One Size Does Not Fit All

With large- and small-cap companies in different stages of ESG adoption, tracking, and reporting, we believe investors should take a tailored approach to engagement to drive the most positive outcomes.

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Small-cap companies tend to be in earlier stages of adoption with fewer resources to dedicate to the monitoring and communication of ESG initiatives. We have found this provides a unique opportunity to have meaningful and constructive dialogues about these topics with the companies in which we invest. Through these conversations, we are able to influence and support their ESG initiatives, providing an important perspective as shareholders in terms of what matters to us from a resource allocation and data disclosure standpoint.

In addition, as we are significant and long-term shareholders who have demonstrated engagement around ESG issues, management teams of smaller companies often proactively seek our feedback and guidance as they endeavor to advance ESG initiatives within the company. Having this dialogue with our companies is important in not only driving greater focus on material ESG issues, but also in enabling us to participate as shareholders when company progress is recognized by ESG ratings vendors and other investors.

Among large caps, individual managers may have less influence, considering they typically hold a smaller share of a company's stock. As a result, collaborative shareholder engagements—when a group of institutional investors comes together to engage with a company on a particular ESG topic—are a common approach to influencing corporate behavior in the large-cap space. We have selectively participated in a small number of collaborative engagements focused on issues we believe to be material for owned large- and mid-cap companies.

More commonly, we engage directly with portfolio companies in the large-cap space. Our investment team has built strong relationships with management teams, which provide us the opportunity to have a direct dialogue about the prioritization of key ESG initiatives and their alignment with corporate strategy. These conversations also allow management teams to gain better perspective on our ESG priorities as long-term shareholders.

## Investment Implications

Across our U.S. investment universe, there is a great deal of variability in terms of ESG adoption within companies, data availability, and ratings signals, which necessitates a flexible approach to ESG integration and engagement across the capitalization spectrum. It is becoming increasingly critical that, as active managers, we employ independent thought and our own perspectives in managing ESG risks and opportunities in portfolios. Since developing our own materiality framework and E, S, and G ratings in 2018, the importance of these inputs in our investment process has only grown. We believe our bottom-up approach, centered on deep, fundamental due diligence that holistically incorporates material ESG factors, provides us with an opportunity as active investors to exploit inefficiencies in this area.

### **Tara Patock, CFA**

Tara Patock, CFA, is a portfolio specialist for William Blair's U.S. growth and core equity strategies. She is also a member of the ESG leadership team for William Blair Investment Management. Before joining the firm in 2013, she was a consultant with Pavilion Advisory Group. Before joining Pavilion, she was a registered sales associate with Oppenheimer & Co. Tara is a member of the CFA Institute and the CFA Society Chicago. In addition, she holds the SASB Fundamentals of Sustainability Accounting (FSA) credential. Tara received a B.B.A., summa cum laude, in economics and finance from Loyola University Chicago and an M.B.A., with honors, from the University of Chicago's Booth School of Business.

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