The Hidden Pitfalls of Third-Party Data in Portfolio Construction

Why sustainable investing demands an evidence-based approach and how Osmosis Investment Management is leading the way.

Introduction

Environmental, Social, and Governance (ESG) metrics have become essential tools in portfolio construction. However, the industry's growing dependence on third-party ESG data providers has revealed significant pitfalls that can undermine the integrity and performance of sustainable investment strategies. Osmosis champions a different path - one that emphasises evidence-based, proprietary data collection and analysis.

The Complex Landscape of ESG Data

E, S, and G represent distinct and complex challenges. ESG rating agencies employ hundreds of indicators to measure a firm's performance across these dimensions — from carbon emissions and water usage to human rights practices and board governance. Yet, addressing E, S, and G issues simultaneously within a risk-controlled portfolio remains inherently difficult.

Materiality and Divergent Ratings

Rating providers differ in how they prioritise E, S, and G categories, leading to inconsistencies. A company can score highly on sustainability with one provider and poorly with another.

Osmosis has always focused on the E of ESG, focusing on carbon emissions, water withdrawal and waste generation as they pertain to economic value, an approach which allows for specialisation and cuts through the ESG noise.

Challenges with Third-Party ESG Data

There is no single source of ESG truth — only a focused, evidence-based approach can distinguish true sustainability leaders.

Data Quality and Standardisation

The lack of standardised ESG reporting frameworks results in variable disclosure levels and reliance on estimations.

For this reason, Osmosis only uses raw, public environmental data, standardised in-house using proprietary Osmosis sectors to avoid the distortions caused by inconsistent third-party estimations. See also [the Obstructive Role of Scope 3 Emissions Data in Portfolio Construction].

The Problem of Aggregated Scores

Third-party providers aggregate diverse data into simplified ESG scores. This process is fraught with:

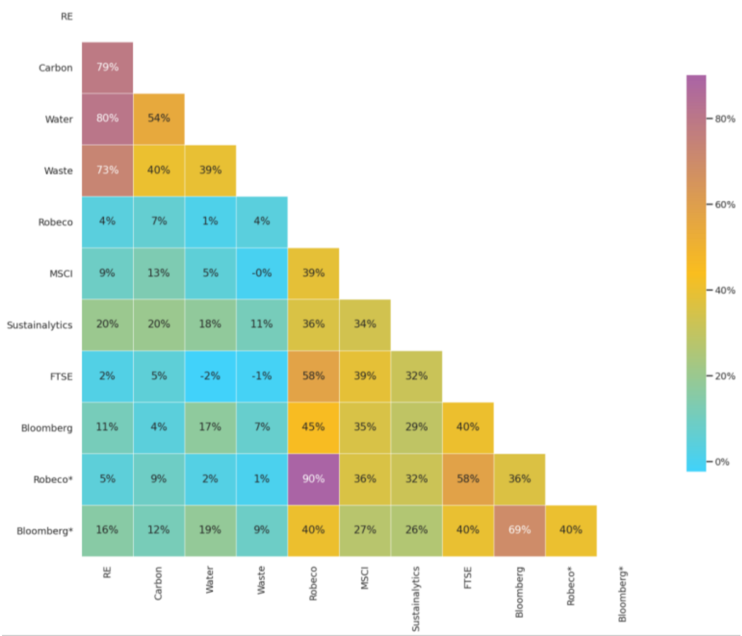
- **Lack of Transparency**: Vendors seldom disclose their data adjustment methodologies.
- **Subjectivity and Bias**: Qualitative judgments introduce inconsistencies.
- **Low Correlation**: Different providers often produce conflicting ratings.

Research by Osmosis shows that ESG scores from multiple vendors are not only inconsistent but also poorly correlated with Osmosis' proprietary Resource Efficiency scores, which focus on quantifiable, objective indicators.

ESG scores from multiple data vendors are not correlated to Osmosis' proprietary Resource Efficiency scores.

The ESG scores are also lowly correlated amongst each other.

Third party data vendors lack a consistent approach to defining, measuring, and weighting sustainability issues. Osmosis' research focuses on the economic realities of environmental sustainability.



Note: We show the correlations between Osmosis' environmental factor scores (Resource Efficiency, Carbon, Water, and Waste) and ESG scores from different data vendors. 'Env' indicates scores that are solely based on the environmental pillar. A higher percentage number indicates a higher correlation between the two respective metrics in question. Sample period: ESG data covering the years 2022 and 2023 and corresponding Resource Efficiency data over the same time period. * indicates scores that are solely based on the environmental pillar. Source: Osmosis IM, Bloomberg, FactSet.

Greenwashing and Green-Hoping

Greenwashing - exaggerating a company's sustainability efforts - remains a significant challenge, compounded by reliance on self-reported data. Without rigorous verification, it becomes hard to separate genuine efforts from marketing tactics.

Additionally, Osmosis identifies "green-hoping" - valuing companies based on promises rather than achievements - as a pervasive issue. The firm advocates for prioritising actions over intentions.

Sustainability isn't about pledges and promises—it's about measurable, verified impact.

Osmosis' Unique Approach to Data Collection

Osmosis' data collection process is manual, thorough, and rooted in objectivity:

- **Direct Corporate Reporting**: Data is sourced directly from corporate sustainability reports.
- **Sector-Specific Expertise**: Multi-lingual analysts specialise in environmental reporting within their respective sectors.
- **Proactive Identification**: Monthly reviews identify new data points through CSR alerts and corporate disclosures.
- **Rigorous Verification**: Data is standardised, statistically validated, and discrepancies are resolved through direct company engagement.

Continuous engagement ensures that companies not only report accurately but also improve their transparency over time.

Where many firms rely on generalist financial analysts with ESG certifications, Osmosis integrates environmental scientists, engineers, and subject-matter experts into its research process. This multidisciplinary approach ensures that the complexities of sustainability are properly understood and accurately reflected in investment decisions.

Conclusion: Choosing the Harder, Better Path

Third-party ESG data may offer convenience but falls short in delivering precision and integrity. It is therefore not suited to for integration in an alpha seeking portfolio. For investors committed to genuine financial and environmental outcomes, proprietary, evidence-based data collection and human expertise are non-negotiable.

For more information on how data is integrated into Osmosis's models please contact investorrelations@osmosisim.com

Important Information