A Clustering Approach for S&P 500 Index Based on Environmental, Social and Governance Ratings of Multiple Agencies

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Keywords: ESG, Cluster Analysis, Responsible Investing, Ratings.

Abstract: This article addresses the lack of standardization in the assessment of companies' environmental, social and governance (ESG) practices. To avoid implicit bias in selecting a specific rating, this study suggests using multiple assessment sources simultaneously to categorize companies as good or bad from an ESG perspective. Even with the differences in scope, measurement, and weighting between the agencies' methodologies, when applying the clustering algorithm to the ratings of companies within the S&P 500 index, it was possible to observe that the groups formed exhibited significantly different average scores for ESG practices. In this way, this article offers an alternative to mitigate the impact of rating plurality on the results of empirical studies and on the analysis process conducted by investors.

1 INTRODUCTION

Socially Responsible Investing stands out from other investment approaches because its investors consider environmental, ethical, and social impacts, as well as the corporate governance of the companies they invest in during the process of analyzing and evaluating capital applications. Pax World Fund, for example, was one of the first funds established with this focus: its investors, opposed to the Vietnam War, avoided investing in arms and ammunition companies (Renneboog et al., 2008).

From the 1970s to the present, the industry of so-called sustainable investments has evolved significantly, driven not only by legislation but also by "ethical consumption," where consumers are willing to pay a higher price for products that align with their personal values. The growth of total capital managed with a socially responsible perspective has given investors greater influence over the financial market, while requiring companies to take a clearer stance on their social, environmental, and governance practices (Sparkes & Cowton, 2004). The report "Who Cares Wins" (2004), published by the United Nations Global Compact, not only officially introduced the term ESG (Environmental, Social, and Governance) but also provided guidelines on how to integrate each of these pillars into portfolio management processes.

The integration of these aspects into the analyses conducted by investors was also promoted through the Principles for Responsible Investment (PRI). The institution assigned investors the role of main promoters of the culture of responsible investments within the financial market and investee companies; the network of associates is committed to incorporating practices that consider socio-environmental and governance aspects into their investment processes (Hoepner et al., 2021; Principles For Responsible Investment, 2021).

The incorporation of ESG aspects into the investment decision-making process occurs in several ways: ESG Integration, which involves the explicit inclusion of environmental, social, and governance aspects in the financial analysis of companies, is the most widely used method globally, followed by negative screening, which consists of excluding certain countries or sectors from the universe of investable stocks (Ciciretti et al., 2023; Global Sustainable Investment Alliance, 2020; van Duuren et al., 2016; Kotsantonis et al., 2016). Another form of integration, derived from the latter, is positive screening. Also called "best in class," this strategy involves investing only in companies with exemplary ESG practices compared to others (Bertelli & Torricelli, 2024). Corporate engagement is the third most widely used strategy. It involves engaging with the top management of companies to address environmental, social, and governance issues (Dimson et al., 2015; Barko et al., 2022).

The effectiveness, from the perspective of investor returns, of these ways of incorporating environmental and social aspects of governance into portfolio management is widely debated. Bertelli & Torricelli (2024), when analyzing screening strategies (both positive and negative) in the European stock market from 2007 to 2021, conclude that to achieve significant returns using this strategy, investors need to focus on a longer investment time horizon and be willing to relax the rigor of their exclusions.

Still on the application of the screening strategy, Wang et al. (2022) observe that, in the Chinese stock market, portfolios constructed using this method have a worse Sharpe ratio and return compared to others. The authors also conclude that screening translates into a more conservative approach to investing, which ends up accommodating the preferences of investors who are averse to high levels of risk.

In contrast to incorporating ESG aspects into the investment process through screening which, by limiting the universe of potential investments, ends up compromising the portfolio diversification process (Bertelli & Torricelli, 2024), the engagement strategy with companies tends not to cause this "damage" to the investor, since in this approach, the investor generally uses his influence as a shareholder to encourage senior management to implement changes within the company (Adebowale & Onipe Adabenege Yahaya, 2024; Schanzenbach & Sitkoff, 2020).

Regardless of the approach used, incorporating socio-environmental and governance factors into the investment analysis process involves evaluating non-financial elements of companies, such as the impact of their activities and the efficiency of their practices in ESG dimensions (van Duuren et al., 2016). The difficulty in obtaining standardized information about companies' socio-environmental conduct, coupled with the discrepancies between the methodologies and attributes considered by each financial market agent, can make assessment from this perspective controversial. The lack of consensus on the best way to qualify (or disqualify) a company's environmental, social, and governance practices diminishes the effect of allocations made by socially responsible investors and, consequently, reduces the impact on the financial performance of investments (Billio et al., 2021).

When analyzing the relationship between investor behavior and uncertainty regarding the quality of socio-environmental and governance practices of potential investees, Avramov et al. (2020) corroborate the idea that the variability of valuations can distort the relationship between risk and return on assets. They conclude that uncertainty is related to a reduction in demand for risky assets and an increase in the market premium required by investors.

The development of the sustainable investment market has made agents in this universe prepare to meet demands related to this topic. Rating agencies began to include ESG aspects in their analyses and subsequently started publishing specific scores for each of the dimensions considered (environmental, social and governance). However, each rating agency developed its own methodology for evaluating ESG practices, using the data and information they deemed appropriate for this purpose. Furthermore, the scale used to rank companies also differs depending on the rating provider, making it even more difficult for investors to compare assessments (Billio et al., 2021).

When investigating the reasons for the discrepancy between assessments, Berg et al. (2022) identified three sources of dissonance: Scope, Measurement, and Weighting. The first refers to the fact that ratings can be generated from different sets of attributes; for example, to evaluate the Environmental sphere, one agency may consider the amount of energy used per unit of product produced, while another may use the amount of carbon emitted per unit of revenue generated. The second source of divergence (Measurement) concerns how agencies use different indicators to evaluate the same attribute; the quality of the Company's internal policies can be assessed based on the number of labor actions it has open or based on employee turnover, for example. The third source (Weighting) consists of differences in perception about the relevance of attributes to a company's score — in one assessment, the weight attributed to waste management may be greater than that attributed to water consumption, for example, and vice versa for another agency.

By comparing the ratings assigned by six agencies, Avramov et al. (2020) confirmed the variation in scores from different providers, finding an average correlation between them of just 0.48. Considering some other agencies, Berg et al. (2022) observed that the average correlation between the grades awarded was 0.54, also finding that measurement was the main source of divergence between grades, followed by scope and weighting.

Regardless of their origins, the discrepancies observed make it difficult to analyze the performance (from an ESG perspective) of companies and harm the market reading carried out by companies regarding how their initiatives on the topic are being perceived by the investment industry. Furthermore, the dissonance between ratings is an obstacle to empirical studies, as the choice of which assessment will be used can significantly impact the results and

conclusions obtained (Berg et al., 2022). From De Spiegeleer et al. (2023), for example, when comparing the results obtained using the ratings of two different agencies (MSCI and Sustainalytics) in the mean-variance model with restrictions, concluded that the impact of including ESG aspects on portfolio performance depends on the source of the rating used to measure the restrictions.

In the literature, there are records of different ways to address the lack of standardization in the assessments of companies' environmental, social, and governance aspects. Some researchers choose to select ESG ratings from a specific agency ((López Prol & Kim, 2022), (Shanaev & Ghimire, 2022), (Broadstock et al., 2021)); others, in addition to using rating providers, create their own assessments of socio-environmental and governance practices: Chen et al. (2021), for example, used a data envelope analysis model (Data Envelopment Analysis – DEA) to recalculate companies' ESG scores. Pedersen et al. (2021) chose to use, in addition to the ratings provided by a specialized agency (MSCI), specific assumptions for each of the dimensions considered (environmental, social and governance).

In the context of the impact of the lack of standardization of ratings, this work aims to contribute to the debate by offering a solution through clustering companies based on the ESG ratings assigned to them by multiple agencies. By using the clustering method presented, it is possible to categorize companies as good or bad from an ESG perspective, while simultaneously avoiding implicit bias in selecting ratings from a specific agency. In this way, this article suggests an alternative approach to mitigate the impact of rating plurality both on the results of empirical studies and on the decision-making process of investors.

2 METHODOLOGY

Based on the ESG scores of listed companies, the K-means algorithm was used to classify stocks as good or bad — an approach similar to that seen in Sariyer & Taşkın (2022) and Pranata (2023).

2.1 K-Means Clustering

Clustering techniques allow data to be separated so that it is possible to observe similarities among members of the same set and differences between those belonging to different groups. Grouping elements based on a similar characteristic can help

identify other common characteristics among members of the same group (James et al., 2013).

Among the methodologies employed in combinatorial clustering algorithms, there are two widely applied methods: the partition-based method and the hierarchy-based method. According to Jain (2010) and Reddy & Vinzamuri (2018), the first one iteratively searches for groups aiming to optimize an objective function, in order to improve the quality of the grouping performed. The hierarchical method, in turn, has two major approaches: the *top-down* approach, where all data starts in a large group and is recursively partitioned into smaller groups until each analyzed data is assigned to a cluster; and the agglomeration method, in which each data is a group; iteratively, pairs of groups are merged, until a hierarchy of groups is formed.

The variables used in the grouping process are distributed into two large groups: quantitative and qualitative. The distinction between these two types is crucial in choosing the methodology to be applied, as methods efficient for one category of data may be less effective for the other (McCullagh, 1980); the ratings used in this study are examples of ordinal qualitative data.

One way to resolve the issue of the absence of a distance metric between ordinal data is to treat them as numerical data, that is, as consecutive integers, to preserve the information that certain values are better than others (Gentle et al., 1991; Zhang & Cheung, 2020). In this study, qualitative ratings were converted to a numerical scale, so that the lowest score of each rating provider was assigned the value 1, and to this value, one unit per notch was added up to the highest existing score on each agency's scale. Once a way of measuring the distance between the data was established, it was possible to use the K-means algorithm to perform the partition.

The K-means method aims to separate the data into a predetermined number of groups, with the objective of obtaining the minimum desirable distance between the data and the centroid of each group. Given the number of desired clusters (K) and an initial set of centroids, the algorithm calculates, at each iteration, the distance between each data and each of the centers. In K-means clustering, the objective function (F) to be minimized is generally the sum of the squared errors; that is, for each point belonging to each group (G_k):

$$F(G) = \sum_{k=1}^{K} \sum_{x_i \in G_k} (g_k - x_i)^2 \qquad (1)$$

Where the midpoint of cluster K is g_k. Once the defined convergence condition is not met, the algorithm updates the position of each group's centroid to the average of the points belonging to it and performs the distance calculation again until minimizing its objective function (Hastie et al., 2001; Reddy & Vinzamuri, 2018; Jain, 2010). The algorithm is summarized below:

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1. Define the number K of groups.
2. Make an initial guess about the position of the K- centroids.
3. Calculate the distance of each point to the corresponding centroid of its group.
4. **As long as the distance between each point and its centroid exceeds the convergence criterion:**
    Calculate the average of the points in each group and update the value of the K-centroids;
    Determine K groups, allocating each data point to its closest centroid;

Algorithm 1: K-means method algorithm.

Defining the number of clusters (K) used in the classification algorithm is one of the main challenges in the data separation process. One of the metrics used to assess clustering quality is the Silhouette Score, which measures how close each element in a cluster is to an element in another cluster. The score in question varies from [-1,1], with results closer to 1 indicating a better classification of the data (Shahapure & Nicholas, 2020; Sariyer & Taşkın, 2022; Dudek, 2020). The Silhouette Score was used in this work to assess whether the classification of data into two large groups was indeed the best possible for the sample used.

Thus, using the ratings provided by various agencies for the environmental, social, and governance aspects of companies, it was possible to divide the analyzed shares into two groups: K_{good}, formed by N_g shares of companies considered good from an ESG perspective, and K_{bad}, formed by N_b companies considered bad from the same angle; companies that did not have an ESG rating from at least one of the agencies considered were removed from the universe of shares analyzed in this study.

2.2 ESG Ratings

To classify the companies, ratings from three agencies were used: MSCI, S&P Global, and Bloomberg. Each rating provider has its own set of scope, measurement, and weighting for granting the ESG score.

The MSCI agency uses public data to feed its methodology, which assesses not only each company's exposure to socio-environmental and governance risks that are material to its sector of activity, but also the way in which the company manages these risks. The topics evaluated are weighted according to their impact and urgency within each sector. The final score reflects how the company is positioned (either as a leader or a laggard) relative to others in its sector. Thus, even companies operating in sectors that generate greater negative externalities can obtain a good score if their practices and their socio-environmental and governance risks are considered better than others in the sector (MSCI Inc, 2020).

The ratings provided by Bloomberg are also derived from public data. However, the agency's methodology seeks to assess how each company manages socio-environmental and governance issues that are financially material to the continuity of its activities. In addition, the agency analyzes the magnitude, probability, and timing of the impact of these issues on the company being evaluated. The final ESG score is a combination of the scores for each of the dimensions (Environmental, Social, and Governance). The weight assigned to the Environmental and Social pillars varies according to the relevance of each of them for each industry evaluated. The weight of the Governance score, in turn, is the same for all sectors, as the agency considers that country-specific factors in which each company operates are more relevant to the evaluated dimension than the sector in which the company operates (Bloomberg, 2023).

Finally, S&P Global uses, when available, its own questionnaire, (The S&P Global Corporate Sustainability Assessment (CSA)), together with public data when assigning its ratings. The agency's methodology also considers the materiality (impact, probability, and timing) of each issue for the company being evaluated, the ecosystem it comprises, and its stakeholders. The indicators analyzed are standardized across sectors and aggregated in a weighted manner to form the final rating, which then undergoes new standardization (S&P Dow Jones Indices, 2023; S&P Global, 2022).

3 RESULTS AND DISCUSSION

The initial steps in applying the proposed methodology involve data collection and processing. The ESG scores from the S&P, MSCI, and Bloomberg agencies were extracted from the Bloomberg terminal, along with the market data of the analyzed companies (price, total return, volatility, and market capitalization). Stocks that had ratings from only one or two of the agencies were excluded from the analysis.

In order to separate the impact of the COVID-19 pandemic, two-time intervals were analyzed, namely: January 2016 to December 2019 and January 2020 to December 2023. In both periods, the initial universe of shares considered in the analysis comprised all companies that were part of the S&P 500 during the analyzed interval; those companies that became part of (or ceased to be part of) the index at any point during these time windows were also excluded from the analysis.

3.1 Obtained Clusters

The groups were obtained using the Scikit-learn library in Python. After preparing the database, the ESG ratings from three agencies were used as input for 360 companies in the first period (January 2016 to December 2019) and 420 companies in the second period (January 2020 to December 2023).

The grouping was carried out in order to classify the shares into two groups: one group with the shares of companies considered good from an environmental, social, and governance perspective, and another with those considered bad in this regard. The *Silhouette Score*, used to indicate the optimal number of clusters, confirmed that partitioning into two groups would be ideal (Figure 01).
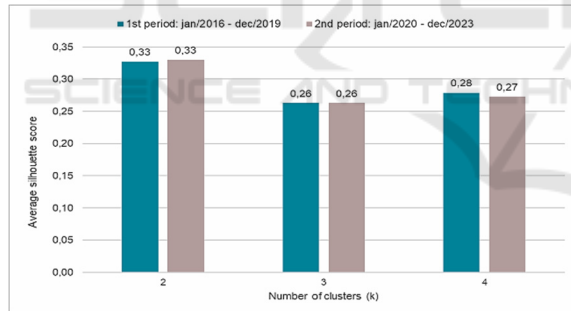

Figure 1: Silhouette score for different numbers of clusters.

Thus, two clusters were constructed for each evaluated period. Although it is possible to note an overlap between the ratings of the groups — a consequence of the difficulty in grouping companies based on the evaluations of the different agencies — a distinction between the clusters can also be observed based on their average scores (Figures 2 and 3); the grouping carried out based on the ESG scores of the shares resulted in statistically different groups (Tables 1 and 2).
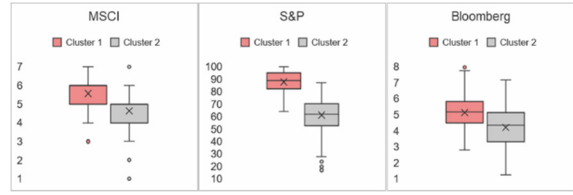

Figure 2: Distribution, by agency, of the scores of each cluster of the shares considered in the period from January/2016 to December/2019.
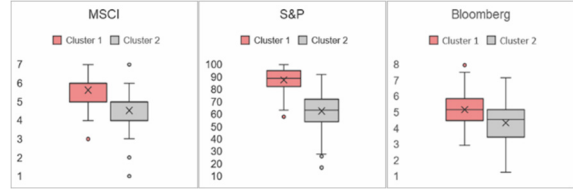

Figure 3: Distribution, by agency, of the scores of each cluster of the shares considered in the period from January/2020 to December/2023.

In both periods analyzed, cluster 1 (defined as K_{good}) presents, for the three agencies considered, an average score than cluster 2 (defined as K_{bad}), in addition, in both intervals, the number of shares classified as better from an ESG perspective was greater than those classified as worse (Tables 1 and 2).

Table 1: Average agency scores by cluster from January/2016 to December/2019.

Cluster	Number of shares	Agencies		
		MSCI	S&P	Bloomberg
1 (Kgood)	254	5,6	87,8	5,1
2 (Kbad)	174	4,6	61,3	4,2
Significance of the difference	p-value	0,00	0,00	0,00

Table 2: Average agency scores by cluster from January/2020 to December/2023.

Cluster	Number of shares	Agencies		
		MSCI	S&P	Bloomberg
1 (Kgood)	221	5,6	87,4	5,2
2 (Kbad)	139	4,5	62,6	4,3
Significance of the difference	p-value	0,00	0,00	0,00

Regarding the sectors in which the companies operate, those belonging to the sectors (based on the classification established by The Global Industry Classification Standard (MSCI and S&P Dow Jones Indices LLC, 2023)) of healthcare, industry (capital goods), technology, basic consumption, materials,

communication services and real estate were predominantly allocated to the cluster with the best average socio-environmental and governance scores, while most of the companies analyzed from the utilities, discretionary consumption, and energy (oil and gas) sectors were assigned to the cluster with the worst ESG performance (Tables 3 and 4).

Table 3: Number of companies belonging to each cluster by sector of activity for the first period (January/2016 to December/2019).

Sector	1st period: jan/2016 - dec/2019	
	Cluster 01 (K_{good})	Cluster 02 (K_{bad})
Communication Services	9	7
Consumer Discretionary	18	19
Consumer Staples	18	15
Energy	9	10
Financials	28	28
Health Care	40	5
Industrials	31	22
Information Technology	30	9
Materials	12	7
Real Estate	16	5
Utilities	10	12

Table 4: Number of companies belonging to each cluster by sector of activity for the second period (January/2020 to December/2023).

Sector	2nd period: jan/2020 - dec/2023	
	Cluster 01 (Kgood)	Cluster 02 (Kbad)
Communication Services	11	9
Consumer Discretionary	23	21
Consumer Staples	20	15
Energy	9	11
Financials	30	33
Health Care	45	10
Industrials	34	30
Information Technology	39	13
Materials	14	11
Real Estate	19	5
Utilities	10	16

The group formed by shares with the best ESG ratings (K_{good}) showed, in relation to the group composed of shares with the worst ESG ratings (K_{bad}), a higher average return between the years 2016 and 2020 (Table 4); however, from 2021 onwards, this behavior changed, and the so-called bad cluster began to show greater profitability. A similar dynamic occurred with the risk indicator (volatility) of the groups (Table 5), indicating a shift in behavior during the second period analyzed: the group with companies holding the worst ESG scores exhibited the highest average volatility in the period. Despite these observations, the groups do not show statistically significant differences when compared in terms of average volatility and average return.

Table 5: Total Return at the end of the year.

		2016	2017	2018	2019	2020	2021	2022	2023
Cluster 1 (K_{good})	Mean	17%	24%	-5%	33%	19%	30%	-10%	15%
	Min	-41%	-24%	-53%	-21%	-44%	-37%	-65%	-48%
	Max	227%	100%	47%	119%	302%	142%	94%	246%
	Std. Dev.	26%	23%	20%	21%	35%	26%	26%	32%
Cluster 2 (K_{bad})	Mean	16%	22%	-7%	29%	14%	32%	-6%	18%
	Min	-27%	-43%	-57%	-28%	-57%	-37%	-68%	-54%
	Max	72%	133%	41%	91%	743%	196%	119%	184%
	Std. Dev.	17%	24%	19%	22%	63%	34%	29%	32%
Significance of the difference (for mean)	p-value	0,79	0,47	0,30	0,07	0,30	0,62	0,22	0,35

Table 6: Volatility.

		2016	2017	2018	2019	2020	2021	2022	2023
Cluster 1 (K_{good})	Mean	27%	21%	25%	26%	45%	29%	32%	29%
	Min	15%	12%	16%	15%	27%	15%	17%	15%
	Max	66%	42%	46%	49%	99%	61%	72%	69%
	Std. Dev.	9%	6%	6%	7%	12%	8%	9%	8%
Cluster 2 (K_{bad})	Mean	27%	21%	25%	25%	48%	30%	33%	30%
	Min	15%	11%	14%	14%	22%	14%	20%	17%
	Max	83%	45%	47%	50%	107%	66%	72%	61%
	Std. Dev.	9%	6%	6%	7%	14%	10%	10%	8%
Significance of the difference (for mean)	p-value	0,64	0,66	0,94	0,66	0,02	0,03	0,38	0,64

The average correlation within each group also increased from the first to the second period analyzed (Table 6), even though 80% of the shares considered were present in both periods' samples. This change in the metric level hinders the diversification process and results in more risk for efficient portfolios.

Table 7: Average correlation of each group by period.

Cluster	1st Period (2016 - 2019)	2°nd Period (2020 - 2023)
1 (Kgood)	0,281	0,428
2 (Kbad)	0,276	0,438

4 CONCLUSION

The sustainable investment industry has evolved significantly, driven by legislation, consumer demand, and the investors themselves. Including socio-environmental and governance factors in the investment analysis process often implies assessing non-financial elements of companies, which, in turn, makes it challenging to reach a consensus on the best way to qualify (or disqualify) a company's ESG practices.

The lack of standardization of metrics for evaluating companies' environmental, social and governance practices, and the challenges in comparing the scores given by evaluators, were addressed in this work by grouping stocks based on the ratings provided by multiple agencies.

The groups formed exhibited significantly different average scores for ESG practices. Thus, despite the differences in methodologies, metrics, and scales used by the rating agencies, it was possible to differentiate between the good companies and the bad ones (from an ESG perspective). While there is some overlap between the ratings of the groups — due to the challenge of grouping companies based on evaluations from different agencies, a clear distinction between the clusters could still be observed. Therefore, this study contributes to the literature and the investment process by offering an alternative that reduces the impact caused by choosing to use assessments from a single ratings provider.

Regarding the sectors in which the companies operate, those in healthcare, industry, technology, consumer staples, materials, communication services, and real estate were mainly allocated to the cluster with the highest average socio-environmental and governance scores. In contrast, most of the companies from the utilities, consumer discretionary, and energy (oil and gas) sectors were assigned to the cluster with the poorest ESG performance.

Future research could investigate other attributes, such as market capitalization, cost of capital, or metrics related to companies' operational performance, to identify the characteristics common to the members of each cluster. Additionally, it could explore how these characteristics compare between companies operating in the same sector but belonging to different clusters. Upcoming work could also investigate the particularities of each sector (especially those dominated by stocks from a specific group) to understand what makes a sector and a company good from environmental, social and governance point of view.

Another dilemma concerning socially responsible investments is whether a portfolio built around sustainable guidelines can still deliver a good risk and return relationship to the investors. When considering the average volatility and return of the shares in each cluster, the groups were not statistically significantly different. However, the results pointed to a change in the behavior of assets during and after the coronavirus pandemic.

The group of stocks with the highest ESG ratings showed a higher average return between 2016 and 2020 compared to the group with the lowest ESG ratings. From 2021 onward, this pattern shifted, and the 'worst' cluster started to slightly outperform in terms of the group's average profitability. A similar pattern was observed with the risk indicator (average volatility) across the groups, reflecting a shift in

behavior during the second period analyzed: the group of companies with the lowest ESG scores showed the highest average volatility. In addition to that, the results of this study revealed that the average correlation within each group also increased from the first to the second period analyzed – this shift could have negatively impacted the portfolio diversification dynamics at the time.

In this context, future research could investigate how portfolios made up of these assets would behave, over a range of time periods or in specific moments of high market stress, in order to try to verify whether assets considered good from an ESG perspective could offer better returns or lower risks to the investor. In addition to that, upcoming work could explore the shift in dynamics during and after the COVID-19 pandemic and how it impacted the risk and return relationship of portfolios.

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