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ESG investing: A growing approach to values-based investing

by Linda Kelly, Senior Lead Analyst – Investment Research

Once considered a niche approach, there is growing evidence that environmental, social, and governance (ESG) investing is coming into the mainstream. Assets in dedicated ESG strategies have been growing rapidly, data and analysis has become more sophisticated, and interest in incorporating ESG has expanded beyond large institutional investors. There are now $12 trillion of U.S. assets under management (AUM) incorporating ESG criteria, a 38% increase from 2016.[1] More than 100 new sustainable mutual funds and exchange-traded funds (ETFs) were launched from 2015 to 2017,[2] and there is a growing interest in ESG coming from women and millennials, a group who will be inheriting significant wealth in the the years ahead. As awareness of ESG investing increases and misperceptions are addressed, interest and demand are poised to accelerate further.

This paper will discuss ESG investing, including its history and outlook for the future. By digging into the details of ESG, investors will have a better understanding of the benefits that this approach can provide as well as some important considerations.

$12 trillion

The value of U.S. assets under management now incorporating ESG criteria.[3]

38%

Increase in value since 2016 of U.S. assets under management now incorporating ESG criteria.[1]

100

The number of new sustainable mutual funds and exchange-traded funds that were launched in the U.S. from 2015 to 2017.

A brief history of socially responsible investing (SRI)

The roots of ESG investing can be found in SRI, the primary approach to values-based investing that goes back centuries. SRI involves filtering objectionable companies out of a portfolio for purpose of values alignment. Faith-based institutions were among the first adopters as they screened out “sin stocks”—companies involved in gambling, alcohol, and tobacco—to avoid activity they considered morally questionable. Today, SRI continues to be used by all types of investors based on individual values and beliefs. For example, environmentally-conscious investors often look to reduce or eliminate companies with exposure to fossil fuels. Investors concerned about gun violence can screen out firearm manufacturers and Christian funds continue to use SRI to create portfolios aligned with their stewardship focus and core values.

ESG Investing: Going beyond SRI

ESG investing, often used interchangeably with “sustainable investing,” is the next step on the values-based investing continuum. ESG is much different and more complex than SRI and means different things to different people. At its core, ESG is an investment strategy that evaluates securities based on a firm’s approach to Environmental and Social policies and Governance structure. In this approach, managers consider a company’s ESG profile in their evaluation process in addition to traditional financial metrics. In this inclusionary process, managers search for "good" companies that have favorable ESG characteristics, rather than selecting companies based solely on fundamental analysis. Consideration of ESG data, often categorized as "non- accounting" information, is integrated into the entire investment process.

Impact Investing – Seeking a positive change

The final approach on the value-based investing continuum refers to investing for both a financial and social benefit. The objective is to create a positive and measurable impact on an environmental or societal issue, such a climate change, clean water, or poverty, in addition to achieving a financial return. Most impact investments are in the private markets where there is greater opportunity to deliver specific outcomes. This is also a growing area of interest and will be a topic for a future paper.

Values Based Investing covers a spectrum of needs and objectives.

Conventional Investing • **Socially Responsible Investing** • **ESG Investing** • **Impact Investing** • **Philanthropy**

Alignment	Integration	Impact
Socially Responsible Investing	ESG Investing	Impact Investing
Exclusion of companies and/or sectors to fit the investor's mission or values.	Systematic consideration of ESG factors in the decision-making process.	Aims to produce a specific outcome in addition to a financial return.

Often grouped under the umbrella term "sustainable investing"

ESG data – The first step

Gathering quality ESG data is the first step in the integration process. Investment managers look to acquire data on a broad range of topics which are key to any business. Corporate policies and practices covering areas noted below are some of the most common.

Environmental	Social	Governance
• Climate change and carbon emissions • Air and water pollution • Waste management • Energy use and efficiency • Biodiversity	• Product related issues • Data protection and privacy • Gender and diversity • Workforce/Employee engagement • Community relations • Labor standards	• Board composition • Executive compensation • Audit committee structure • Shareholder rights • Bribery and corruption • Disclosure and transparency

ESG data used to be manually obtained from limited sources, but now there is a growing industry of research providers that gather and cull extensive data on thousands of companies from many sources, both in the public and private sphere. MSCI Research and Sustainalytics are two of the leading ESG data aggregators that provide information on all aspects of a firm's operation. Investment managers may use such third-party data, as a primary or secondary source, or gather their own data from various sources including trade industry association reports, government publications, and disclosures from the companies themselves.

Investment managers and research providers then use the data to calculate scores for each environmental, social, and governance issues for each company covered. They also gather information on any controversies surrounding a company's operations. The scores for the underlying factors are then rolled up to calculate a top line ESG score following specific methodologies, which vary across managers.

This score is an amalgamation of measures including:

- Emission and waste controls
- Data security policies
- Labor relations
- Board structure and more

Ultimately, ESG scores provide a way to compare firms across an industry as part of the manager's security selection process. Some managers may only use the top-level score, while others incorporate more granular scores at the underlying ESG level.

> More than 85% of S&P 500 companies now publish a Corporate Responsibility Report.[4] Such reports cover not only a company's direct sustainability efforts, but also how they consider and promote sustainability for all their stakeholders.

ESG investing – Doing well by doing good

While many individual and institutional investors desire ESG strategies to fulfill their values or investment mandates, investment managers' focus on ESG goes beyond the societal and environmental benefit of promoting sustainability. Managers also consider ESG factors to minimize risk and maximize opportunities. They view ESG data as an untapped source of valuable information that may provide a competitive advantage and lead to better long-term performance results. The thesis is that a company that cares about the environment, looks after their employees, and exhibits good governance has less risk, better fundamentals, and will be more resilient to the downside.

Overall, considering ESG factors provides more robust investment analysis and leads to better decision-making.

Diversity
Promoting diversity encourages firms to adopt more equitable practices for a better world. Companies that are more diverse are likely to attract the best talent, and companies with diverse boards have shown to have better performance.

Ethical decision-making
Firms that embody high standards of ethical integrity develop long-term competitively advantaged decision models.

Environmental policies
Companies with sound environmental practices are less likely to face government regulation/costly litigation and environmental controversies.

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Active ownership as an advantage

Many ESG managers also actively support their principles through shareholder engagement. Such engagement includes voting shareholder proxies, filing shareholder resolutions, and working directly with management to promote sustainability and improve business practices.

By becoming active owners, ESG managers can extend their reach to improve the quality of a company's ESG practices and policies, resulting in better risk management and long-term performance. There are many examples of institutional investors' demands and ESG managers' active involvement driving positive change for improved corporate policies and practices overall.

Myth busting the ESG performance trade-off

A common myth of values-based investing is that investors need to sacrifice performance for values. The argument is that whenever an investment process, like SRI, limits the investable universe through filters, investment cycles can lead to underperformance when excluded companies or sectors do well. In fairness, many SRI funds screen out tobacco and experienced sub-par performance during the many years the tobacco industry generated exceptionally strong returns. The overall reputation of SRI suffered as a result.

ESG, however, is different than the solely exclusionary SRI and there is a growing body of research suggesting ESG investing provides comparable or even better financial returns than conventional investments (See table below).

At a minimum, the empirical evidence does not support the notion that ESG investing, using both negative and positive screens, means sacrificing performance and considering ESG may in fact generate alpha. The premise that an investor must be willing to give up returns to actively align their portfolios with their values is just no longer true.

The myth-busting research behind ESG

Study	Summary Finding
2018 Axioma Study – ESG's Evolving Performance	In general, increasing exposure to ESG rarely underperforms the market, and often outperforms the market.[5]
2019 MSCI Study Foundations of ESG Investing	ESG can affect performance through both lower cost of capital/higher valuations and higher profitability/lower exposure to tail risk.[6]
Barron's and Morningstar Studies	Found that a growing percentage of sustainable funds outperformed conventional funds.[7]
2015 Harvard Business School Study	Found firms with good performance on material sustainability issues significantly outperform firms with poor performance.[8]

The considerations behind ESG investing

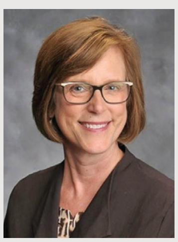
ESG is still a relatively new approach to investing with clear challenges to be addressed. Terminology is confusing, ESG data is imperfect, and there are quality and consistency issues in ratings. ESG scores can significantly differ between research providers—and with no universally accepted standards and definitions, misunderstanding and skepticism can result.

Also, investors need to keep in mind that ESG investing is an extension of traditional investing. When evaluating an ESG manager, analysts need to consider not only the underlying research and security selection process, but also the robustness of the ESG data and integration. For values-focused investors, the overall sustainability philosophy and engagement of the firm is also important to consider. Rigorous due diligence on the investment team and process continues to be critical in active manager selection and digging deep into ESG integration is just one piece of that work. Also, investors need to watch out for funds that are ESG in name only, with limited ESG research or active ownership. In-depth analysis becomes critical as such funds may not provide the portfolio or performance desired.

Looking forward

ESG investing is growing rapidly, and we think this trend will continue as more investors understand the benefits that ESG can provide. For values-focused investors, implementing a responsible investing portfolio is easier than ever. ESG managers with a solid performance history and strong investment process can provide not only values alignment, but also a competitive advantage for long-term investment returns as well. Finally, both institutional and individual investors' consideration of ESG factors in selecting investments and in proxy voting is a growing trend that is influencing companies to improve their overall ESG practices and policies. In our view, the collective force of all these efforts is an unmistakably positive development encouraging change for a more equitable and sustainable world.

For more information, please contact your Key Private Bank Advisor.



About the Author

Linda Kelly is a Senior Lead Analyst with more than 25 years of experience working with clients and portfolio managers on customized investment solutions. Her focus is on specialized, non-traditional investments including derivative strategies and values-focused investing. Linda's area of expertise includes socially responsible investing, ESG, impact investing, structured notes for unique risk/return outcomes, and covered call overlays for yield enhancement.

Linda received her BA from the College of Wooster and her MBA from DePaul University. She also holds a Certified Financial Planner™ designation and is actively involved in various non-profit boards.

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