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Applying ESG Factors to Investment Decisions – February 2019

INTRODUCTION

Many families want responsible investing to play an increased role in the design of their investment portfolios. The goal is a greater alignment between their investments and their personal values, promoting outcomes that are financially rewarding while supporting positive social and environmental change.

Investment managers increasingly appreciate the need to accommodate *sustainable investing*. Trends supporting interest in ESG include increasing awareness amongst asset managers that (i) sustainability issues do impact financial performance, and (ii) millennials and women, two demographics that will be managing an increased share of AUM going forward, have demonstrated an affinity to *responsible investing* (potentially impacting manager selection).

However, obstacles to adoption include confusion around terminology, rationale and implementation. *For example, are ESG (environmental, social and corporate governance), sustainable, socially responsible and impact investing different names for essentially similar evaluation frameworks, or would they require substantially different implementations in the eyes of the cognoscenti?*

We believe that at a broad level, each of these concepts encourage the integration of the clients' personal values or society's perceived concerns or an entity's mission into consideration, alongside traditional criteria, when making investment decisions.

GENERAL RATIONALE

Applying ESG factors to investment decisions likely leads to a more complete analysis of the investment opportunity because it involves analysis that might have been overlooked by traditional approaches.
DWS and the Univ of Hamburg reviewed (in 2015) the conclusions of over 2000 studies and found that the majority of such studies found a positive relationship between ESG factors and corporate financial performance; while relatively few found a negative relationship.

A long-term study by JP Morgan found that stocks with the poorest ESG scores exhibited greater volatility during choppy markets … supporting the view that *sustainable investing* may help make investment portfolios more durable. A recent Bank of America study found companies with better ESG performance exhibited lower earnings volatility and higher ROE over the period reviewed.

While not all managers expressly state that they apply ESG factors, good investment analysis necessarily identifies sound corporate behavior and business strategies that serve to protect the company and its stakeholders. It would seem unwise to ignore key sustainability issues when assessing a company's ability to generate long-term financial returns.

IMPLIMENTATION

Developing a Framework

There are over 2,000 signatories to the U.N.'s responsible investments initiative, established in 2006 and called the ***Principles of Responsible Investment*** (**PRI**). Signatories commit to six principles designed to embed ESG considerations into investment decision-making processes and to hold the companies in which they invest to account for ESG failures.

In 2015, the U.N. set out 17 ***Sustainable Development Goals*** (**SDG**) relating to societal challenges including poverty, inequality, climate change, the environment and justice. Its intention was to redirect investments to address specific problems that may not attract capital purely on expected financial performance metrics, with the goal to achieve a cleaner, healthier and more equitable world.

However, given the broad nature of the goals as well as the implementation language having been prepared for governments rather than investors, it has not been easy for investors to translate these goals to specific practices.

Implementing Within the Investment Processes

JPMorgan estimates $23 trillion of assets are now managed with at least an indication that ESG factors

play a part as investment criteria, with over $100 billion invested in ESG Funds.

Managers applying ESG factors to portfolios, funds and sector indices apply a range of approaches including: (i) an exclusionary approach using screens or sector bans; (ii) a "positive" bias designed to include companies with certain performance or improvement scores; and (iii) thematic, or impact, investing.

1) ***Exclusions based on broad failure.***
As a first step, *responsible investing* will look to avoid companies that fail to meet the most basic standards on issues such as corruption, environmental degradation and human rights.

2) ***Systematic exclusions***.
The early and still a predominate ESG approach is to exclude sectors seen as not meeting society's priorities. Initially, these tended to be the so-called "sin" stocks (gambling, alcohol and tobacco).

An exclusionary approach has to deal with how broadly a net is thrown. Do you exclude companies that sell alcohol or tobacco (food retailers, pharmacy chains) or just manufacturers? Do you exclude weapons manufacturers or also those providing components or that have much larger businesses in other sectors (e.g., Boeing or Airbus)? Do you exclude all fossil fuel producers, or only the products with the highest carbon intensity?

This exclusionary approach is sometimes criticized as: being too limiting, potentially hurting returns, (ii) not doing enough to encourage behavioral changes, (iii) not having a strong economic rationale, and (iv) presents a risk of capture by social activist movements.

3) ***Screening-based inclusions.***
Arguably, a more effective ESG approach goes beyond exclusions as managers become more focused on what to include, as much as what to exclude. Under a *best-in-class* or positive approach, companies are included or emphasized that have the strongest ESG credentials.

This approach is useful for managers that want to label a fund as ESG based on quantifiable measures (although there are questions about the effectiveness of third-party scoring models).

4) ***Integrating ESG factors.***
The recent trend is a more comprehensive approach whereby ESG factors are integrated with traditional analysis to improve the investment decision-making process and highlights risk.

For example, a manager with whom we work closely, states that:

> *"… our approach to investing responsibly and integrating ESG considerations is guided by our mandate to deliver returns that will enable our clients to achieve their long-term investment objectives and our core values. We believe that companies with sound business practices, including strong corporate governance and responsible management of material environmental and social issues, have better success and deliver stronger financial performance over time. Conversely, companies that have poor environmental, social or corporate governance practices present risks and controversies that may hinder their financial performance."*

Under this approach, industry analysts investigate ESG risks as part of their in-house research process and may compliment that work with third-party research. Conclusions are integrated into investment decisions.

This approach can also run alongside an exclusionary framework. For example, the manager cited above excludes tobacco, gaming and thermal coal miners from all portfolios, while its ESG Fund adheres to a much more restrictive investment policy which precludes investments in companies for which ESG information is insufficient or which do not pass certain ESG filters.

5) ***Thematic Investing***.
Thematic or *impact investing* generally funds strategies addressing specific environmental or social challenges. This is often done through investment vehicles that are private and project oriented.

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