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Sustainable Investing

Redefining investing for the long term

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The investment world is continually evolving, with one of the most notable transformations of our generation under way. We have observed it to increasingly be the case that investors no longer wish to keep their good intentions for society relegated to charitable giving, but are also looking to "do good" with their investments. We think one way to consider trying to achieve these personal and financial goals is to apply a set of socially conscious standards that focuses on the long-term sustainability and ethical behavior of a company, which is referred to as "sustainable investing."

Sustainable investing comes in many forms and can mean different things to different people. We seek to clear the air on this changing space and offer some perspective on what we view as an effective way to generate long-term gains from both the societal and financial perspectives.

Investing in the future

At its core, sustainable investing is redefining what many investors mean by "long-term investing." Historically, "long term" has been consistent with one or more complete market cycles spanning many years. In recent years, we feel like that has *devolved* into an increasingly short-term focus, concentrating on quarterly performance. We believe the strong growth of sustainable investing has, in part, been a response to the flaws of this short-term thinking. In an effort to achieve their goals, many investors are recognizing the necessity of maintaining a longer investment horizon that includes the expected impact companies have on society.

As we will discuss in a later section, sustainable investing encourages companies to focus less on near-term earnings targets and more on long–term profitability. Importantly, sustainable investors also believe that, over time, this type of focus from a company will yield higher returns. Said differently, sustainable investing is a way of working to achieve both social and financial goals.

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Figure 1
Four main ways to invest sustainably

We use sustainable investing as an umbrella term encompassing four main investment strategies in this field (Figure 1):

- Environmental, social, and governance (ESG) investing*—An investment discipline that considers ESG issues in investment decision making as well as traditional factors in an effort to achieve financial objectives
- Socially responsible investing (SRI)—Investment discipline that considers investors' values, likely excluding industries with negative social or environmental impacts, such as tobacco, alcohol, firearms, or fossil fuels
- Thematic—Maintains an emphasis on a specific theme, such as the environment or gender equality
- Impact—Investing capital with the intention of generating a measurable, beneficial social or environmental impact alongside a financial return

The sustainable investing movement

The origins of sustainable investing can be traced back decades.[1] In the 1960s, it became popular as investors boycotted investments in companies associated with the Vietnam War and the apartheid government of South Africa. Over the last 50 years, the scope of sustainable investing has evolved and broadened to become one of the most profound developments in investment management. As of the start of 2020, 33% of all U.S. professionally managed assets—$17.1 trillion—is governed by a sustainable investing mandate, and the vast majority incorporates ESG criteria, according to the US SIF Foundation's 2020 *Report on US Sustainable and Impact Investing Trends*.[2]

Sustainable investing assets have grown tremendously worldwide. According to the UN Principles for Responsible Investment, as of March 2022, over 5,000 asset owners and investment managers controlling $121.3 trillion in assets have pledged to follow the organization's six principles for responsible investment, the first three of which involve incorporating ESG considerations into their investment decision-making and ownership policies.[3]

* There is no guarantee that integrating environmental, social, or governance (ESG) analysis will provide improved risk-adjusted returns over any specific time period. The evaluation of ESG factors will affect the strategy's exposure to certain issuers, industries, sectors, regions, and countries, and may impact the relative financial performance of the strategy depending on whether such investments are in or out of favor.

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In our view, the solid growth in the integration of sustainable investment criteria has been powered by three primary motivations: 1) a desire to invest in companies that align with an individual's or organization's own values; 2) the recognition that investor dollars can be directed in a way to foster positive environmental and social change; and 3) the need to generate risk-adjusted returns on par or better than traditional investment strategies.

SRI vs. ESG

The two most prevalent forms of sustainable investing are SRI and ESG, which have subtle but important distinctions in how they aim to carry out the goals of sustainability.

- Where SRI typically takes an *exclusionary* approach, eliminating entire industries that are viewed as harmful to the economy or social well-being from the investable universe, ESG uses an *inclusionary* approach, selecting companies that exhibit positive ESG characteristics relative to industry peers. ESG's inclusion of all economic sectors allows for a more diversified portfolio and may improve the portfolio's chances of achieving returns similar to the broader market.
- SRI tends to be more *targeted* in the list of issues it excludes from the portfolio, with tobacco, firearms, and gambling usually front and center. In contrast, ESG takes a comprehensive approach, where it looks to invest and drive capital to companies making positive improvements in a broader range of long-term issues. An example of an ESG issue would be carbon footprint (total greenhouse gas emissions caused by, in this case, a company, expressed as carbon dioxide equivalent). Every company has a carbon footprint and those making concerted efforts to shrink their footprint is taken into consideration.

Figure 2

What is ESG? A roadmap to sustainable

All factors shown are for illustrative purposes only, may not always be considered or determinative, and there are other factors that are considered.

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Academics have long struggled with the question of whether ESG factors help or hurt an investment portfolio's performance. In our view, there are myriad reasons why answering this question is challenging, including lack of completeness and accuracy of the data.

- SRI tends to be *static*, where exclusions are generally maintained based on a client's personal standards until such time as the client directs otherwise. ESG is more dynamic, with the larger goal of positive change, incentivizing that good behavior with greater capital allocation. It is sometimes easier to effect change through an ESG strategy, as the investor may be more engaged with management and proxy voting than an SRI investor who has no intention of taking a stake in a particular industry.

Given these differences, our view is that ESG is a more effective way of investing sustainably (Figure 2). However, we realize sustainable investors are often more personally and emotionally invested in their portfolios than is typically the case, and the right strategy is ultimately based on the individual client.

Can you do good *and* do well?

Many investors harbor doubts about the ability of an ESG portfolio to generate competitive returns. The skepticism is understandable. Any time investors limit their investment opportunity set through additional constraints, they run the risk of generating suboptimal returns. This is true of any constraint imposed by a fund manager, and is not limited to ESG factors.

Academics have long struggled with the question of whether ESG factors help or hurt an investment portfolio's performance. In our view, there are myriad reasons why answering this question is challenging, including: lack of completeness and accuracy of the data; the relatively short timeframe for analyzing the impact of ESG on returns; and difficulty in determining causality.

That said, a research paper by MSCI (global provider of financial analytics and market indices) published in the *Journal of Portfolio Management*[4] showed that ESG scores for companies were positively correlated with their stocks' profitability and dividend yield,* and negatively correlated with drawdown risk** and volatility, which occurs when the value of a market or individual security rises or falls abruptly over a period of time. For example, a higher ESG score coincided with higher profitability and higher dividend yields with lower risk and volatility. The research concluded many companies with high-ranking ESG scores can generate the following benefits for shareholders:

1. **Higher profitability:** High ESG-rated companies are often more competitive, many can generate above-average returns and often resulting in higher profitability and dividend payments
2. **Lower tail risk:** High ESG-rated companies can be less susceptible to idiosyncratic, event-driven major declines, such as product recalls
3. **Reduced systematic risk:** High ESG-rated companies are often less subject to risk that affects the broad market overall and cannot be diversified away.

* Dividend yield equals the annualized dividend (profits that company pay to shareholders) paid per share divided by the stock price per share. It is a portfolio characteristic at a specific point in time provided to illustrate the relative focus on dividends and does not reflect historical or expected portfolio results. Yield is one component of total return—yield remains positive, and may increase, as prices decline.

** Drawdown risk measures the potential drop in portfolio asset values from the most recent stock market peak to the most recent stock market trough.

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Figure 3

ESG investing in action

Companies that have changed their behavior due to pressure from ESG investors.

Target reduced the use of toxic PVC plastic in children's products in response to pressure from ESG investors. As a result, Target now has a sustainable product standard that scores thousands of products based on toxicity. Other major retailers, like Walmart and Sears, have followed suit.

Kroger makes a portion of their revenue from firearm sales. ESG investors pressured retailers and distributors to take action on the issue of gun violence. As a result, Kroger reviewed its firearms policy, raised the purchase age to 21 and removed firearms from the shelves in one of its subsidiaries all together.

After several food safety issues at Chipotle locations across the country, the restaurant chain promoted "food with integrity" without any accompanying policies or data. ESG investors led a shareholder resolution that pushed the company to publish a comprehensive sustainability report in 2018 as a response.

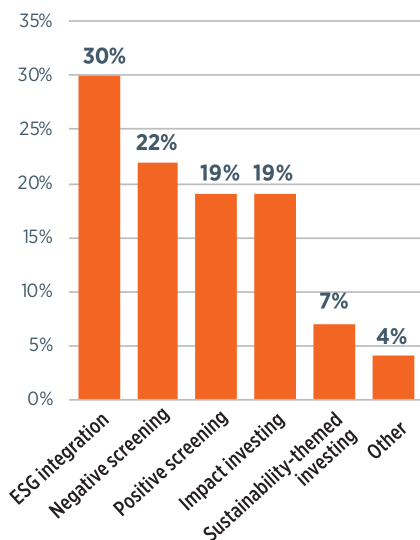
References to specific companies are provided solely to illustrate how certain companies have modified their practices based on ESG investor influence and are not intended as a recommendation to buy or sell a particular security.

The challenge with this, as an investor, is determining causality. That is, are companies with more sustainable practices and, therefore, higher ESG scores able to generate higher profits as a result? Or, are more profitable companies simply able to devote more resources to ESG issues? The former may indicate that ESG should be incorporated into every investment process. The latter would say very little about an ESG-friendly company's ability to generate future profitability, other than perhaps there exists some correlation between the two.

Figure 4

Wealthy investors and ESG

How high-net-worth practices incorporate ESG factors for clients.



Source: Cerulli Associates.
Data as of December 2019.

While the data remain somewhat inconclusive, there is reason to doubt that integrating ESG criteria causes investment performance to suffer. On the contrary, there is gathering evidence that companies incorporating sustainable business practices may perform better over the long term. It may be that ESG-friendly businesses are often more focused on the long game, seeking to make near-term investments succeed long term, both in their sustainability efforts and pursuit of profits. A focus on sustainability is also likely to attract more customers and investors (in our experience with clients and their children, we find this especially to be the case with the Millennial and Gen Z generations).

ESG investors themselves, too, may actually make a difference in the priorities of corporate management through several means of engagement: divestment, proxy voting, dialogue with management, interaction with customers, communication with regulators, and general thought leadership. In this way, we believe ESG investors have the ability to motivate companies to "do better" and encourage those already operating sustainably to continue the investment in our collective future (Figure 3). Cerulli data from 2019 showed that 58% of high-net-worth-focused advisor practices use ESG and SRI strategies and said they will increase their allocations in 2020; and 8% of those practices plan to introduce these strategies during that timeframe.[5] Interested clients are relying on a variety of strategies to integrate ESG into their portfolios (Figure 4). The projected rise in ESG incorporation is also reflective of our overall view, as well as our expectation for it to increasingly factor into corporate decision making.

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Based on this, in our view, if ESG factors are incorporated into an already-rigorous investment process, an ESG portfolio may have the ability to generate long-term returns equal to or better than traditional portfolios. In other words, when done correctly and carefully, there may be no need for investors to choose between investing according to their values and reaching their investment goals.

Sustainable investing and your portfolio

Sustainable investing is yet another evolution in the investment world, one that could end up having as much of an impact on the way we invest as electronic trading platforms or passive (index-tracking) investment vehicles. As the conversation continues, we expect to see an increase in the number and sophistication of solutions to help deliver on sustainable investing goals.

If you are interested in learning more about integrating an ESG framework into your portfolio, please contact your advisor.

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ENDNOTES

1 https://www.morningstar.in/posts/57694/history-sustainable-investing.aspx

2 https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf

3 Principles for Responsible Investment, Signatory Update, April to June 2022, https://www.unpri.org/signatories/signatory-resources/quarterly-signatory-update

4 Guido Giese, et al., "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance." July 2019. *The Journal of Portfolio Management.*

5 Cerulli data with https://info.cerulli.com/rs/960-BBE-213/images/Cerulli-US-HNW-and-UHNW-Markets-2020-Information%20Packet.pdf

Investment style/Factor risk: Strategies that focus on ESG factors will cause them to sell or avoid certain stocks. Such stocks may subsequently perform better than stocks selected considering ESG factors. The evaluation of ESG factors will affect a strategy's exposure to certain issuers, industries, sectors, regions, and countries, and may impact the relative financial performance of the strategy depending on whether such investments are in or out of favor. There is no guarantee that integrating ESG analysis will provide improved risk-adjusted returns over any specific time period.

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