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Demystifying ESG & Responsible Investing

Investors today are giving greater thought to how they can align their investments with their values. With the array of acronyms (ESG, RI, SRI, BRI) and terminology (impact investing, green investing) out there, this space can be confusing to navigate. This paper seeks to discuss the history and evolution of the ESG/Responsible Investing space, clarify the three main approaches to investing within this space (SRI, ESG Integration, and Impact Investing), and help the plan sponsor decide which approach is best suited for their plan.

HISTORY & EVOLUTION

While ESG investing is a growing trend, it is not a brand-new concept. Responsible investing in the United States dates all the way back to the 18th century, and even before that, has its origins in biblical times. "Socially Responsible Investing (SRI)" was born through investors with a desire to align their investments with their faith-based values. They stayed away from investments that were involved in things such as slave trade, smuggling, liquor and tobacco manufacturing, weapons, and gambling. In 1928, Boston-based company, Pioneer Investments (today known as Amundi Pioneer) founded its flagship mutual fund, the Pioneer Fund, that implemented negative screening into its investment process. SRI ramped up in the 1960s from Vietnam war protestors and gained momentum in the 1970s with investor concerns over things such as the apartheid, fair trade, and discriminatory lending. The Chernobyl and Three Mile Island nuclear disasters in the 1980s fueled investor concerns regarding the safety of our environment and climate change. This led to the launch of the US Sustainable Investment Forum (US SIF) in 1984, which is the leading voice advancing sustainable, responsible, and impact investing across all asset classes in the US.

From the negative screening approach came a movement centered around corporations and the great influence they have in the world as the world has become increasingly industrialized and global in nature. The term "ESG" (Environmental, Social, & Governance) was coined in 2005 with the publication of the landmark study "Who Cares Wins" by late UN Secretary General Kofi Aman. His objective through this study was to get companies to operate more sustainably and with a greater sense of corporate responsibility. Soon after this, the UN launched the UN Principles for Responsible Investment (UN PRI) in 2006. This ESG approach is centered around the belief that if a corporation is run by ethical, equitable, socially responsible, and environmentally conscious management with an effective governance structure for socio-ecological benefit, they can have a great impact in the world while benefitting their bottom line.

"Impact Investing" has been the newest terminology in the industry that emerged around 2007. Impact investors look to invest in companies and projects whose core mission is to generate social and/or environmental impact alongside a financial return. They do not just seek to invest in companies that manage ESG factors and risks within their organization; they explicitly target tangible beneficial outcomes to the environment and/or society. In 2015, the U.N. General Assembly passed a resolution in support of 17 Sustainable Development Goals (SDGs), which cover an array of global social, economic, and environmental challenges to solve by 2030. SDGs have been embraced by investors and companies who want to contribute to solving these environmental challenges such as no poverty, zero hunger, and quality education, just to name a few.

THREE APPROACHES TO ESG/RESPONSIBLE INVESTING

1. Socially Responsible Investing (SRI)

This approach seeks to invest with an alignment of one's values, morals, faith, or other specific ethical guidelines. This is mostly accomplished through negative screening and/or positive screening which actively eliminates or selects investments that align with one's stated objectives. For example, companies that have a negative impact on the environment and/or society or companies that do not align with one's faith-based values would be screened out. Positive screening would screen-in only companies that align with stated objectives. Biblically Responsible Investing (BRI) falls under this category. BRI employs screens that exclude companies that do not align with a biblical worldview.

2. ESG (Environmental, Social, and Governance) Integration

This approach is essentially an extension of active fundamental bottom-up research where analysts and managers focus on risk mitigation and long-term return opportunities in the selection of their portfolio holdings. Managers specifically seek out companies that effectively manage environmental, social, and governance risks within the operations of their organization and, in turn, have a positive impact on the environment and society while improving their bottom line.

ESG integration focuses on mitigating three types of material risks:

- **<u>Environmental</u>**- Environmental risks relate to how a company handles itself with regard to environmental conservation and sustainability. Examples include a company's energy consumption, waste disposal, land development, and carbon footprint. An environmental risk consideration may include whether a food and beverage company is managing water risks in its supply chain.
- **<u>Social</u>**- Social risks deal with a company's relationship with its employees and vendors. Examples include a company's initiatives related to employee health and well-being and how supplier relationships align with corporate values. A social risk consideration may be to examine if an apparel manufacturer has any forced labor in its supply chain.
- **<u>Governance</u>**- Corporate governance risks examine how a company is directed and controlled, including things such as the corporate decision-making structure, independence of board members, treatment of minority shareholders, executive compensation, and political contributions. A governance risk consideration may be whether the board has independence or if there is separation between the chairman of the board and the CEO.

3. **Impact Investing**

This approach to investing starts with a core objective to help a business or organization accomplish specific goals that are beneficial to society or the environment in a measurable way. It is based on the thought that money and resources should be directed towards companies that are actively seeking solutions for environmental issues and social ills. The ability to *measure* social and environmental "performance" is just as important as being able to measure financial performance. Money managers are often actively engaged with the companies they invest in through ongoing dialogue with management, proxy voting, and shareholder resolutions to address critical issues. Often with impact investing, investors are willing to give up some short-term return in order to achieve a positive impact over the long-term.

Examples of impact funds include those whose objective is to invest in companies that strive to empower women in the workplace, thus promoting gender equality. Another may include investing in companies offering solutions to help solve the global water challenge, thus promoting clean water and sanitation. <u>Green investing</u> is a term used to describe investing in such a way that benefits the environment. An example of this would be to invest in companies that supply alternative sources of energy such as wind and solar, or companies with a low carbon footprint, promoting climate action. "Green bonds" are bonds issued by municipal entities, the private sector, or multilateral institutions to finance projects that are intended to have a material, positive net benefit on the environment and/or the climate. An example would be the issuance of bonds to raise money to finance clean public transportation, wastewater management, and green buildings.

WHICH APPROACH IS BEST?

When deciding which approach is best for you, it is important to develop an investment objective that aligns with all the stakeholders involved- yourselves as a committee, your organization as a whole, and the participants of your plan. You may want to consider the following questions:

1. What are your core values?
2. What balance of return generation and values alignment are you trying to achieve?
    - Is the objective for investment to generate the best possible returns while aligning with core values even if outperformance of the broad market is not possible in every period?
    - Is the objective for investment maximum return generation relative to the broad market even if it means sacrificing some of your core values to achieve that return?
    - Is the objective for investment to generate the best possible risk adjusted returns from companies that fully manage ESG risks in their organization?
    - Is the objective for investment to generate the best possible return while having a measurable impact to society where having an impact is more important than (or equally as important as) outperforming the broad market in every period?

The good news is that multiple research studies have shown that factoring material ESG risks into the investment process can help generate high quality and competitive risk adjusted returns over the long term. It is possible to find investments where you do not have to make a trade-off between generating returns and investing in a socially responsible way.

LOOKING AHEAD…

ESG investing is gaining momentum as it becomes more and more mainstream. The big growth spurt is yet to come. Demographics make it clear that over time as millennials age and become a more economically significant portion of the workforce that there will be a massive shift into ESG assets. We are already seeing significant growth in this space. As of the end of 2017, the universe of sustainable investing held $12 trillion in assets in the US according to US SIF. ESG focused mutual and exchange traded funds saw double the amount of inflows in 2018 than they saw in 2017. As of recent surveys, only 4% of 401k plans have an ESG fund available for investment, and ESG funds only hold 0.03% of 401k assets. This is expected to grow as the generations shift and more and more people take an interest in aligning their investments with their values.

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