Sustainable Investing: A Force for Positive Change

Sustainable investing is a force for positive change. While regional terminology may differ, sustainable investing is an approach that incorporates environmental, social, and governance (ESG) issues when building an investment portfolio, while encouraging companies to improve their ESG risk-management practices. Interest in sustainable investing continues to grow, which can be measured by the remarkable growth in assets under management (AUM) of more than $30.7 trillion.[1] In the process, sustainable investing has changed the investment industry, improved companies, and helped communities. These extraordinary outcomes are aligned with the basic intention of sustainable investing: to build wealth responsibly without sacrificing investment principles.

Changing the Investment Industry

Sustainable investing has positively changed the investment industry by challenging and then adapting traditional approaches of the investment decision-making process. This process evolved slowly at first, starting when the Pax World fund, which excluded manufacturers of weaponry from its portfolio, launched in 1971 and became the first sustainable investing mutual fund. Other large investors began to follow Pax, and instances of divestiture grew, as manufacturers of tobacco and companies with operations in Apartheid-era South Africa were removed from investment portfolios. Divestiture, or excluding securities from an investment universe on the basis of standards and norms, is the oldest sustainable investing method.

By the late 1980s, two small companies emerged to carry the transition beyond this primary method of sustainable investing. Both companies began gathering data that allowed investors to build an investment universe on the basis of a company's ESG data and then compare this data relative to peers, which ultimately merged "value-driven investors" with "values-driven investors."

Value(s)-driven investors. In 1985, Innovest Strategic Value Advisors, Inc. (Innovest) began using its proprietary analytics platform to assist clients in uncovering hidden risks and value potential in companies that conventional securities analysis could not detect, a focus commonly desired by ***value-driven*** investors. In 1988 Kinder, Lydenberg, Domini & Co. (KLD) was founded with a mission to remove barriers to socially responsible investing and influence corporate behavior, a focus commonly desired by ***values-driven*** investors. In 2010, MSCI purchased both Innovest

[1] Global Sustainable Investment Alliance, "2018 Global Sustainable Investment Review (2018)." http://www.gsi-alliance.org/trends-report-2018/

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and KLD, forming MSCI ESG Research, which has become the world's largest ESG-rating data source. It currently provides ratings on 7,500 companies and more than 650,000 equity and fixed income securities.[2]

While Innovest, KLD, and other similar companies were collecting ESG data, the actual "ESG" usage didn't appear until a 2004 United Nations Global Compact report titled, "Who Cares Wins: Connecting Financial Markets to a Changing World." The report sought to "develop guidelines and recommendations on how to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services, and associated research functions."[3]

In 2005, the United Nations Environmental Program's Financial Initiative's (UNEP-FI) "Freshfields Report" discussed at length the financial relevance of ESG data and the concern of fiduciary duty in the use of ESG data in the investment decision-making process.[4] This concept was later updated to state that "the fiduciary duties of investors require them to incorporate ESG issues into investment analysis and decision-making processes, consistent with their investment time horizons."[5]

These two reports became foundational pieces of the UN-backed "Principles of Responsible Investment (PRI)," which was launched in 2006. The initial group of 18 signatories[6] has evolved into a thriving global initiative with more than 2,400 members representing over $86 trillion in AUM. The UN-backed PRI's role is to advance the integration of ESG issues into the investment decision-making process, following a set of six investment principles in which signatories agree to:

1. Incorporate ESG issues into their investment analysis and decision-making processes
2. Be active owners and incorporate ESG issues into their ownership policies and practices
3. Seek appropriate disclosure on ESG issues by the entities in which they invest
4. Promote acceptance and implementation of the Principles within the investment industry
5. Work together to enhance their effectiveness in implementing the Principles
6. Each report on their activities and progress toward implementing the Principles.

With more investors adopting the UN-backed PRI and increased ESG data availability, ESG issues increasingly are being considered when building an investment portfolio. This sustainable investing

Environmental factors may include climate change, deforestation, pollution, resource depletion, and water; social factors may include child labor, employee relations, human rights, modern slavery, and working conditions; governance factors may include bribery and corruption, board diversity and structure, executive pay, political lobbying and donations, and tax strategy.

[2] https://www.msci.com/esg-ratings

[3] https://www.unglobalcompact.org/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf

[4] Freshfields Bruckhaus Deringer and United Nations Environment Programme Finance Initiative, "A Legal Framework for the Integration of Environmental, Social, and Governance Issues into Institutional Investment" (2005). http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

[5] United Nations Global Compact, UNEP Finance Initiative, PRI. "Fiduciary Duty in the 21st Century." 2019.

[6] Original signatories included: Amalgamated Bank, Amundi, Aviva Investors, Bank J. Safra Sarasin Ltd, BNP Paribas Asset Management, BMO Global Asset Management, British Columbia Investment Management Corporation, Calvert Research and Management, Daiwa Asset Management Co. Ltd, Domini Impact Investments, Generation Investment Management LLP, Groupama Asset Management, Hermes Investment Management, Insight Investment, Janus Henderson Investors, Mitsubishi UFJ Trust and Banking Corporation, Sumitomo Mitsui Trust Asset Management, Threadneedle Asset Management Ltd.

process, known as ESG incorporation, can be applied using a combination of three primary strategies:

- **Integration.** Involves the explicit and systematic use of ESG issues in investment analysis
- **Screening.** Involves the application of filters to a list of potential investments based on an investor's preference and includes both negative/exclusionary and positive/best-in-class screening
- **Thematic.** Involves the use of traditional financial analysis coupled with an intention to contribute to a specific ESG outcome and includes sustainability-themed and impact/community investing.

Growth in sustainable investing. Growth in sustainable investing has been remarkable, as shown by more than $30.7 trillion in AUM pursuing these strategies in mutual funds, exchange-traded funds (ETF), separate accounts, and accredited investment vehicles. Positive/best-in-class screening and sustainability-themed strategies are the fastest growing strategies, with recent annual growth rates of 50% and 92%, respectively. In terms of size, negative/exclusionary screening is the largest—and oldest—strategy, while ESG integration is the second largest—although it recently has been growing more than twice as fast as negative/exclusionary screening.[7]

A combination of client demand, increasing recognition that ESG factors can affect risk and return, and regulation is driving the growth of sustainable investing. Inventors are increasingly demanding greater transparency about how and where their money is invested. For today's investors, the way they invest matters.

In addition, there is growing recognition that ESG factors can influence investor returns. An analysis of more than 2,000 academic studies on how ESG factors affect corporate financial performance found an overwhelming majority of positive outcomes.[8] Another analysis concluded that 80% of academic studies show that stock price performance of companies is positively influenced by good sustainability practices.[9]

Since the mid-1990s, sustainable investing regulation has provided more guidance on the consideration of ESG factors in the investment process. Globally, there are more than 730 hard- and soft-law policy revisions across some 500 policy instruments that support, encourage, or require investors to consider long-term value drivers, including ESG issues.[10]

Improving Companies

Sustainable investing has positively changed companies through the practice of shareholder engagement, which encourages more responsible corporate practices while discouraging corporate practices that may lead to increased exposure to risk. While the growth of shareholder engagement began in the mid-1970s, it wasn't until it was codified in the UN PRI that shareholder engagement really took root. Since then, shareholder engagement has been a driver behind some significant corporate policy changes, including increased corporate disclosures, a key element in the ESG integration process. In addition, recent research illustrates that shareholders that engage with companies on ESG issues can create value for both investors and companies by exchanging information, producing and diffusing knowledge, and building relationships.[11]

[7] Global Sustainable Investment Alliance, "2018 Global Sustainable Investment Review" (2018). Available at http://www.gsi-alliance.org/trends-report-2018/

[8] https://download.dws.com/download?elib-assetguid=714aed4c2e83471787d1ca0f1b559006&wt_eid=2156623951900953270&wt_t=1566240624353

[9] Gordon Clark, Andreas Feiner, and Michael Viehs. "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Performance." (Oxford University and Arabesque Partners, 2014). September 2014.

[10] United Nations Global Compact, UNEP Finance Initiative, PRI. "Fiduciary Duty in the 21st Century." 2019.

[11] https://www.unpri.org/academic-research/how-esg-engagement-creates-value-for-investors-and-companies/3054.article

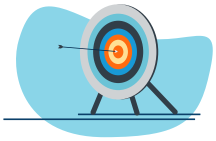
Why Sustainable Investing Matters

Interest in sustainable investing continues to grow, with more than $30.7 trillion in AUM. Client demand, increasing recognition that ESG factors can affect risk and return, and regulation are driving the growth.

A 2017 study by the Morgan Stanley Institute for Sustainable Investing found high levels of interest in sustainable investing among individual investors:

75%

of all respondents—and **86%** of millennials—were interested in sustainable investing.



80%

were interested in sustainable investments that can be customized to meet their interests and goals.

71%

believed that companies with leading sustainability practices may be better long-term investments.

Similarly, a 2016 survey by Natixis Global Asset Management of participants in 401K and other defined contribution plans found:

82%

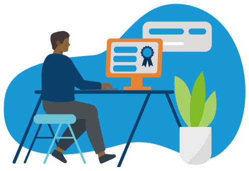
of respondents said they want investments in their retirement plan that reflect their personal values.

62%

of plan participants said they would increase their contributions if they knew their investments were doing social good.

74%

would like to see more socially responsible investments in their retirement plan offerings.



64%

of all respondents were concerned about the environmental, social, and ethical records of the companies they invest in.

Shareholder engagement can be applied using a combination of four primary strategies:

- **Proxy process.** This allows shareholders to engage with a company on its ESG disclosure, polices, and practices through shareholder resolutions and proxy voting. A shareholder resolution is a proposal submitted to a company to be voted on by all shareholders at the annual shareholder meeting. Shareholders can then vote on resolutions through proxy voting. Investment advisers who vote their client proxies have a fiduciary duty to vote proxies in their client's interests.
- **Dialogue.** Communicating with a company to demand changes in practices that impact ESG issues may include direct dialogues with the company, participating in multi-stakeholder initiatives, and taking collective action with other investors.
- **Policy.** Shareholders may attempt to influence governmental regulations to require companies to improve their ESG impact. This may include asking companies to be a public voice for a policy, submit public testimony, and encourage regulatory bodies to codify best ESG practices.
- **Assertive action.** This includes taking legal action or creating a public campaign (i.e., divestment) to force or pressure a change in company behavior. Examples include organizing divestment campaigns and pursuing a seat on the company's board of directors.

Investment managers, often with the cooperation of other investment managers and non-profit organizations such as Ceres, As You Sow, and the Interfaith Center on Corporate Responsibility, have helped companies address ESG risks while also identifying ESG opportunities within their business practices. Some high-profile shareholder engagement examples include:

- In 2015, Domini Impact Investments (Domini), Trillium Asset Management (Trillium), and Friends of the Earth engaged with a large home improvement retailer to eliminate from its stores neonicotinoid pesticides, which are leading contributors to global bee population declines. The shareholder proposal, submitted by Domini and Trillium, asked the company's board of directors to conduct a risk assessment of its environmental protection policies and practices to determine whether continued sales of neonicotinoid-containing products were in the best interests of the company, its consumers, and its shareholders. The investors withdrew the shareholder proposal in response to new commitments, as the company announced it will phase out neonicotinoids as suitable alternatives become available.[12] Another large home improvement retailer quickly followed suit.
- In 2015, Pax World was the lead filer of a shareholder proposal at a large consumer electronics retailer, and co-filed shareholder proposals at two large e-commerce retailers, requesting disclosure of the results of pay equity assessments. As a result, the large consumer electronics retailer announced the results of the company's gender pay assessment at its annual meeting that year and stated that the company is committed to closing the pay gap.[13]
- In 2016, Trillium announced the successful withdrawal of its shareholder proposal at a large apparel retailer, based on the company's commitment to report on the actions it has taken to identify and curtail human rights risks in its supply chain. Trillium first filed this proposal when a large apparel retailer reported that it sourced nearly half of its private-label product from factories that were at risk of human rights violations.[14]

[12] https://www.domini.com/insights/

[13] https://impaxam.com/news-and-views/

[14] https://trilliuminvest.com/

Helping Communities

Sustainable investing also has positively changed communities through community-oriented investing, which brings capital directly to underserved communities, such as low-income neighborhoods and rural communities that conventional markets do not reach. It also involves delivering explicit social benefits, such as affordable housing and small business loans, using an investment product that can be managed for risk and return. Community investing can be accomplished primarily through cash, fixed income, and private equity asset classes.

Investors can engage in community investing through Community Development Finance Institutions (CDFIs) that specialize in serving low-income communities. First established in the 1970s and certified by the US Treasury Department, CDFIs are private intermediaries that provide capital and technical assistance to communities and people underserved by conventional lending institutions. CDFIs fall into four basic categories: community development banks, community development credit unions, community development loan funds, and community development venture capital. A very common community investment practice is to place cash on deposit in CDFI banks or credit unions.

Additional fixed income options for community investing include promissory notes and government bonds for housing and other activities in Community Reinvestment Act (CRA) geographies. Promissory notes offer investors market-like returns while providing capital to a diversified portfolio of intermediaries and funds that are investing in communities left out of traditional capital markets. These notes help finance projects that may include affordable housing, community development, education, environmental sustainability, health, renewable energy, small business, and sustainable agriculture.

Certain investment managers have developed market-rate fixed income strategies that focus on community development by investing in high-quality mortgage-backed securities backed by US federal agencies. One pioneer in the field, Ron Homer at Access Capital Management, created customized mortgage pools within CRA geographies and backed by Fannie Mae to help provide capital to underserved communities. In order to meet various reporting requirements, Ron's granular approach has been able to identify specific benefits from this investment method, including providing more than 17,000 mortgages for low- and moderate-income home buyers, more than 93,000 affordable rental units, and nearly 6,000 nursing home facility beds.

Next Steps

Sustainable investing will continue to be a force for positive change in the investment industry, corporations, and our communities. Understanding the sustainable investing impact can help you better understand where and how your money is invested.

Prior to considering investment options, you may want to consider your motivations for sustainable investing. Identify the ESG issues that most resonate with you. This process will help you learn more about the issues and help you narrow down and identify investment services that best match your investing principles.

To invest in a manner that contributes to positive change, that is appropriate for your age, investment objectives, risk tolerance, and return objectives, you may want to consult your LPL financial professional.

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