BAIRD

# Aligning Social Objectives with Financial Goals

*An Introduction to ESG Investing*

By Baird's Asset Manager Research

## Introduction

The discipline of responsible investing covers many different titles and approaches, such as "socially responsible investing," "ethical investing," "impact investing," "values investing" or "sustainable investing." While the terminology and methods may differ, they all carry the same goal of building a more viable and equitable world by taking into account increasingly important nonfinancial factors like environmental, social and corporate governance issues. This paper seeks to provide an introduction to the responsible investing landscape and outline how responsible investing has become increasingly ingrained in today's portfolio management process.

## Approaches to Responsible Investing

Responsible investing has experienced an evolution over the years. Traditional forms of socially responsible investing focus on avoiding or screening out industries or companies that do not meet investor's ethical, social or environmental preferences. This process, called exclusionary or negative screening, typically results in shunning "sin stocks" or those companies with ties to tobacco, alcohol, pollution and weapons manufacturing, for example. For some faith-based investors, the process might also extend to exclude companies involved in contraception and abortion-related activities. While there are benefits to negative screening's "do no harm" approach, this process results in a limited investable universe that may ultimately impact long-term investment returns.

ESG INCORPORATION STRATEGIES AND TERMS

**Socially Responsible Investing:** A portfolio construction process that attempts to avoid investments in certain stocks or industries through negative screening according to defined ethical guidelines.

**ESG Integration:** The systematic and explicit inclusion by investment managers of ESG risk and opportunities into traditional financial analysis.

**Impact Investing:** Targeted investments, typically made in private markets, aimed at solving social or environmental problems.

Though negative screening is still widely utilized, the common framework used today has evolved to take a positive, rather than negative, approach to screening investments. Today's approach focuses on finding companies with certain positive attributes related to environmental, social and corporate governance factors that will have an impact on shareholder value over time (see Table 1). These ESG factors are integral investment risk factors with the potential to materially affect the value and trajectory of securities. One only has to look at the wealth destruction that resulted from the financial crisis to understand that lax corporate governance can have serious financial consequences. When looking at environmental factors, disasters like BP's Deepwater Horizon and the Exxon Valdez oil spills can have significant financial and reputational damage that can haunt companies for years. With ESG integration, the goal is to understand how companies handle ESG risks and opportunities and what effect these may have on corporate behavior and performance. Compared to exclusionary screening, positive screening is expected to lead to more durable and balanced portfolio construction.

TABLE 1:

**Example of ESG Risks and Issues**

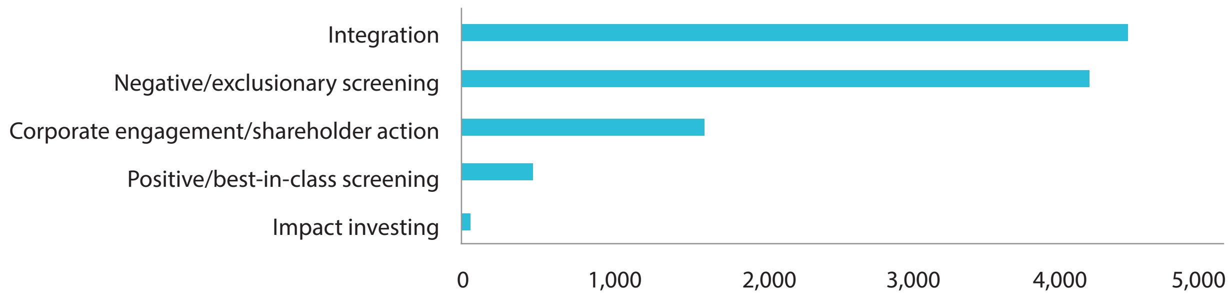
| Environment | Social | Governance |
|---|---|---|
| • Carbon Emissions<br>• Product Carbon Footprint<br>• Energy Efficiency<br>• Insuring Climate Change Risk<br>• Water Stress<br>• Biodiversity and Land Use<br>• Raw Material Sourcing<br>• Financing Environmental Impact<br>• Toxic Emissions and Waste<br>• Packaging Material and Waste<br>• Electronic Waste | • Labor Management<br>• Human Capital Development<br>• Health and Safety<br>• Supply Chain Labor Standards<br>• Controversial Sourcing<br>• Product Safety and Quality<br>• Chemical Safety<br>• Financial Product Safety<br>• Privacy and Data Security<br>• Access to Healthcare<br>• Access to Finance | • Corruption and Instability<br>• Financial System Instability<br>• Business Ethics and Fraud<br>• Anticompetitive Practices<br>• Corporate Governance |

Source: MSCI ESG Research

An increasingly popular area of responsible investing has taken the ESG integration process a step further by seeking to make a direct positive social or environmental impact alongside positive financial returns (see Exhibit 1). Impact investing focuses on providing capital to companies, organizations and projects with the goal of directly addressing ESG-related challenges. Examples include the creation of "green bonds," which fund projects that have positive environmental benefits like renewable energy and clean water, or "social impact bonds," which pay investors if the cost of incidence of something like foster care or prisoner recidivism is reduced (see Exhibit 2). As an offshoot of microfinance, impact investing was primarily contained to private investments. Today, impact investing has transitioned to public markets with focused investments in institutions whose products or services proactively confront social and environmental issues.

EXHIBIT 1:

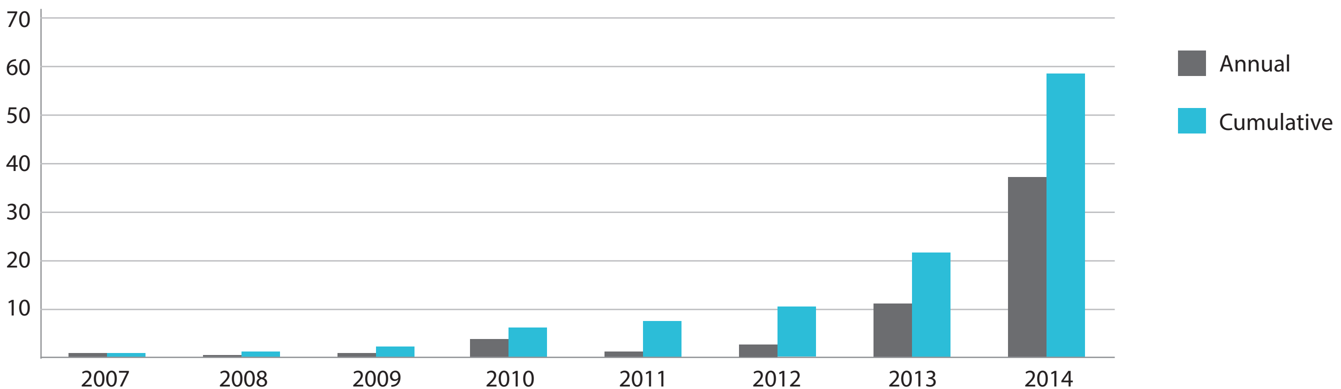
**Responsible Investing Assets by Strategy (2014)**
*$ Billions*




Source: Global Sustainable Investment Alliance (GSIA), 2014

EXHIBIT 2:

**Green Bond Market: Annual and Cumulative Issuance**
*$ Billions*




Source: The Climate Bonds Initiative, 2014

## Why Integrate Responsible Investing Techniques?

The motivations for incorporating responsible investing techniques into the portfolio management process vary. For many investors, there is a desire to align their personal values with their investment decision. With today's wave of socially conscious consumers and the rise of the empowered millennial, there is an increasing desire to invest in the way we live, with consumer behavior influencing the way we make investment decisions.

For others, there is growing acceptance that an emphasis on ESG factors can positively impact portfolio performance over the long term by reducing risk and enhancing returns compared to a traditional portfolio. ESG factors represent real investment risks that have a tendency to be lower in frequency but higher in impact. Because today's markets have become increasingly short-term-focused, a thorough understanding of nonfinancial but high-impact risks can make a focus on ESG factors even more important.

## A Question of Returns

Despite increased popularity, there has been a reluctance to incorporate ESG factors into the portfolio management process over concerns investors would be forced to sacrifice performance in favor of their social, ethical or environmental beliefs – that investing for good performance and investing to do good are mutually exclusive. While there is a risk of underperformance with any strategy, studies have shown responsible investing provides a benefit to shareholders over the long term.

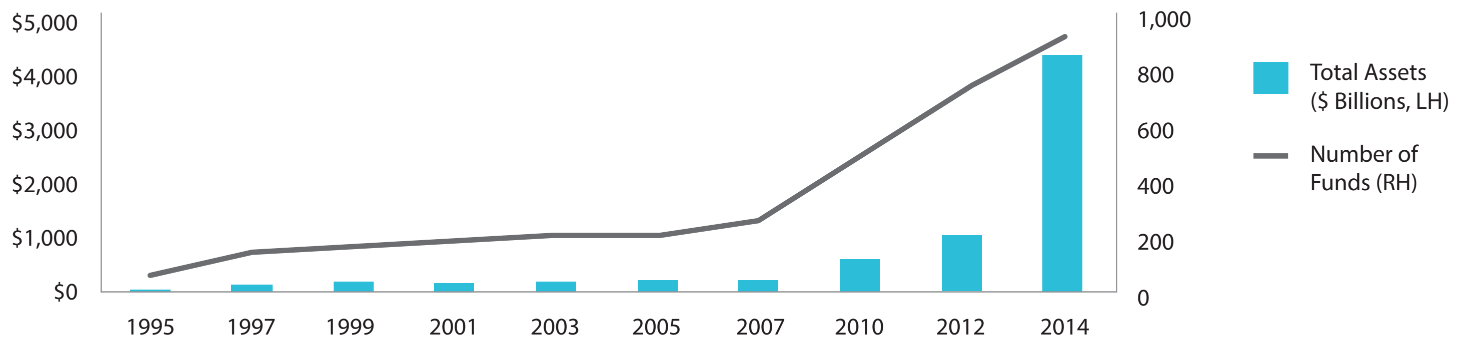
A 2012 meta-analysis conducted by Deutsche Bank examined more than 100 academic studies relating to the success of responsible investing.[1] That meta-analysis found that in each study, companies with high ESG ratings had higher credit ratings and an overall lower cost of capital, indicating that investors recognized these companies as being less risky relative to the broader market. When examining financial performance, 89% of the studies showed that companies with high ESG ratings exhibited market-based outperformance, while 85% of the studies showed these same companies exhibited higher accounting-based profitability relative to the broader market. Interestingly, 88% of the studies showed that traditional negative screening approaches provided neutral or mixed relative performance, indicating broad SRI-focused strategies performed neither better nor worse than traditional approaches.

## Growing Demand

While the demand for responsible investing has typically been concentrated among institutional investors of the world, there is increasing interest among today's retail investors. At the forefront of this trend are millennials and women, who are showing the most interest for responsible investing. Surveys conducted by U.S. Trust and Bank of America note that while a little more than half of all high-net-worth individuals surveyed thought the environmental and social impact of their investments was important, that number rises to 73% when focusing on just millennials and women.[2] More importantly, these demographics stand to gain or inherit the most wealth over the coming years. Studies expect women will manage or control two-thirds of the nation's wealth by 2030,[3] driven by generational and spousal transfers. The numbers are even more staggering when looking at today's increasingly powerful millennial generation, who are in line to inherit $30 trillion by midcentury.[4] Despite questions of the efficacy of responsible investing, there is little doubt the demand for responsible investing will continue to grow.

EXHIBIT 3:

**U.S. Investment Funds Incorporating ESG Factors**




Source: The Forum for Sustainable and Responsible Investments (U.S. SIF), 2014

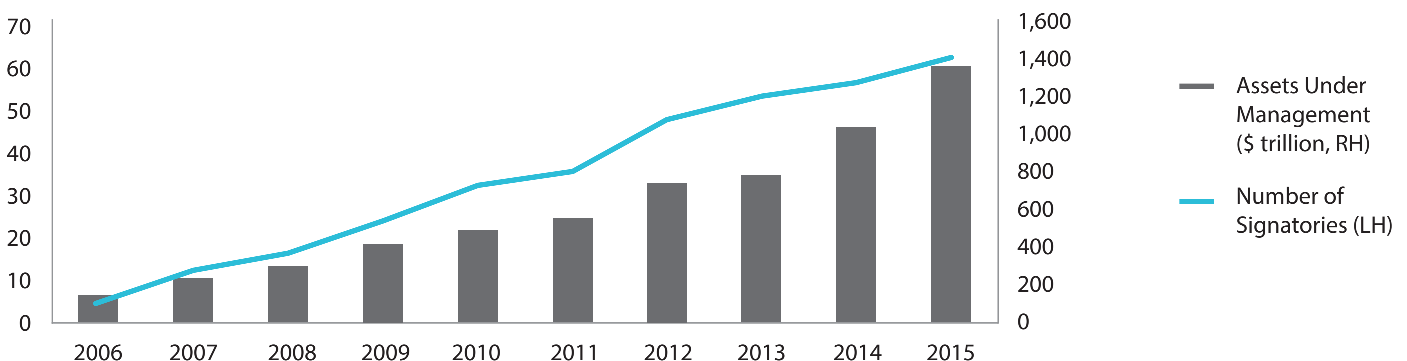
## Wider Acceptance

What was once considered a niche investment discipline has since become one of the fastest growing areas in investment management (see Exhibit 3). According to the U.S. Forum for Sustainable and Responsible Investment, the U.S. market for socially responsible and ESG-focused strategies grew 76% between 2012 and 2014, with assets reaching $6.57 trillion.[5] More impressive, responsible investment products are capturing more than $1 of every $6 in investable assets under professional management.[5]

At the same time, there has been a steady rise in the number of companies signing the United Nations Principles for Responsible Investment (UN PRI). The Principles are a set of six voluntary commitments to incorporating ESG factors into the investment process and ownership practices, requiring participating companies to publicly disclose their progress as it relates to implementation and adoption. Through 2015, the UN PRI reports the number of signatories has grown to more than 1,300, representing $59 trillion in assets under management (see Exhibit 4).[6]

EXHIBIT 4:

**Signatories in the UN PRI and Their Assets Under Management**




Source: UN PRI, as of April 2015

Fortunately for investors, the number of high-quality options is increasing across asset classes and styles. With hundreds of strategies now available, investors can construct entire asset allocations of passive or active strategies across equity, fixed income and alternatives with a focus on responsible investing principles.

## Conclusion

The growing acceptance of responsible investing as a mainstream discipline is the result of changing societal trends and more thoughtful approach to implementation. Formally limited to negative screens, today's approach incorporates positive ESG factors into the research process. Evidence suggests that ESG factors can have an important positive impact on investment performance, ultimately putting to rest conventional thinking that investing for sustainability means sacrificing returns. If you are interested in implementing responsible investing into your portfolio, talk to your local Baird Financial Advisor or visit rwbaird.com.

[1]"Sustainable Investing: Establishing Long-Term Value and Performance," Deutsche Bank Group, June 2012.

[2]2014 U.S. Trust Insights on Wealth and Worth, ustrust.com/survey.

[3]M. Quis-Newins, "Untapped Market: Women May Be Gaining Economic Power, But They Still Feel Financial Planners Are Not Recognizing Their Potential" (March 1, 2010). Available at www.financial-planning.com/fp_issues/2010_3/untapped-market-2665922-1.html.

[4]The "Greater" Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth, Accenture, 2012.

[5]Sustainable and Responsible Investing Trends in the United States, US SIF Foundation, 2014. (Latest available data).

[6]U.N. Principles for Responsible Investing, "PRI Fact Sheet". http://www.unpri.org/news/pri-fact-sheet/.

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