North American Management

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MARKET PERSPECTIVES

SUSTAINABLE INVESTING:

Aligning values with investment decisions

However it is defined — socially responsible investing (SRI), environmental, social and governance (ESG) integration, or investing for impact — sustainable investing seems to be everywhere in the press today. In fact, it's an investment discipline that's been percolating for more than 50 years. In 1971, a New York Times editorial penned by the then-CEO of TIAA , a top institutional pension fund manager, advocated that businesses look beyond just profits in making business decisions. This was a sharp rejoinder to a common argument, expressed for decades prior, that there is inherent conflict between sustainable investing and the profit motive. (Milton Friedman once famously titled an article, "The Social Responsibility of Business Is to Increase Profits." [1])

Sustainable investment strategies aim to consider and integrate the analysis of ESG factors into the investment process. A benefit of ESG integration is that it may provide a more complete investment picture, adding impact to risk and return. Evaluating how companies are meeting ESG challenges and opportunities provides additional insight into a company's culture, risk management practices, and operating quality. While some consider sustainable investing to be a natural step in the evolution of investing, many believe it recognizes that there are non-financial aspects to investing in companies that may deliver significant benefits to society and to the environment.

Today, the availability of independent, third-party data offers the opportunity to make more precise, tailored investment decisions based on specific ESG inputs. We believe the sustainable investing ecosystem has now evolved to a level where it has the potential to deliver returns that do not require investors to sacrifice their core values or principles. In addition, active asset owners can engage, influence, and raise awareness with companies, which may make companies better and lead to improved operating performance. Investment managers look for the presence of certain sustainable business practices in companies as signals that may allow them to better manage risks and opportunities and deliver long-term, competitive performance. **Figure 1** presents a set of ESG criteria that may be integrated into the investment process.

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Figure 1:
ESG Investment Criteria

POTENTIAL BENEFITS OF SUSTAINABLE INVESTING

In general, sustainable investing has the potential to address a number of investor objectives:

- **Values alignment:** Sustainable investing offers investors the ability to balance investment goals with their values.
- **Returns generation:** ESG integration may identify companies with long-term, durable competitive advantages, and the presence of good governance may lead to stronger fundamental metrics such as return on equity (ROE), dividend payout, and share buybacks.
- **Risk mitigation:** Effective active managers, who are productive stewards of sustainable investing capital and who are able to engage with company managements, may be able to identify and evaluate evolving, value-destroying risks associated with specific stocks and bonds.
- **Impact on social/environmental issues:** Sustainable investing may address significant collective unmet challenges through targeted investments that set explicit goals for financial return as well as social or environmental benefit.

[1] *The New York Times Magazine*, Sept. 13, 1970.

A FEW CAVEATS

While it may first appear that investing in ESG-rated companies would be as simple as avoiding or divesting in certain companies, the process of selecting securities and managers using ESG criteria is not always straightforward. Following is a high-level summary of key obstacles:

Exclusion vs. ESG integration: Some investors would prefer to avoid certain areas of the market but are unsure how far those exclusions should go. If investors want to stay away from defense companies, for example, does that also mean they avoid their suppliers or banks that finance them as well? At what point does this impact portfolio returns? We believe that portfolios need to be diversified across various strategies and methodologies (see **Figure 2**, below).

Materiality: To mine data sources and create effective lenses by which investors can analyze a company's ESG footprint, identifying what indicators are relevant or significant matters — the essence of materiality. What is material to a company can vary significantly by asset class, region, sector, industry, and product offering. Therefore, to effectively discern between good and poor ESG companies, it is important to develop a granular, cohesive, and comparable ESG framework.

Longer time horizon: Driving progress and reaping rewards from sustainable investing takes time and requires in-depth research to seek companies that are actively solving sustainability challenges.

OUR SUSTAINABLE INVESTMENT JOURNEY:

Identifying managers skilled at applying ESG data

North American Management's investment team has spent the last several years building an ESG framework to identify and partner with who we believe to be the best ESG investment managers. These investments make the core of our client strategies. As part of that effort, we gained insights into identifying the material ESG issues that have a direct bearing on a manager's investment strategy. At the core of this work is vetting managers who are using proprietary ESG data and evolving their processes to drive a competitive long-term advantage. For example, what matters to a mature public utility — such as issues related to energy efficiency or transition from coal or oil inputs — matters much less to a bank, whose fortunes are driven more by governance and risk management. For strategies that invest in emerging markets, governance and macro signals may play a more important role, while fixed income managers may be evaluated for their ability to drive impact more than other ESG factors. Our research suggests there is no one way to invest in ESG assets. For that reason, NAM uses several strategies to construct ESG-focused portfolios (**Figure 2**).

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Figure 2: Sustainable Investing Strategies

Sustainable Investing Strategy	Definition
Negative/Exclusion Screens	Excludes specific investments from universe based on limiting reputational or operational risk. Could include norm-based screening based on compliance with international standards.
Best in Class/Positive Selection	Chooses investments based on positive ESG performance relative to industry peers.
Sustainability-Themed	Invests in themes linked to sustainability, focusing on issues related to ESG criteria.
ESG Integration/Overlay	Explicitly includes ESG criteria into financial analysis.
Engagement/Active Ownership	Uses shareholder power to influence company behavior, engage with companies on specific issues, and perhaps unlock value over time.
Impact Investing	Targets investments that seek to solve environmental or social concerns. Impact investing is intended to generate social and environmental impact along with a financial return.

Source: Adapted from Eurosif European SRI Study 2016.

CONCLUSION AND NEXT STEPS

We believe sustainable investing has the potential to deliver competitive returns to investors while aligning their portfolio to more closely reflect their social and moral beliefs. To learn more about how ESG Investing at NAM can better reflect your values, please contact your Wealth Advisor.

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