INVESTMENTS & WEALTH MONITOR

A reprinted article from July/August 2019

ESG Data Drives Demand for Sustainable and Impact Investing

By Jeff Gitterman and Paul Ellis, JD

INVESTMENTS & WEALTH INSTITUTE®
formerly IMCA

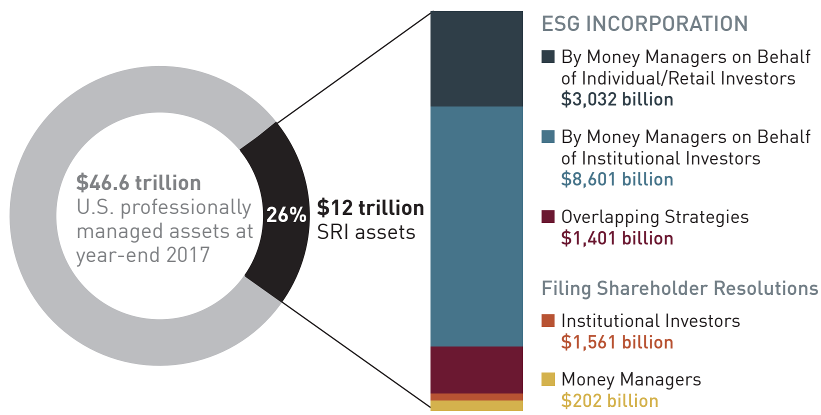
ESG Data Drives Demand for Sustainable and Impact Investing

By Jeff Gitterman and Paul Ellis, JD

Most financial advisors have been flirting for years with environmental, social, and governance (ESG) investing strategies in their portfolio allocations. In a 2018 Eaton Vance survey, 79 percent of 1,000 U.S. advisors say their clients have expressed interest in sustainable investing, but only 31 percent consider ESG an important part of their practices.[1] In addition, many advisors say they use ESG investing only to respond to individual client requests for products addressing specific issues such as gender pay-parity, renewable energy, or other nonfinancial ESG concerns. When we look at the universe of professionally managed assets using ESG criteria, individual investors account for $3.03 trillion and institutional investors and money managers account for $8.6 trillion (see figure 1).[2] Large institutional investors are seeing that ESG issues can positively affect alpha generation and risk management, so they incorporate ESG analytics in their research, analysis, and decision-making across portfolios.

Figure 1

SIZE OF SUSTAINABLE, RESPONSIBLE, AND IMPACT (SRI) INVESTING, 2018



Source: US SIF Foundation

We present the business case for ESG investing as an integral part of a diversified portfolio strategy for clients of registered investment advisors (RIAs). Specifically, we focus on the robust research showing the positive effects of ESG investing on corporate financial performance as well as the rising demand for sustainable and impact investment products by clients, particularly women and millennials. We conclude by presenting approaches to ESG investing that have been developed by advisors collaborating with asset managers over more than 20 years to support a wide range of investors.

We define ESG as a dataset that considers material and nonfinancial ESG metrics in support of traditional balance sheet analysis. We use the terms sustainable, responsible, impact, and ESG investing interchangeably.

INVESTING WITH ESG DATA IS ON THE RISE

Growth in assets under management (AUM) of ESG-focused investment funds has outpaced the broader asset management industry in recent years. US SIF (The Forum for Sustainable and Responsible Investment) Foundation's "Report on US Sustainable, Responsible and Impact Investing Trends" (Trends Report) has been tracking the growth of sustainable, responsible, and impact investing biannually since 1995 and is the industry standard. According to the 2018 Trends Report, U.S.-domiciled AUM that use sustainable and ESG investment strategies grew from $8.7 trillion at the start of 2016 to $12 trillion at the start of 2018, a 38-percent increase (see figure 2). This represents 26 percent of the total U.S. assets under professional management, or one in four dollars. Since 1995, these assets have increased 18-fold, a compound annual growth rate of 13.6 percent.[3]

The 2018 Trends Report also shows a significant increase in the use of ESG data with institutional investors and money managers. The $8.6 trillion that incorporated ESG at the beginning of 2018 represents a 19-percent increase over the total reported in 2016.

Morningstar's 2018 Sustainable Funds Landscape report shows that a record number of new funds were launched in 2018, increasing the number of sustainable funds tracked by 50 percent. In addition, in 2018 a large number of existing funds added sustainability or ESG criteria to their prospectuses; 2018 was the third consecutive year of record net flows into sustainable funds despite unfavorable market conditions.[4]

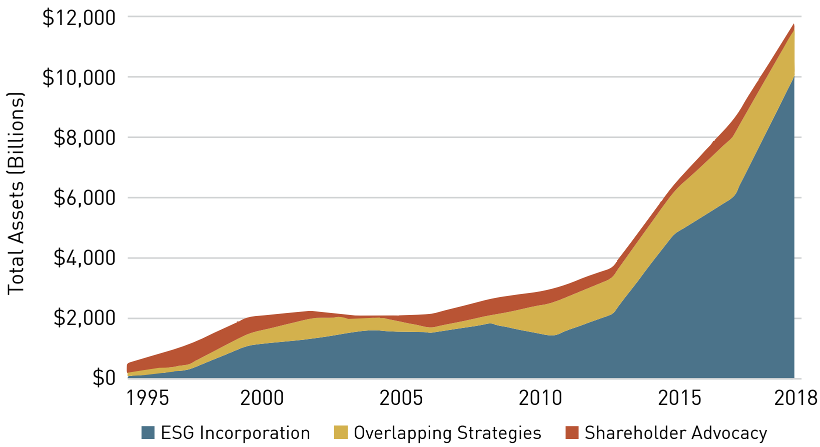
This trend shows no sign of slowing. In fact, the pace has quickened in the past year with the launch of new index-based exchange-traded fund (ETF) portfolios by BlackRock, Vanguard, and Fidelity, among others. As of March 2018, Nuveen was managing more than $20 billion in ESG-focused products for institutional and individual investors.[5] As demand increases from investors for the integration of these issues into their portfolio strategies, leading asset management firms including SSGA, PIMCO, and Alliance Bernstein have launched investment funds that incorporate ESG analysis into their prospectus objectives.

ALPHA GENERATION AND RISK MITIGATION DRIVEN BY ESG DATA

ESG issues that are material to the value of companies owned in an investment fund or portfolio can positively influence the market value of shares and the long-term risk management of the fund or portfolio. A 2015 meta-study published in the *Journal of Sustainable Finance and Investment* is the most exhaustive overview of academic research on the relation of ESG criteria and corporate financial performance (CFP). The study looked at more than 2,000 primary studies (1970–2015) and allows for generalizable statements. The aggregated results show that "the business case for ESG investing is empirically very well-founded," with the large majority of meta-studies (62.6 percent) reporting a positive relation between ESG criteria and CFP that appears stable over time (see figure 3).[6] The report concludes that "investing in ESG pays financially." The study's authors also point out that 50 percent of the total global institutional asset base, valued at $60 trillion, was managed by signatories to the Principles for Responsible Investment.

Figure 2

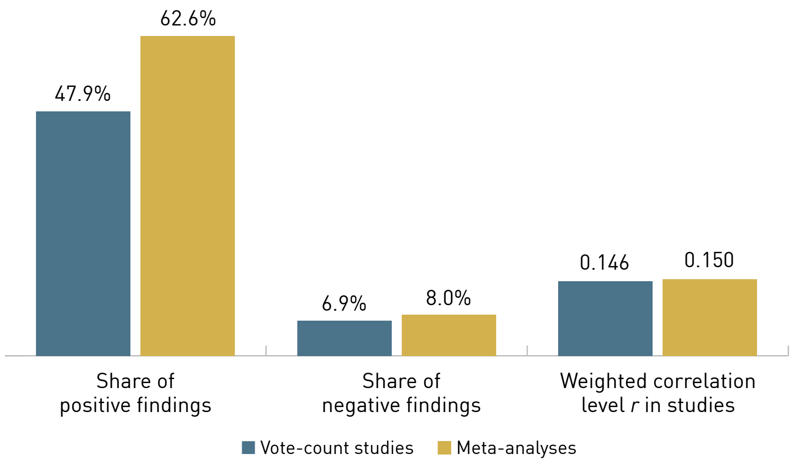
SUSTAINABLE AND RESPONSIBLE INVESTING IN THE UNITED STATES, 1995–2018



Source: US SIF Foundation

Figure 3

RELATION BETWEEN ESG AND CFP



Source: Friede et al. (2015), "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies" (see endnote 6)

Another widely recognized meta-study reinforces the business case for companies with sound sustainability standards. Among the most significant findings from the more than 200 studies, 90 percent exhibited lower cost of capital, 88 percent exhibited better operational performance, and 80 percent exhibited positive stock price performance.[7] One of the leading studies on the social dimension of ESG showed that a portfolio of the 100 Best Companies To Work For, which included 14 countries, earned an annual alpha of 3.5 percent in excess of the risk-free rate from 1984 to 2009 and 2.1 percent above industry benchmarks.[8] The growing body of research offers compelling evidence for ESG analysis as a risk mitigator and alpha producer, reinforcing that firms with high scores for ESG metrics integration have lower cost of capital than their industry peers.

CLIMATE CHANGE

Climate change and its associated risks are high on the list of risk-management priorities across the industry. The 2018 Trends Report identifies climate change risk as the most important specific ESG issue considered by money managers in asset-weighted terms, with assets under management focused on climate change risk more than doubling from 2016 to 2018 to $3 trillion.[9]

At the federal public policy level, the latest National Climate Assessment, a 1,515-page scientific report produced by 13 federal agencies, summarized the impact on the U.S. economy: "Without substantial and sustained global mitigation and regional adaptation efforts, climate change is expected to cause growing losses to American infrastructure and property and impede the rate of economic growth over this century."[10]

In March 2019 the Federal Reserve Bank of San Francisco published "Climate Change and the Federal Reserve," stressing the following statement: "In coming decades, climate change—and efforts to limit that change and adapt to it—will have increasingly important effects on the U.S. economy. These effects and their associated risks are relevant considerations for the Federal Reserve in fulfilling its mandate for macroeconomic and financial stability."[11]

The urgency and opportunities are there for ESG data to transform the investing landscape. Advisors should consider the potential for ESG alpha generation in new low-carbon energy technologies, resource and waste management, and sustainable agriculture, to name just a few examples. One of the most dramatic opportunities is the United Nations Sustainable Development Goals (SDGs), a global framework of 190 countries that are incorporating ESG criteria to tackle poverty and grow the world economy by an additional $20 trillion beginning in 2030. In the Harvard Law School Forum on Corporate Governance and Financial Regulation, the article "UN Sustainable Development Goals—The Leading ESG Framework for Large Companies," reports that 40 percent of the world's largest 250 companies started referring to the SDGs in their corporate reporting as of February 2018. The article states that the SDGs "offer an effective way to look at opportunities and risks, to translate the impact of … investment activities into real economy outcomes and provide a useful means of engaging with stakeholders."[12] Advisors who want to take advantage of ESG investing for their portfolio allocation strategies can find exciting opportunities both nationally and globally.

CAPTURING ESG DATA

The collection and processing of data for identifying material ESG factors continues to grow at the sector, industry, and company levels. There are numerous independent and institutional ESG and impact research platforms such as Sustainalytics, S&P Dow Jones, and FTSE Russell, as well as proprietary research technologies created by asset management firms. A good example of the latter is the Arabesque S-Ray data service. Launched in 2017 by Arabesque Asset Management, it provides multiple lenses on the sustainability of the world's largest corporations. The technology uses big data and machine learning to systematically combine more than 250 ESG metrics with news signals from more than 50,000 sources across 20 languages. This rich data enables subscriber investors, corporations, and consumers to make better informed financial decisions. The service has become a widely adopted standard for measuring ESG data and is used by BNY Mellon, JP Morgan, State Street, S&P, Accenture, and the Japanese Government Pension Fund, among others.

Sustainalytics and Morningstar collaborate to provide investors and advisors with work station capabilities for analyzing ESG data incorporation. The Morningstar Sustainability Rating™ for funds, for example, allows investors to evaluate how well a company is managing ESG factors relevant to its industry. Bloomberg collects ESG data on 9,500 companies in 83 countries and executive compensation data for more than 5,600 companies in 69 countries, with a projected increase to 13,000 companies by the end of 2018. The number of customers using its data has almost tripled over the past five years, to 14,935 users.

INVESTORS ARE DEMANDING ESG INVESTING APPROACHES

In the United States, nearly 84 percent of women and up to 90 percent of millennials are interested in sustainable investing, with a 38-percent increase in interest by millennials since 2015.[13] These two investor cohorts will be the recipients of $58.1 trillion in wealth transfers through 2061,[14] with $24 trillion in assets passing to millennials in the next 15 years.[15] Multiple studies show that women and millennials have made it clear that financial advisors who are not prepared to integrate ESG issues into long-term investment allocation strategies will lose them as clients. Overall, their values-conscious behavior as consumers is expected to drive their choices as investors.

Advisors who work with family offices and foundations also will benefit from understanding the growing trend toward ESG investing. In his book *The Purpose of Capital*, Jed Emerson describes working with ultra-high-net-worth family offices in support of their multigenerational commitment to sustainable and impact investing. The book refers to the Campden/UBS Global Family Office Report 2018, which says that one-third of family offices are investing with impact, and 54 percent plan to increase their allocation to impact and ESG investing in 2018.[16] Emerson makes the case that second- and third-generation members of these families are participating in the management of both lifestyle and philanthropy-directed pools of capital. Interestingly, this group is reflecting a generational preference for ESG-focused portfolio allocation ahead of the mass-affluent recipients of the wealth transfer now under way.

Women and millennials increasingly are asking how they can influence company behavior, both by rewarding companies with positive ESG ratings and by working to change behavior within companies with negative ratings. Shareholder advocacy offers these investors the opportunity to influence ESG integration into the long-term value creation of companies owned in their portfolios. Institutional investors and money managers have been participating in shareholder advocacy for years. In 2018 those who filed or co-filed shareholder resolutions on ESG issues represented \$1.8 trillion.[17] Advisors that want to improve on the dismal 2-percent capture rate on intergenerational inheritance transfers between baby boomer clients and their adult children can begin by adding ESG and shareholder advocacy to their overall investment strategies.

MODELS FOR INTEGRATING ESG INTO PORTFOLIO ALLOCATION

ESG integration into an advisory firm's asset allocation strategy starts with a basic understanding of ESG to ensure advisors, analysts, and clients are on the same page. Our firm refers to ESG as the "GPS of investing." Here's how we explain it: Like the GPS navigation system in a car, the ESG metrics available through big data and artificial intelligence provide real-time information from around the world about material issues that affect company performance and market valuation. The ESG dataset available for companies and funds, along with fundamental balance sheet analysis, help advisory firms evaluate portfolio construction opportunities across asset classes and risk profiles. This process produces efficient, low-cost models that can save advisors time and resources during investment allocation.

There are several approaches to integrating ESG datasets, including active management, passive management based on quantitative models, and some combination of the two. A turnkey asset management program (TAMP) offers yet another approach. The first step in any model, however, is using some combination of material ESG data and fundamental balance sheet analysis to establish the foundation upon which additional social and impact value considerations can be layered.

> *Klimo says he believes that today's ESG investor seeks to identify companies that are setting the standard in ESG policies and practices.*

Examples of active management are the approaches taken by Scott Klimo, chief investment officer and portfolio manager at Saturna Capital, and Karina Funk, a partner and portfolio manager at Brown Advisory.[18] Portfolio managers such as Klimo and Funk concentrate stock ownership to leverage sustainability as a driver of performance in public markets. Klimo says he believes that today's ESG investor seeks to identify companies that are setting the standard in ESG policies and practices. These companies are moving toward best practices with specific, measurable signposts that active managers use to gauge progress and performance. Actively managed portfolio strategies often are more concentrated than a broad, market-based index such as the S&P 500 in the number of companies owned and the percentage of fund assets allocated to each company's stock. Funk has taken lessons from private equity and publicly traded companies to create a framework that identifies companies with advantages in sectors of the economy where the scale is already there. Funk identifies three reasons to think of impact within public equities: scale, necessity, and availability of capital, and she highlights the data showing that large companies with large global footprints have a material impact on sustainability profiles.

To complement an actively managed portfolio that uses ESG criteria for investing in some combination of stocks, bonds, and pooled asset mutual funds or separately managed accounts (SMAs), many investors incorporate passively managed ESG exchange-traded funds (ETFs) that are based on quantitative model indexes. These indexes, created by firms such as MSCI, S&P Dow Jones, FTSE Russell, and Morningstar, are becoming more popular as demand increases. The ETFs based on these indexes provide low-cost, thematic investment allocations within a total portfolio strategy—for example, an ETF that owns companies developing and refining renewable and low-carbon energy strategies based on solar, wind, or battery technologies. The expectation of accelerated share-price increases in the companies owned in such an index-based ESG ETF also must be weighed against the overall risk profile of the investor, whether institutional, individual, or philanthropic. There also may be mission-based or other income-focused criteria related to portfolio distribution requirements of investment income not usually generated by such high-growth asset allocations. Such renewable energy technologies often require multiple business cycles to scale and capture market share and, as a result, are subject to greater short-term market volatility as well.

Advisors that want a wider range of services can work with a TAMP that specializes in sustainable investing. TAMPs can provide an all-inclusive platform for portfolio modeling, marketing support, and continuing education. ESG-focused TAMPs can offer specific investment themes, such as fossil-free portfolio strategies for investors who want to screen out companies engaged in fossil-fuel exploration and production. This type of negative screening uses ESG data to eliminate companies or entire industries from investment consideration. Our firm finds that RIAs that use our

TAMP are looking for a turnkey approach that allows them a best-in-class ESG solution without having to become an expert in carbon intensity, Scope 1, 2, and 3 emissions, sustainable supply chain sourcing, or diversity at Facebook, to name just a few of the complex issues involved in sustainable investing. The financial management industry has gotten flatter thanks to big data and new technologies that allow a single analyst to cover a global universe of stocks and industries, and the rise in popularity and success of TAMP models is just the latest manifestation of that flattening trend. RIAs now can manage more assets, cover more investments, and keep up due diligence better than ever.

Active investment models and TAMPs may include some form of shareholder activism to engage with companies around specific issues, particularly where the research shows the value of ESG data on the bottom line. At Arjuna Capital, for example, co-founder and managing partner Natasha Lamb's portfolio strategy includes shareholder activism around issues such as gender pay equity and parity. She has confronted Facebook, Amazon, Apple, and Nike regarding ethical pay policies and other barriers that typically keep women from moving into leadership positions. Lamb stresses the importance of making a solid business case for removing barriers that prevent women from advancing in the workplace. Jennifer Sireklove, director of responsible investing at Parametric, which has more than $120 billion in AUM, has spent six years expanding ESG integration and shareholder advocacy across the company's client base. Sireklove is clear that there is a "sea change in individual owners and small organizations who are really interested in how their assets in collection with other like-minded assets can influence change."[19] Advisors should be aware that Morgan Stanley's Sustainable Signals Survey shows that 80 percent of the general population is more likely to adopt sustainable investing if they can tailor the impact.[20]

CHOOSING THE BEST PATH TO ESG INVESTMENT INTEGRATION

Advisors can take a number of the following steps to start integrating ESG strategy into their practices:

- Build network partnerships for research, asset management, and continuing education. Collaboration helps RIAs navigate the ever-evolving road of ESG investing through cost reduction, time savings, and goal selection. Advisors can network with other RIAs and help scale impact start-up firms through donor-advised funds and section 1241 of the tax code. Collaboration produces ESG and impact product innovation through investment fund launches and collective scaling of AUM.
- Get certified. Several sustainable and responsible-investing industry organizations, including the Sustainability Accounting Standards Board (SASB), The Forum for Sustainable and Responsible Investment (US SIF), and The Investment Integration Project (TIIP) offer advisor and analyst certified education curriculums. These organizations also offer membership support for industry professionals and research libraries for members. The Chartered Financial Analyst® (CFA®) certification curriculum also includes ESG-focused modules.
- Use a consultant who specializes in ESG marketing and analytics to help build a communications platform to tell your business story. Managers of active ESG portfolio strategies often collaborate with consultants and are a good source of leads.
- Add an analyst dedicated to researching the sustainable and ESG investment universe, building models, and interviewing managers.
- Engage a TAMP to manage ESG integration.

CONCLUSION

Consumer demand for ESG investing is rising, especially among women and younger investors. The financial markets are responding to this demand and to the urgency and opportunities stemming from climate change risk and other non-financial issues that are rapidly becoming part of portfolio analysis. Asset managers are delivering numerous new active and passive portfolio products. Institutional investors have responded by significantly increasing ESG AUM, but the majority of financial advisors are still taking a much more conservative approach. Now is the time for advisors to get more serious, particularly given the robust research showing that integrating ESG criteria translates into better operational performance and positive stock-price performance. The broad spectrum of investing approaches highlights that there is no one-size-fits-all answer to ESG investing integration for RIAs and advisory firms, so we encourage advisors to engage with ESG resources and experts. The bottom line: We expect ESG investing to grow.

Jeff Gitterman is a co-founding partner of Gitterman Wealth Management, LLC, and a thought leader in the field of sustainable, impact, and ESG (environmental, social, and governance) investing. He earned a BS in business administration and management from Rider University. Contact him at jgitterman@gittermanwealth.com.

Paul Ellis , JD, is the principal at Paul Ellis Consulting, host of The Sustainable Finance Podcast *at BrightTALK.com, and a featured columnist at* Financial Advisor Magazine. *He earned a BA from Tulane University and a JD from Tulane Law School. Contact him at paul@paulellisconsulting.com.*

ENDNOTES

1. See US SIF (The Forum for Sustainable and Responsible Investing) Foundation's 2018 *Report on US Sustainable, Responsible and Impact Investing Trends*. https://www.ussif.org/trends.
2. Ibid.
3. Ibid.
4. See Morningstar Sustainable Funds Landscape Report: https://www.morningstar.com/lp/sustainable-funds-landscape-report.
5. See https://www.nuveen.com/responsible-investing.
6. See Gunnar Friede, Timo Busch, and Alexander Bassen, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies," *Journal of Sustainable Finance & Investment* 5, no. 4 (2015), pp. 210–233, http://dx.doi.org/10.1080/20430795.2015.1118917.

7. See Gordon L. Clark, Andreas Feiner, and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance" (Oxford University Smith School of Enterprise and the Environment, March 2015), http://dx.doi.org/10.2139/ssrn.2508281.
8. Ibid.
9. See endnote 1.
10. See Section 2 in The Economy in "The Fourth National Climate Assessment, Volume II: Impacts, Risks, and Adaptation in the United States," Global Change.Gov (November 2018), https://nca2018.globalchange.gov/.
11. Glenn D. Rudebusch, "Climate Change and the Federal Reserve," Federal Reserve Bank of San Francisco (March 2019), https://www.frbsf.org/economic-research/publications/economic-letter/2019/march/climate-change-and-federal-reserve/.
12. See Betty Moy Huber, Michael Comstock, and Hilary Smith, "UN Sustainable Development Goals—The Leading ESG Framework for Large Companies," post, The Harvard Law School Forum on Corporate Governance and Finance (October 4, 2018), https://corpgov.law.harvard.edu/2018/10/04/un-sustainable-development-goals-the-leading-esg-framework-for-large-companies/.
13. See "Millennials Drive Growth in Sustainable Investing," Morgan Stanley Sustainable Signals 2017, https://www.morganstanley.com/ideas/sustainable-socially-responsible-investing-millennials-drive-growth. See also the guide from The Money Management Institute and The Investment Integration Project (TIIP) giving practice guidance for both independent and affiliated financial advisors: "Fundamentals of Sustainable Investment: A Guide for Financial Advisors" (March 2019), William Burckart and Jessica Ziegler, https://www.mminst.org/mmi-news/new-report-%E2%80%93-fundamentals-sustainable-investment-guide-financial-advisors.
14. The $58.1 trillion number is based on 2011 data. See Paul G. Schervish and John J. Havens, "A Golden Age of Philanthropy Still Beckons: National Wealth Transfer and Potential for Philanthropy Technical Report," Center on Wealth and Philanthropy, Boston College (May 2014), https://www.bc.edu/research/cwp/publications/by-topic/wealthtransfer.html.
15. Michael Sisk, "How to Keep the Kids," *Barron's* (June 4, 2011), https://www.barrons.com/articles/SB50001424053111904210704576357873121823708.
16. Jed Emerson, *The Purpose of Capital: Elements of Impact, Financial Flows, and Natural*, 1st edition (Blended Value Group, 2018).
17. See endnote 1.
18. Disclosure: Gitterman Wealth Management currently utilizes these active managers in its ESG Mutual Fund Models. For interview with Scott Klimo see: "The Case for Active Management in ESG and Impact Investing," podcast (February 4, 2019), http://www.paulellisconsulting.com/podcast/the-case-for-active-management-in-esg-and-impact-investing/; for interview with Karina Funk see Paul Ellis and Kristina Markos, "Using Sustainable Business Advantages To Drive Shareholder Value," *Financial Advisor Magazine* (December 14, 2018), https://www.fa-mag.com/news/using-sustainable-business-advantages-to-drive-shareholder-value-42380.html?section=. A podcast with Funk is available at: http://www.paulellisconsulting.com/podcast/generating-alpha-through-active-portfolio-management-at-brown-advisory/.
19. For interview with Natasha Lamb, see Paul Ellis and Kristina Markos, "Sustainable Finance's Fierce Warrior," *Financial Advisor Magazine* (October 30, 2018), https://www.fa-mag.com/news/sustainable-finance-s-fierce-warrior-41666.html?section=; for interview with Jennifer Sireklove see Paul Ellis, "Owning and Influencing: Advancing ESG Incorporation and Shareholder Engagement," *Financial Advisor Magazine* (March 4, 2019), https://www.fa-mag.com/news/owning-and-influencing--advancing-esg-incorporation-and-shareholder-engagement-43615.html?section=.
20. See endnote 11.

CONTINUING EDUCATION

To take the CE quiz online,
www.investmentsandwealth.org/IWMquiz

INVESTMENTS & WEALTH INSTITUTE®
formerly IMCA

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org