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Values to Value-Based Investing: The Evolution of Sustainability

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The concept of investors aligning their financial goals alongside certain values has been a feature of socially responsible investing for decades. This idea has garnered tremendous interest more recently, leading to a variety of approaches. This paper discusses the evolution of the industry to date and various methods of incorporating Environmental, Social and Governance ("ESG") considerations in a portfolio.

Corporate Conscience, the Millennial Voice, and Alternative Data: Trends in Sustainable Investing

The quarterly earnings cycle, 24 hour news and constant barrage of social media… it seems with every decade that passes comes an increasingly heightened focus on the "now". Technology has spurred this transformation, rapidly evolving how people communicate and interact; affecting everything from corporations' intensified focus on short-term profits over long-term investments, to the soundbites that dominate thoughtful political discourse today. In contrast with this short-termism, a growing number of market participants have pledged to take a long-term view on investing through sustainable initiatives. Whether viewing it through the lens of investment returns, a company's future viability or an individual's footprint, "sustainable practice allows us to meet the needs of present users without comprising the ability of future generations to meet their own needs".[2]

Growing investor demand has also been fueled by support from leading asset owners and financial institutions, acknowledging their intergenerational commitments and thus having an inherently long-term view. In 2006, 63 investment companies representing $6.5 trillion in assets committed to alignment with the United Nations-supported Principles for Responsible Investment (The PRI), today there are over 2,200 signatories representing over $80 trillion in assets. [3] The PRI was predicated on the idea that companies and investors should take into account the implications of their holdings in respect to the world's environmental, social and governance (ESG) goals. The term ESG covers a wide range of complex and often interrelated issues, such as water management, community relations and board structure.[4] Over the years, the PRI has challenged fiduciary responsibility, sparking the conversation on whether non-financial data, such as a company's ESG characteristics, should be considered in light of investment decisions. Signatories to the PRI commit to incorporating ESG issues into their investment analysis as well as ownership policies and practices. Today, over 73% of investment professionals worldwide surveyed by the CFA Institute consider ESG issues in their investment process.[5]

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[2] As defined by the UN World Commission of Environment and Development Report, 1987
[3] UN Principles for Responsible Investment Annual Report, 2018
[4] Gordon L. Clark, Andreas Feiner and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance," Arabesque Partners (March 2015).
[5] CFA Institute, "CFA Institute ESG Survey"

Further underscoring today's changing cultural environment is the Business Roundtable's recent announcement shifting its mission statement from a focus on shareholder primacy, to instead prioritize and consider multiple stakeholders including customers, employees, suppliers and communities as well as shareholders. In this statement we observe the largest corporations in the United States revising their definition of the purpose of a corporation away from short-term profit maximization to a more holistic and sustainable view of value creation.

Additionally, the millennial generation has been at the vanguard of sustainable investing, demanding more from companies they support and invest in, including greater transparency, a sense of purpose and broader stakeholder and community alignment. 87% of millennials globally believe that the "success of business should be measured in terms of more than financial performance alone."[6] Empowered through one of the largest generational wealth transfers from Baby Boomers, and on the precipice of their prime earning years[7], numerous studies suggest that millennials are increasingly interested in deploying capital to those companies viewed as making a positive impact or reflecting personal values. A 2017 FactSet study of high net worth investors states that 90% of millennials want to direct their allocations to responsible investments over the next five years

While it is clear the momentum behind sustainable investing is building, we believe there are many investor considerations in determining how best to meet objectives across financial, environmental, social and governance dimensions.

The Business Case for Sustainability: The Opportunity within Non-Financial Metrics

Investors are becoming increasingly aware that ESG issues can have a measurable effect on a company's value, as well as its reputation. Data measuring ESG can provide additional insights into potential opportunities or risks outside of traditional financial metrics. Value creation takes place in and depends on environmental, social and governance systems. Economic activity that is not sustainable degrades those systems, diminishing their future viability and value. For instance, future regulation could negatively impact firms that produce high levels of emissions, firms treating employees poorly may face a backlash from consumers or future talent, a firm with inadequate governance may be more likely to be involved in a scandal or controversy.

While the investment professional has a well-developed language and formal system for measuring and assessing the value created, or destroyed, by financial capital, they do not yet have a similarly robust system to assess the value created or destroyed by the use or misuse of ESG capital. However, "what we do have is an evolving language of ESG issues, factors and indicators" (Greis, 2018).
The UN PRI Global Compact provides a general framework outlining the three ways in which sustainability through the integration of environmental, social and governance issues can lead to a competitive advantage. [8]

[6] Harvard Business Review: The Top 10 Sustainable Business Stories of 2017
[7] The Deloitte Millennial Survey 2018
[8] United Nations Global Compact Value Driver Model (PRI-UN Global Compact, 2013).

RISK	PERFORMANCE	REPUTATION
▪ Company specific risks ▪ External costs/ externalities	▪ Process innovation ▪ Production innovation	▪ Human capital ▪ Consumers

Asset owners are now asking companies to appreciate, understand and act upon the trade-offs that exist between financial and sustainable performance. Sustainable economic activity maintains or enhances ESG systems, increasing a company's future viability and value. The future value of the investment depends heavily on the future state of the system.

Values to Value-Based Investing: The Evolving Approaches to Sustainability

The concept of investors aligning their financial goals alongside certain values has been a feature of socially responsible investments (SRI) for decades. However, sustainable investing has evolved considerably from the early SRI funds that primarily looked to exclude certain companies irrespective of financial impact.

Increasingly, investors are looking to take a more active stance with respect to their investments, utilizing a "voice" over "exit" approach in many instances. Shareholder proposals filed at companies requesting enhanced transparency to make investor decisions as well as a means to influence overall change have become a primary pressure tactic. For example, the shareholder proposal process recently helped to drive Dick's Sporting Goods from selling assault rifles and three years of shareholder resolutions later Exxon gave way and welcomed former atmospheric scientist and director of the Woods Hole Institute to its board. As a result, ISS and Glass Lewis, which provide shareholder proposal guidance, are increasingly influencing how investors' voices are heard on certain issues.

Broadly speaking, investors tend to group forms of ESG investing into four primary buckets, however many investors look to incorporate multiple methods in order to meet their unique objectives.

SOCIALLY RESPONSIBLE OR VALUES-BASED INVESTMENT	Aligning a portfolio alongside investors' specific ethical, political, social or religious views through the active exclusion of certain companies from the investment universe driven by specific guidelines.
INTEGRATION	The incorporation of ESG factors alongside traditional fundamentals in stock selection or portfolio construction with the objective of enhancing risk-adjusted returns. Based on a growing body of research which suggests ESG factors may help to identify better managed companies or flag companies with potential risks.[9]
IMPACT	Capital directed to companies with the ultimate goal of driving positive outcomes and aiding organizations in accomplishing specific goals beneficial to society or the environment. Examples include investing in companies with alignment to the UN Sustainable Development Goals (SDGs), or promoting gender diversity.
ENGAGEMENT	Investors actively communicate and collaborate with companies either directly or by filing/co-filing shareholder proposals and proxy voting with a goal of improving public transparency, disclosure, risk management and social accountability. The engagement partnership can occur with companies who already demonstrate a deeply integrated ESG approach as well as those who presently may not.

Conclusion

Now more than ever, investors are looking to form a deeper and more holistic understanding of financial markets and human behavior to better identify opportunities to create, sustain and protect value while delivering on client objectives. There is a growing need for investment decisions to be considered in a broader context, including risks and opportunities related to environmental, social and governance dynamics which may have long-term benefits on overall investment outcomes. As a firm, we are continuously expanding our research in this area to further refine our understanding of the implementation of alternative insights into the investment process and further explore the impacts of sustainable investing on pricing future risk and return opportunities.

[9] Khan, Serafeim, and Yoon, "Corporate Sustainability: First Evidence on Materiality", The Accounting Review 91, 1697-1724, 2016, Dunn, Fitzgibbons and Pomorski, "Assessing Risk through Environment, Social, and Governance Exposures." 2016

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IMPORTANT INFORMATION

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