

Morningstar

The magazine of independent research for the world's financial professionals

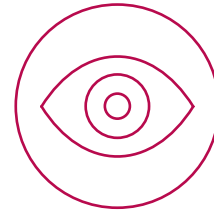
December/January 2016



Sustainable Investing Takes Off

A new generation of investors wants strategies that deliver performance and peace of mind.





ESG

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The Appeal of Sustainable Investing

Amid a demographic shift, more investors want to have an impact.

SUSTAINABLE INVESTING

Jon Hale

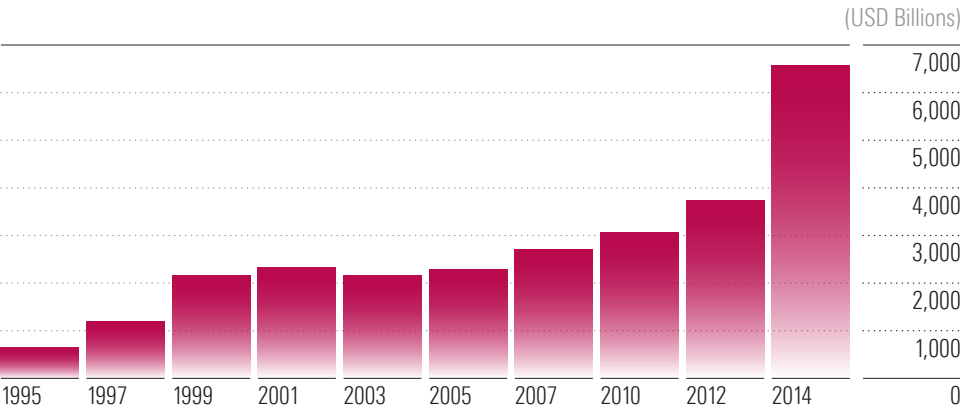
Sustainability is on a lot of people's minds these days. Jeremy Grantham opened his keynote address at last summer's Morningstar Investment Conference by outlining several issues that he said were "obsessing" him, among them long-term resource limitations, climate problems, food problems, income inequality, and the loss of corporate stakeholders.

Grantham's obsessions reflect widespread concerns of investors over sustainability issues, as well as the growing recognition of the need to move toward a more sustainable global economy. In areas such as consumer choice and workplace satisfaction, surveys report widespread support for sustainability concepts. According to the 2014 Nielsen Global Survey of Corporate Social Responsibility, more than half of consumers surveyed globally said they would be willing to pay more for products and services from companies committed



EXHIBIT 1

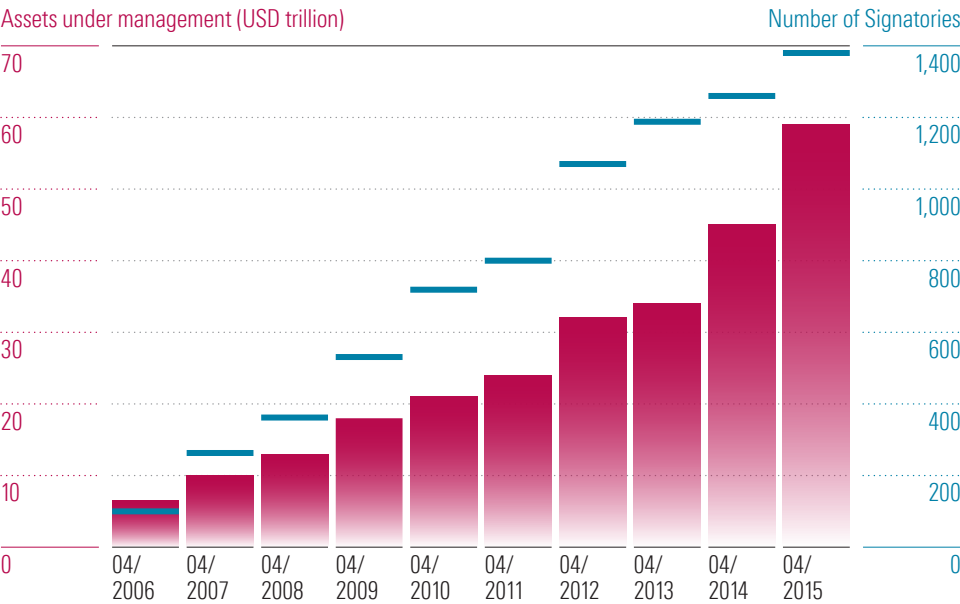
The ESG Landscape Assets in sustainable investments are growing in the United States.



Source: US SIF, The Forum for Sustainable and Responsible Investing.

EXHIBIT 2

Jumping on the Bandwagon Nearly 1,400 asset-management firms, representing \$60 trillion in assets under management, have signed the U.N. Principles for Responsible Investment.



Source: U.N. Principles for Responsible Investment.

to positive social and environmental impact.¹ Two thirds said they would prefer to work for a socially responsible company.

Similarly, interest in sustainable investing appears to be growing in the investment world, particularly among women and younger people, two groups who are rapidly becoming more influential investment decision-makers. Recent studies by U.S. Trust² and Morgan Stanley³ found a large majority of female investors, more than 70% in each study, agreed that environmental, social, and governance, or ESG, factors are important considerations when making an investment, while men were more evenly divided. A 2011 Pew Research survey found Gen-Xers and, especially, millennials to be more concerned about environmental issues and global warming than baby boomers.⁴ The Morgan Stanley survey found that 84% of millennial investors were interested in sustainable investing and were twice as likely as investors overall to make sustainable investment decisions.

Women and millennials are becoming more influential investment decision-makers. In the United States alone, women now have decision-making control over an estimated 40% of the nation's investable assets.⁵ By some estimates, \$30 trillion is going to pass from baby boomers to younger generations over the next half century.⁶ That money will move into the hands of investors who appear to be significantly more interested in sustainable investing than their elders.

A Growth Industry

With these favorable demographic trends just starting to provide a tailwind, sustainable investing has already seen a significant increase in assets under management (EXHIBIT 1). In its 2014 biennial report on assets under management, US SIF, The Forum for Sustainable and Responsible Investment, identified \$6.6 trillion invested in the

1 "Doing Well by Doing Good: Increasingly, Consumers Care About Social Responsibility, but Does Concern Convert to Consumption?" June 2014. The Nielsen Co.
2 "2015 U.S. Trust Insights on Wealth and Worth." 2015. U.S. Trust.
3 "Sustainable Signals: The Individual Investor Perspective." February 2015. Morgan Stanley Institute for Sustainable Investing.
4 "The Generation Gap and the 2012 Election." Nov. 3, 2011. Section 8: Domestic and Foreign Policy Views. Pew Research Center.
5 "Power of Purse Highlights Women's Wealth Leadership." Jan. 23, 2015. Morgan Stanley.
6 "The 'Greater' Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth." 2015. Accenture.

field in the United States, a 76% increase from its 2012 study. That's a big number, and it includes a wide range of approaches, some more comprehensive in their approach to sustainability than others, among mostly institutional investors. The same study showed a much smaller, yet growing, retail segment with just less than \$2 trillion invested in various open-end, variable-annuity, exchange-traded, and closed-end funds. The size of that segment, however, more than tripled between 2012 and 2014.⁷

Asset-management firms are showing more interest in sustainable investing. In April 2006, the United Nations-supported Principles for Responsible Investment, or PRI, was launched with 100 signatories, representing \$6.5 trillion in assets under management, committing

to incorporate ESG factors into their investment analysis and decision-making process, to be active owners engaging with companies about ESG issues, and to report publicly on their activities and progress. Nearly a decade later, the number of signatories is nearing 1,400, and assets under management are nearly \$60 trillion (**EXHIBIT 2**). Signatories include many large institutional investors, investment managers, and investment service providers. Among the more than 900 investment managers are 11 of the 15 largest in the world, including BlackRock, Vanguard, JPMorgan, Goldman Sachs, PIMCO, and Franklin Templeton.

Challenges Remain

As it moves toward the investing mainstream, sustainable investing faces several challenges.

Definitional

What exactly is meant by sustainable investing? There are not only varying definitions and approaches, but investors have often been able to define it for themselves and then have asset managers customize portfolios to suit. This can work in the institutional and high-net-worth space, but raises the challenge of scalability in retail investing, where asset managers have to offer standardized, rather than customized, portfolios. That means the conventional asset managers wanting to get into the game will have to decide how to define sustainability.

Overcoming the definitional challenge requires sustainable investing to be defined in a reasonable, easily understood way that reduces the confusion that can derail a conversation from

⁷ "Report on US Sustainable, Responsible and Impact Investing Trends." 2014. The Forum for Sustainable and Responsible Investing.

What's in a Name?

While we refer to sustainable investing as an approach that incorporates environmental, social, and governance, or ESG, factors in an investment process, there are a number of other terms commonly used to describe the field: *socially conscious* (a term still used in Morningstar's database), *socially responsible*, *ethical*, *green*, and *impact*. The US SIF industry group calls itself "The Forum for Sustainable and Responsible Investment." An annual industry meeting is called "The Conference on Sustainable, Responsible, Impact Investing."

Investors have engaged these kinds of issues since the 1970s, when many faith-based institutions, colleges and universities, and foundations began to better align their investments with their missions. Commonly known as *socially responsible investing*, or SRI, this approach was largely concerned with screening out certain types of products or services that were inconsistent with the values of the investor. Tobacco, alcohol, and gambling were common exclusions from the portfolios of certain religious organizations, for example. Investors also frequently excluded firearms and military weapons manufacturers, and reflecting one of the key environmental concerns of the day,

nuclear-power producers. The first retail SRI mutual funds used a similar approach.

Still in widespread use today, exclusionary screening is more investor-centric than outcome-oriented. It is also relatively easy for asset managers to use to address the needs of institutional and high-net-worth investors who want customized portfolios that align with their values. An asset manager can adapt many of its existing strategies by simply excluding companies based on a client's list of concerns and re-optimizing the portfolio. While this approach raised concerns that exclusionary screening would lead to inferior investment results, those concerns have proved to be largely unfounded.

Many 20th century SRI investors did not simply have screened portfolios. As active owners, they also engaged companies on broader issues of corporate social and environmental responsibility through proxy voting, filing shareholder resolutions, and importantly, direct engagement with management. Perhaps the most notable instance of active engagement occurred in the 1980s when investors pressured companies to stop doing business in South Africa as

part of the broader anti-apartheid movement, but progress is more typically made in a lower-profile way through discussions with company management.

As more investors focused on engagement issues, these concerns increasingly found their way into evaluations of companies that, in turn, began to be used as part of the security-selection process. Rather than excluding companies based on objectionable product involvement in a traditional SRI portfolio, investors expanded their focus on how well companies were addressing the range of environmental, social, and governance issues that had often been the subject of corporate engagements, and these factors were increasingly seen as material to a firm's financial success.

What we are calling sustainable investing encompasses these broader ESG concerns in portfolios and while many traditional SRI-screened portfolios still exist, the field overall has become increasingly focused on the more comprehensive ESG approach.

Jon Hale



the onset and helps advisors and consultants move their conversations with clients forward.

I propose the following basic definition:

Sustainable investing is an approach that takes into account environmental, social, and governance factors and their impact throughout the investment process.

Beyond that, the specifics will vary, just as they do for any investment approach. Value strategies, for example, share the basic goal of investing in undervalued companies, but employ many different approaches to do that. Some sustainable investment strategies may focus on a best-in-class approach by industry. Others may emphasize metrics such as carbon footprint or focus on positive product impacts. Some asset managers may be active owners who publish proxy voting guidelines, pursue shareholder resolutions, and engage directly with companies on ESG issues.

Regardless of the specifics, when the would-be sustainable investor walks through an advisor’s door, most often with only an inchoate notion of what sustainable investing actually means in practice, the above definition provides a common basis to move forward.

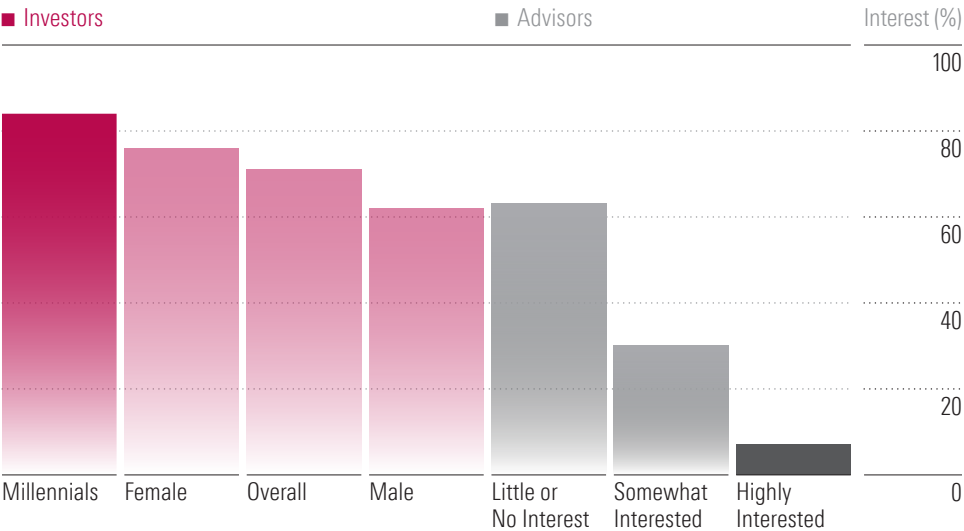
Performance

Performance is a perennial challenge. What should be the performance expectations of sustainable investors? There are theoretical reasons why sustainable investing might be expected to underperform conventional investing. Limiting one’s investable universe for nonfinancial reasons can result in outperforming stocks being left out of a portfolio and, in any event, tracking error relative to benchmarks. There is also the argument that stocks that are shunned by investors for whatever reason exact a premium and, therefore, are expected to outperform.

In practice, however, there is little evidence indicating a performance penalty for sustainable investing, particularly among mutual funds. It is also possible that sustainable investing can lead to outperformance because the consideration of ESG issues can point analysts to material issues that may not surface in traditional financial

EXHIBIT 3

Different Interests A high percentage of millennials and women say they are interested in ESG investing. Financial advisors? Not so much.



Sources: Morgan Stanley Institute for Sustainable Investing, Cerulli Associates.

analysis. If anything, the weight of existing research suggests that there is not a performance penalty for sustainable investing and that there may be a performance advantage.

In the final analysis, there are so many possible ways to address sustainability in the investment context that performance ultimately comes down to execution. Some managers will be better at it than others, pure and simple.

Information

Before sustainable investing can enter the mainstream, information and analysis of sustainable investments have to become more readily accessible to advisors and investors. We’ve seen large firms such as Merrill Lynch, Morgan Stanley, and UBS starting to rectify this problem by creating sustainable-investing platforms for their advisors.

While firms like Sustainalytics are in the business of providing company-level ESG ratings and analysis, their information flows primarily to asset managers to assist them with incorporating ESG factors in their strategies. Very little of this company-level ESG information reaches advisors or everyday investors.

At the portfolio level, there is even less information on how the holdings in a fund stack up on various sustainability criteria. This is the main reason why Morningstar is working on portfolio sustainability scores using data from Sustainalytics. (See our interview with Sustainalytics’ CEO Michael Jantzi on Page 44.) These scores, due out in 2016, will give advisors and investors the ability to compare funds based on how well their holdings are handling ESG risks and opportunities. They will allow investors to compare conventional funds with self-identified sustainable funds, as well as to choose funds based on whatever level of sustainability score they desire. The portfolio sustainability scores will help advisors and plan consultants evaluate funds as well as client portfolios and plan lineups.

Supply and Demand

Despite the widespread and growing interest in sustainable investing, the supply of viable strategies in the retail space is relatively limited. Even among the institutional and high-net-worth investors who dominate the space today, options are lacking for truly integrated ESG strategies and for targeted high-impact investments in areas such as private equity and infrastructure. The number of retail mutual

funds tagged in Morningstar databases as socially responsive stands at 175 in the United States and 1,797 globally. Many of these funds are older, more-traditional SRI funds that use exclusionary screening. Not surprisingly, there have been a number of new fund launches in the space in 2015.

Despite these recent gains, however, it remains difficult for practitioners to put together client portfolios that include sustainable options in all parts of the asset allocation. It is also hard for fiduciaries to recommend sustainable investment options that don't have sufficient—and successful—track records. Perhaps these challenges help explain the lack of interest in ESG of financial advisors (**EXHIBIT 3**).

As a result of these difficulties, client demand may not be met with a portfolio entirely consisting of sustainable investment options. In those cases, the Morningstar sustainability scores will help meet the demand by allowing investors to evaluate conventional funds' portfolios on the basis of sustainability criteria and plugging them in alongside more-intentional sustainable strategies to form a sustainable portfolio for the client.

Jury Is Still Out

These challenges, in the end, are not insurmountable, but they show that while sustainable investing may be poised to enter the mainstream, its success is not guaranteed. At the same time, given the demographic trends favoring sustainable investing, investment professionals today have strong incentive to meet that demand as they transition their book to be younger and more female-oriented. Sustainable investing offers advisors a way to add value not just in terms of performance but in terms of aligning client portfolios with a desire to support the transition to a sustainable global economy. This, in turn, ties investors more closely to their investments, making it more likely that they will stay the course for the long run. ■■

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ESG Strategies Perform Well

More and more academic and industry studies are demonstrating that sustainable investing does not underperform conventional investing, and there is mounting evidence that incorporating environmental, social, and governance factors can have a positive impact on performance.

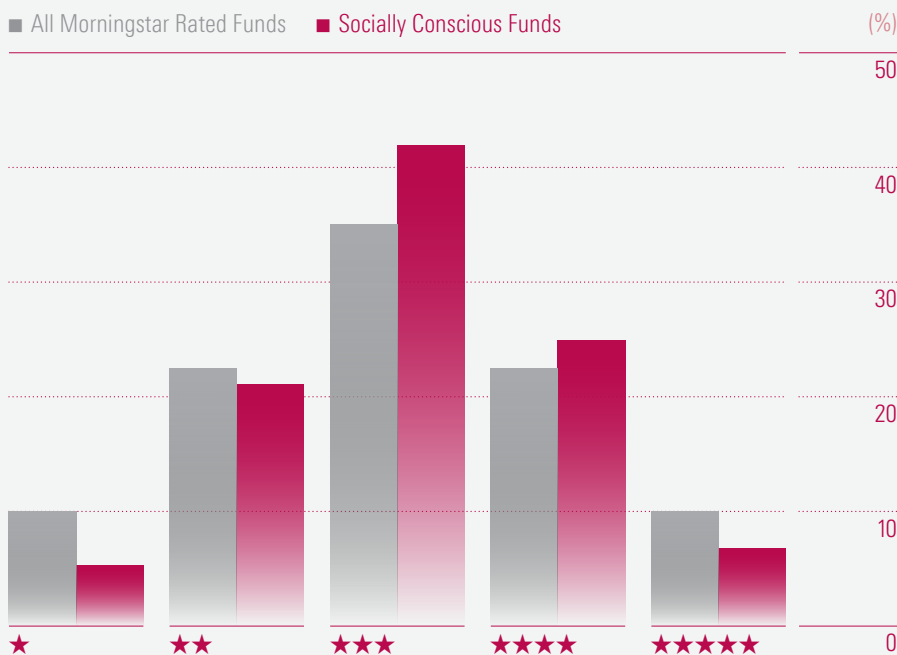
In 2014, researchers at Oxford analyzed nearly 200 studies, reports, and articles on sustainability and found that at the firm level:¹

- ▶ 90% of the studies on the cost of capital show that sound sustainability standards lower the cost of capital of companies.
- ▶ 88% of the research shows that solid ESG practices result in better operational performance of firms.
- ▶ 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices.

A Morgan Stanley study of U.S.-based mutual funds and separately managed accounts, using Morningstar data, concluded that sustainable investments usually met and often exceeded the performance of comparable traditional investments on both an absolute and risk-adjusted basis.²

As of September, there were 1,797 funds in Morningstar's database tagged as "socially conscious." Using the Morningstar Rating for funds as a measure of risk-adjusted return relative to investment category, we see in the chart below that socially conscious funds have a positive tilt relative to the overall universe of funds.

Jon Hale



Source: Morningstar. Data as of 09/30/2015.

¹ Clark, Gordon, Andreas Feiner, and Michael Viehs. 2014. "How Sustainability Can Drive Financial Outperformance."

² "Sustainable Reality: Understand Performance of Sustainable Investment Strategies." March 2015. Morgan Stanley Institute for Sustainable Investing.