Attachment 3

IB2.1 Attachment 3

Key Considerations for Responsible Investing Initiatives

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Empower Results®

Executive Summary

While a number of investors are increasingly interested in responsible investing (RI), with a particular emphasis on environmental, social, and governance (ESG) integration, many remain concerned about whether responsible investing will be beneficial to their investment portfolios. When it comes to launching a responsible investing initiative, there are a number of issues for investors to carefully consider, including local regulatory guidelines, cost, and the financial incentives (or disincentives) for doing so.

This paper offers an analysis of the issues that should be reviewed prior to engaging in a responsible investment initiative, including:

1) What are the drivers of responsible investing?
2) How do different regulatory regimes view responsible investment initiatives?
3) Responsible investment options: What is meant by the following terms?
    a. Socially responsible investing (SRI)
    b. Environmental, social, and governance (ESG) integration
    c. Impact investing
    d. Mission-related investing (MRI)
4) How can different types of responsible investing affect investment returns?
5) Are there additional hurdles for responsible investing initiatives?

We conclude that responsible investing is indeed a growing trend, driven by both top-down and bottom-up demand. We also identify the four types of responsible investing, as well as performance data that supports the use of carefully selected RI strategies. In fact, while investors that utilize negative screening techniques need to consider both tracking error and shareholder engagement risk, the available data suggests that value-neutral strategies, like ESG integration, should have a neutral to slightly positive impact on performance.

Finally, while regulatory requirements should be a significant concern for investors, the guiding principle of most jurisdictions seems to be that RI and ESG investing are not prohibited as long as investors always consider financial prudence first. There are, however, other factors to consider besides regulatory prudence, including lingering issues with data, “greenwashing,” and portfolio construction. Nevertheless, Aon does believe that investors can mitigate these issues, prudently implement RI strategies, and achieve desired sustainability outcomes without forfeiting their fiduciary duties.

Introduction

Responsible investing is growing rapidly. In January 2018, Morningstar reported that assets in sustainable (a common euphemism for "responsible") mutual funds had grown to $98 billion, a 58% increase over the prior year.[1] Indeed, over the course of the last 24 months, interest in responsible investing—specifically, environmental, social, and governance integrated investment analysis—has increased dramatically.

There are a number of reasons for this heightened investor awareness of RI and ESG, including:

Demographic changes. Younger generations (Millennials and Generation X) are more likely to consider an investment's social or environmental impact than older generations[2]. These groups now comprise the largest share of the workforce and stand to inherit additional wealth from Baby Boomer and Senior generations.

Regulatory changes. The United Nations Principles for Responsible Investment (UNPRI) tracks regulatory changes and governmental interventions in the top 50 countries (ranked by GDP) and found that the number of "policy interventions" had grown from around 10 in 1996 to more than 350 in 2016. In Europe, the European Insurance and Occupational Pensions Authority (EIOPA) just announced it will begin to "stress test" pension funds for their exposure to ESG factors in 2019.[3]

Investor-led initiatives. Mega-investor CalPERS announced in May 2015 that all external fund managers must "identify and articulate ESG in their investment practices."[4] In addition, asset owner, investment management, and other signatories to the United Nations Principles for Responsible Investment grew by 14.2% in 2017[5]. New signatories included a broad cross-section of institutional investors, including The Nobel Foundation, Northwestern University, Nippon Life Insurance Company, Transport for London Pension Fund, and the Development Bank of Japan[6].

Despite positive trends in the adoption of RI and ESG investing initiatives, one fundamental question is often raised by investors and other fiduciaries: Is there a benefit to ESG integration, or is responsible investing merely philanthropy disguised as investment strategy? At Aon, we believe that investors should weigh the pros and cons of any responsible investment initiative, and that those that do can benefit from sensibly implemented responsible investment initiatives.

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[1] "Sustainable Funds Prove a Magnet for Money" Leslie P. Norton in *Barron's*, January 31, 2018
[2] "How Millennials Shape Socially Responsible Investing" David Turner in *Institutional Investor*, December 30, 2015
[3] "EIOPA Confirms ESG Risk Assessment in 2019 Pension Fund Stress Tests" Susanna Rust in *IPE*, November 28, 2018
[4] "CalPERS Gives Its Managers ESG Ultimatum" Amanda White for *Top1000Funds.com*, May 22, 2015
[5] United Nations Principles of Responsible Investing signatories available at www.unpri.org
[6] Ibid

The Four Types of Responsible Investment

It is important to note that responsible investing is a catch-all term for "sustainable investment" strategies, rather than a singular approach to "doing good and doing well." In fact, Aon has identified four distinct methods for engaging in responsible investing. The four main subgroups of RI are:

1) **Socially responsible investing (negative screens).** SRI investing involves the avoidance of or divestment from an investment or group of investments, usually based on an investor's or organization's value system. Examples of SRI investing might include fossil fuel-free or tobacco-free investment initiatives, the avoidance of firearms or munitions manufacturing, or eschewing the tobacco, private prison, fossil fuel or other "objectionable" industries.
2) **Impact investing (positive screens—generally aligned with a desired social, economic, or environment outcome).** Impact investing is also generally aligned with an individual's or organization's values. Often referred to as "doing good and doing well," the goal of impact investing is to generate returns while positively impacting a particular demographic group, business outcome, or environmental factor. Examples of impact investing might include investments in public health facilities, workforce housing, clean tech or renewable energy, or gender lens.
3) **Mission-related investing (positive and negative screens using a combination of the responsible investment strategies).** Examples may include faith-based investing or investing to extend a foundation's grant-making capabilities.

4) **Environmental, social, and governance integration.** ESG integrated investing is different from the rest of its RI peers, because unlike socially responsible investing, impact investing, and mission-related investing, which are driven primarily by individual or institutional values, ESG investment decisions continue to be directed by the fundamentals of the investment. After considering technical and fundamental investment factors, ESG investors incorporate non-financial ESG factors to the extent they are material to the company's future financial performance. ESG factors that may be considered material to a company's financial performance could include the following, among others:

Environmental, Social, and Governance (ESG) Factors

Environmental Factors	Social Factors	Governance Factors
Carbon/Greenhouse Gas Emissions	Diversity	Transparency
Ecosystem Change	Consumer Protection	Reporting and Disclosure
Fossil Fuel Dependence	Fair Trade	Executive Compensation
Climate Change	Animal Testing	Shareholder Rights
Water Issues (Use, Access, Impact on Local Supply)	Human Rights	Board Accountability and Makeup
Clean Tech	Health Care	Director Independence
Toxic Chemical Usage	Working Conditions (Living Wage, Harassment, Physical Risks)	Accounting Practices and Policies
Renewable Energy	Child Labor	Voting Practices

Again, it is important to note that the ESG factors above are only relevant to the extent that they have a material impact on future financial performance. However, it is not difficult to ascertain why some ESG factors reach the level of materiality. For example:

Environmental factors. Carbon and greenhouse gas emissions may incur additional regulation and fines, or they can simply reduce a company's efficiency, raising the cost of doing business. Climate change may impact the ability to produce and ship goods in a timely fashion. For companies that are water-intensive, a lack of water for manufacturing, cooling, or irrigation may severely curtail their ability to do business.

Social factors. Many social factors are potential public relations nightmares—and can certainly negatively impact a company's image, customer base and eventually, its financials. But it may be easier to draw a causal relationship between factors such as workforce conditions (e.g., accidents, productivity, and workforce disruption)—all of which can directly add to the cost of doing business. In addition, factors like diversity have been shown to have a material impact on corporate performance, both at the board and rank-and-file employee levels. For a list of studies on the benefit of diversity, please contact us at Aon.

Governance factors. Finally, governance issues such as board structure and executive compensation have been stalwarts of fundamental investment analysis for a long time, and their impact on a company's future financial performance is generally well accepted. For example, Ammann, Oesch, and Schmid (2011) looked at companies from 22 countries during the 2003–2007 period and saw a significant relationship between corporate governance and firm valuation[7], while Kahn, Serafeim, and Yoon (2017) found outperformance among firms with good sustainability ratings[8].

It is important to note that many investors and asset managers that opt not to integrate comprehensive and formalized ESG policies into their investment strategies may actually incorporate some of the factors above, particularly regarding corporate governance. It is also important to note that some of the dynamics above may overlap with more widely accepted factor proxies.

[7] Amman, Oesch, Schmid (2011), "Corporate Governance and Firm Value: International Evidence"
[8] Khan, Serafeim, and Yoon (2017), "Corporate Sustainability: First Evidence on Materiality"

How Does Responsible Investing Intersect With Fiduciary Duty?

One of the most frequent questions investors ask is, "What is my role and responsibility in responsible investment and ESG, particularly if our organization acts as a fiduciary?" In fact, different regulatory regimes have varying views on the role of responsible investing, although the trend line is certainly becoming more RI-friendly across geographies. For example, the UNPRI has found "more than 300 policy instruments which support investors to consider long-term values drivers, including ESG factors"[9] across the 50 largest economies. Still, local regulatory opinions can vary widely. For example:

- In the UK, "there is no impediment to trustees taking account of environmental, social, or governance factors where they are, or may be, financially material,"[10] but institutions that wish to focus on values-based initiatives (SRI, impact investing, or MRI) to affect social or environmental change must pass two tests: Do beneficiaries support the intended ethical outcomes? And will the implantation of such policies be significantly detrimental to returns?[11]
- In the US, there has been somewhat conflicting guidance from regulators. The Department of Labor issued a 2015 bulletin (Interpretive Bulletin 2015-01) that was widely viewed as "friendly" to RI initiatives, as well as a 2018 field assistance bulletin (Field Assistance Bulletin 2018-01) that was more cautionary and reaffirmed that ESG cannot stand on its own as satisfaction of fiduciary duty. The 2018 memo reminds fiduciaries that they must fulfill their ERISA fiduciary duties when selecting investments and reviewing ESG funds for possible investment, concluding that: "ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives."[12]

  The memo also addressed RI-driven shareholder activities conducted by the investor or through its investment managers, which is often a component of an investor's RI initiatives. The memo concluded that: "If a plan fiduciary is considering a routine or substantial expenditure of plan assets to actively engage with management on environmental or social factors, either directly or through the plan's investment manager, that may well constitute the type of 'special circumstances' that the IB 2016-01 preamble described as warranting a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon."[13]

- In Canada, regulations surrounding RI may vary from province to province. In Ontario, for example, the Financial Services Commission of Ontario (FSCO) released an investment guidance note (IGN-004—Environmental, Social and Governance Factors), which became effective on January 1, 2016. IGN-004 states that the plan sponsor must establish and document the discussion on ESG factors as they relate to the plan, consider whether it will incorporate ESG factors into its investment process, and document the basis for its decision.[14] However, some provinces have yet to enact specific RI or ESG guidance for institutional investors.

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[9] Global Guide to Responsible Investment Regulation" UN PRI and MSIC, in collaboration with UNEP and Inquiry: Design of a Sustainable Financial System, September 2016
[10] "Fiduciary Duties of Investment Intermediaries" Law Commission, June 4, 2014
[11] Ibid.
[12] U.S. Department of Labor Field Assistance Bulletin No. 2018-01, April 23, 2018
[13] Ibid.
[14] Financial Services of Commission of Ontario Investment Guidance Notes IGN-004, January 1, 2016

- In the European Union, proposed changes to the IORP Directive would include specific guidance on ESG integration, specifying that: "IORPII establishes the 'prudent person' rule as the underlying principle for pension fund governance and investment. Recital 41a sets out the importance attached to ESG factors, in terms of both the potential impact of ESG factors on portfolio risks and returns and institutional investors' role as long-term investors. Schemes are however free to conclude that they do not need to take ESG factors into account in their investment policy; for example, because it is too costly or complex relative to their scale."[15]

  It is incumbent on investment staff and trustees to understand the regulatory framework for their particular geographic location, although the guiding principle of most jurisdictions seems to be that RI and ESG investing is not prohibited as long as investors always consider financial prudence first.

How Does Responsible Investing Impact Corporate Financial Performance and, Ultimately, Investment Performance?

That question, of course, inevitably raises another question: How do responsible investments perform? Unfortunately, the answer isn't completely straightforward at this point in time. Given the variations of responsible investing, different definitions of "loss," and the relatively nascent nature of the RI beast, it can be difficult to definitively quantify either the past performance of responsible investments or how they should perform in future.

Most investors have the greatest familiarity with socially responsible investing, and many may also conflate SRI with poor investment performance. In truth, divestment can result in an increase in tracking error, with the associated risk of underperformance relative to a non-divested benchmark, and may also reduce portfolio diversification. While not an actual "loss," the impact on performance from this increased tracking error can be substantial.

For example, the study "The Divestment Penalty: Estimating the Costs of Fossil Fuel Divestment to Select University Endowments" (Bradford Cornell, 2015) examines the potential fossil fuel divestment cost to Harvard, Yale, MIT, Columbia, and NYU, projecting that if a set of major institutions that pursued divestment continued to do so and experienced return shortfalls in line with what they experienced in the past, their weighted average asset shortfall would be 6.4% over 20 years and 16.7% over 50 years.[16] While these are theoretical "losses," in practice, when one large public pension did make a $671 million tobacco divestment in 2000, later studies found that the total amount of its foregone gains during the period stood at $3.6 billion.[17]

Actual return experiences from divestment are highly dependent on the specifics of the divestment strategy and the actual, unpredictable, long-term returns of the divested securities. It is important to note also that in 2015, a meta-study that examined 75 primary studies found that there was no significant impact on performance—either positive or negative—as a result of negative screening.[18] However, given the uncertainty around the issue as well as the forfeiture of potential active shareholder engagement, Aon

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[15] "Investment Governance and the Integration of Environmental, Social and Governance Factors" OECD, 2017

[16] "The Divestment Penalty: Estimating The Costs of Fossil Fuel Divestment to Select University Endowments" Bradford Cornell, Visiting Professor of Financial Economics at California Institute of Technology, August 27, 2015

[17] "A Huge Public Pension Faces An Agonizing Decision: Should It Reinvest in Tobacco?" Michael Hiltzik for the *Los Angeles Times* , December 14, 2016

[18] "The Truth Is Finally Starting To Emerge About Socially Responsible Investing" Constance Gustke for *CNBC*, June 16, 2017

urges investors to carefully consider performance-related divestment risks when undertaking an SRI investment initiative.

Unlike SRI, ESG does not require the wholesale avoidance or divestment of any sector or investment, which at least theoretically mitigates tracking error-related performance issues. However, given that ESG integration is a newer form of responsible investing, it still can be difficult to get a definitive picture of expected performance.

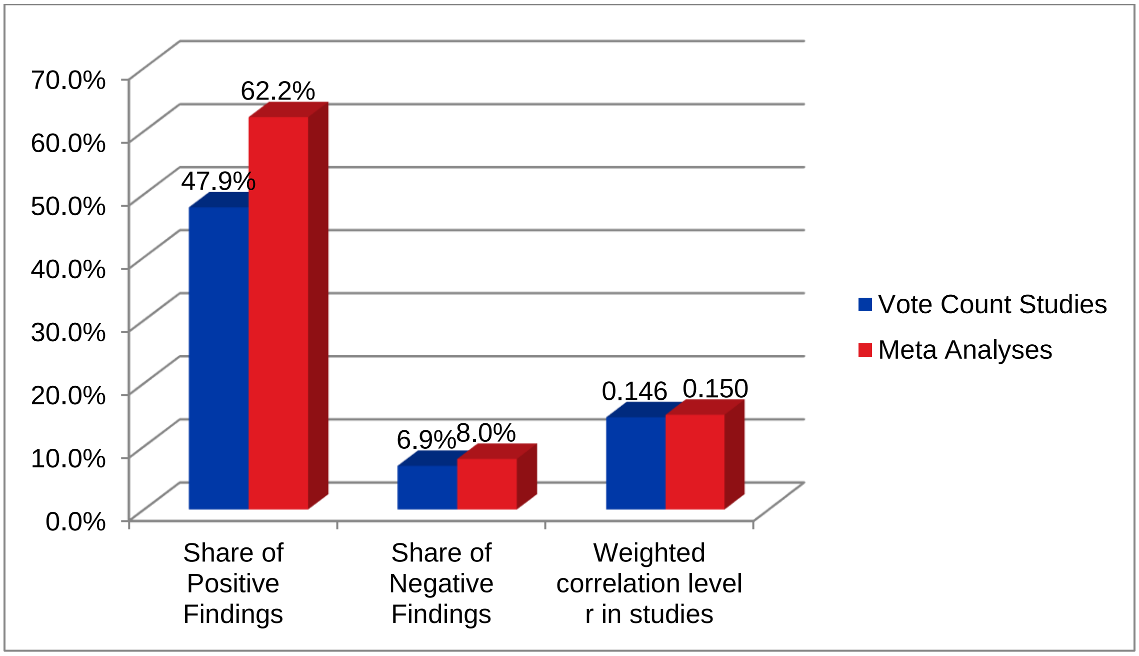
ESG and Corporate Financial Performance

Corporate financial performance (CFP) looks at measures such as profitability and growth. Evaluating ESG's impact on CFP can be thought of as assessing whether ESG is good business practice, although CFP is not the same as investment performance. There is strong evidence to support a positive correlation between ESG and CFP.

The largest meta-study of ESG data, conducted by Gunnar Friede, Timo Busch, and Alexander Bassen (2015), gathered more than 2,000 ESG studies to determine ESG's impact on corporate financial performance based on aggregated evidence.[19] The authors conclude, after a review of roughly 2,200 individual studies from 1975 to 2015, that "the business case for ESG investing is empirically very well founded [and] roughly 90% of studies find a non-negative ESG-CFP [corporate financial performance] relation."[20]

[19] "ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies" Gunnar Friede, Timo Busch, and Alexander Bassen in the *Journal of Sustainable Finance & Investment*, 5:4, 210-233, December 15, 2015
[20] Ibid.

Figure 1



Source: "ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies" Gunnar Friede, Timo Busch, and Alexander Bassen in the Journal of Sustainable Finance & Investment, 5:4, 210-233, December 15, 2015

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ESG and Investment Performance

Of course, corporate financial performance and investment performance are two entirely different animals. The impact of ESG on investment performance is likely to be more mixed because it requires a certain amount of market inefficiency and manager skill to capture. This begs the question of whether managers are able to exploit ESG data to better identify winners and losers, or whether much of this analysis is already "baked into" the markets and existing analysis. When it comes to actual investment performance, only a few academic-style papers have reviewed the performance of ESG strategies. However, early studies on ESG and investment performance have been promising. In one of the latest studies, released in July 2018 by Axioma (a provider of enterprise risk management and regulatory reporting solutions), the author concluded that "increasing exposure to ESG rarely underperforms the market, and often outperforms the market, especially during the last few years."[21]

In this study, Axioma sought to create portfolios that maximized ESG to compare performance versus non-ESG weighted benchmarks. It constructed five different geographically focused portfolios—including US large-mid-small cap (US-LMS), Japan large-mid-small cap (JP-LMS), developed markets ex US large and mid (DMxUS-LM), emerging markets large-mid-small cap (EM-LMS), and developed Europe large-mid-small cap (EUDM-LMS)—using each ESG methodology. The maximum position was 2.5%, tracking

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[21] "ESG's Evolving Performance: First Do Not Harm" Anthony Renshaw, Ph.D. Axioma, Inc., July 2018

error was capped at 3%, and the portfolios were fully invested. Back-tests were conducted from March 31, 2009 to March 28, 2018.

Furthermore, the study created three ESG portfolios based on different methodologies for each geography. For each area, a raw ESG portfolio was constructed, as well as a factor ESG portfolio (covering ESG attributes that were attributable to other factors) and a residual ESG portfolio (covering ESG attributes *not attributable* to other factor exposure). Even though conventional wisdom dictates that residual ESG would be the most attractive element of ESG (for the diversification attributes not covered by factor ESG), the study concluded that "the performance of residual ESG was not notably different from raw ESG. So, [portfolio managers] who wish to avoid decomposing a vendor's ESG score into factor and residual components seem justified."[22]

As the table below shows, all but three of the resultant portfolios demonstrated positive return characteristics, and underperformance was muted, topping out at 0.54%.

Figure 2

Maximize Raw ESG Portfolio	**US-LMS**	**JP-LMS**	**DMxUS-LM**	**EM-LMS**	**EUDM-LMS**
Real Active Return (% Annual)	0.59%	-0.54%	1.91%	1.33%	1.48%
Real Active Risk (% Annual)	2.64%	3.18%	2.81%	3.33%	3.72%
Maximize Factor ESG Portfolio	**US-LMS**	**JP-LMS**	**DMxUS-LM**	**EM-LMS**	**EUDM-LMS**
Real Active Return (% Annual)	0.93%	0.02%	-0.18%	0.40%	-0.16%
Real Active Risk (% Annual)	3.46%	3.62%	3.03%	2.86%	3.78%
Maximize Residual ESG Portfolio	**US-LMS**	**JP-LMS**	**EM-LMS**	**DMxUS-LM**	**EUDM-LMS**
Real Active Return (% Annual)	0.28%	0.31%	3.79%	1.44%	2.29%
Real Active Risk (% Annual)	2.77%	3.23%	2.86%	3.35%	3.59%

Source: "ESG's Evolving Performance: First, Do No Harm," July 2018, Axioma

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In another key study, Tim Verheyden, Robert Eccles, and Andreas Feiner looked at the performance of hypothetical portfolios from 2010 to 2015, screening out the securities with the lowest ESG characteristics while controlling for industry exposure.[23] Portfolios included "Global All" (large and mid-cap stocks from 23 developed and 23 emerging markets), Global All with the bottom 10% of stocks screened out, based on ESG performance, and Global All with a 25% exclusion rate for poor ESG performers. As one can see in Figure 3, the Global All (10%) portfolio outperformed both the Global All (unscreened) and the Global All (25% exclusion) portfolios for annual return, volatility and Sharpe ratio. The results were similar for the "Global Developed Markets" portfolios (Global Developed Markets unscreened, Global Developed

[22] Ibid.
[23] "ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification." Verheyden, Tim, Robert Eccles and Andreas Feiner in the *Journal of Applied Corporate Finance*. Vol. 28, No. 2, Spring 2016.

Markets 10% and Global Developed Markets 25%). The following table summarizes the key results of their study.

Figure 3

	Global All (unscreened for ESG)	Global (ex-lowest 10% based on ESG)	Global (ex-lowest 25% based on ESG)
Annualized return	7.7%	8.0%	7.9%
Annualized volatility	14.4%	14.3%	14.4%
Tracking error	n/a	0.8%	0.9%
Beta	1.00	0.98	0.99

Source: ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification." Verheyden, Tim, Robert Eccles and Andreas Feiner in the Journal of Applied Corporate Finance. Vol. 28, No. 2, Spring 2016.

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Finally, Gautam Dhingra and Christopher Olson of High Pointe Investing offer a more measured conclusion about ESG and investment performance. They concluded in a 2018 paper that "ESG considerations do not act as a constraint on one's ability to maximize returns… [but] [at] the same time, ESG factors, by themselves, do not generate additional returns."[24] In this instance, however, it is important to consider that Dhingra and Olson's study shows neutral, rather than negative, performance impact and involves only a perfunctory screen of ESG factors.

Still other firms have attempted to understand the relationship between ESG and investment performance. The table below summarizes these efforts. Generally speaking, however, these studies suggest ESG's impact on performance has been neutral to positive. They have also been conducted against traditional market benchmarks, rather than ESG adjusted benchmarks, a practice that Aon strongly supports. It is important to note, however, that these studies have been conducted over a relatively short period of time—less than a full market cycle. As a result, we may not yet know how ESG integration will impact investments in a sideways or bear market environment.

Figure 4

Period	Study Author	Link	Investment Type	ESG Return Conclusion	Key Findings
1/2008–12/2014	Morgan Stanley	**"Sustainable Reality: Understanding The Performance of Sustainable Investment Strategies" March 2015**	ESG-focused equity mutual funds	Equal or higher	Sustainable mutual funds outperformed based on return and risk in 64% of the periods measured, had equal or higher median returns for 36% of the periods examined, and equal or lower median volatility for 72% of the periods examined.

[24] "ESG Investing: A Constraint or An Opportunity" Guatam Dhingra, Ph.D., CFA & Christopher Olson, CFA, HighPointe Capital, September 7, 2017

8/2009–4/2016	Barclays	**"Sustainable Investing and Bond Returns: Research Into The Impact of ESG on Credit Portfolio Performance" November 2016**	US corporate investment bonds	Higher	Performance was either 0.29% or 0.42% higher per annum for the high ESG portfolios, depending on portfolio construction methods.
8/2009–4/2018	Barclays	**"The Case for Sustainable Bond Investment Strengthens" October 2018**	US high-yield bonds	Higher	Performance was either 0.45% or 0.25% higher per annum for the high ESG portfolios, depending on portfolio construction methods.
8/2009–4/2018	Barclays	**"The Case for Sustainable Bond Investment Strengthens" October 2018**	US investment-grade bonds	Higher	Performance was either 0.43% or 0.27% higher per annum for the high ESG portfolios, depending on portfolio construction methods.
8/2009–4/2018	Barclays	**"The Case for Sustainable Bond Investment Strengthens" October 2018**	European investment-grade bonds	Higher	Performance was either 0.51% or 0.43% higher per annum for the high ESG portfolios, depending on portfolio construction methods.
CY 2016 and CY 2017	Barron's	**"ESG Funds Outperform Active Rivals" October 10, 2017**	Active ESG mutual funds	Higher	25% of ESG funds outperformed the S&P 500 (versus 12% of conventional active funds) and in 2017, 37% of ESG funds outperformed versus 28% of their conventional peers.

Issues for Mitigation

Responsible investing is not without its difficulties. Whether it's losing a seat at the table due to divestment, quantifying the actual impact of an impact investment, "greenwashing," or data issues, there are a number of additional factors to consider when implementing a responsible investment initiative. These issues include:

Negative screening and divestment. Generally speaking, Aon suggests that investors eschew divestment in lieu of active engagement policies. We believe that investors that sell positions lose what is perhaps their only significant bargaining chip with a company—their proxy vote. As active investors, shareholders can suggest resolutions and band together for proxy votes that stand a chance of influencing future company behavior. Investors may engage with companies directly to the extent they own stock outright, as New York Common has elected to do in an attempt to increase board diversity,[25] or investors can request that outside asset managers interact with corporate management to effect change. One recent example of such a campaign occurred in October 2017, when a group of shareholders led by Zevin Asset Management began a campaign to encourage Starbucks to improve its paid family leave policy.[26]

Unfortunately, once an investor is no longer a shareholder in a company, its opportunity to engage with that company and influence corporate behavior is diminished, and may in fact be limited to protests, letter-writing campaigns, and other forms of indirect impact. Certainly, as Bill O'Reilly (and more recently, Laura Ingraham) discovered, public pressure can force companies—in this case, Fox News—to change their behaviors. However, generally speaking, research has shown that consumer-driven boycotts often do not result in negative financial consequences for a targeted firm.[27]

Aon does recognize that some organizations, either because of strongly held beliefs, public pressure, state laws, specific missions, or a combination thereof, may have reason to divest from certain investments—especially if the only desired corporate behavior is that they stop engaging in essential businesses. In these instances, divestment or SRI strategies may be entirely appropriate.

"Greenwashing." As the ESG investing universe grows, the potential exists for some managers to adopt a "me too" attitude toward ESG investing. These managers may take one of two approaches: They could develop a visible ESG investment policy with little intention of active implementation in order to attract ESG-targeted assets, or they could introduce ESG "screens" with little experience in collecting, evaluating, or acting upon non-financial data. Therefore, it is imperative to vet the underlying motivations and actual ESG capabilities of each potential ESG manager. Investors must strive to understand what data is utilized, when it is incorporated, whether and how ESG factors can be overridden, and frankly, even what the manager means when it uses the term "ESG."

ESG data. Software and data resources to monitor ESG factors have flourished, yet don't always agree. The methodology and underlying data by which ESG ratings are calculated can have a significant impact on the rating and outcome of the integrated data. *The Wall Street Journal* highlighted differences between data providers in a 2018 article, citing differences between providers for ratings on Tesla, Berkshire, Exxon Mobile, Alphabet, and General Motors. Its comparison found some startling contrasts. The article noted that "the biggest surprise is Tesla, ranked by MSCI at the top of the industry, and by FTSE as the

[25] "NY State Pension Fund Pushes For Corporate Board Diversity", Associated Press, March 21, 2018
[26] "Starbucks Investors Press Coffee Chain For Change On Unequal Family Leave" Molly Redden for *The Guardian*, October 2, 2017
[27] "When Corporate Boycotts Work" Rick Paulas for *Pacific Standard*, May 17, 2017

worst car maker globally on ESG issues. Sustainalytics puts it in the middle. The explanation comes down to what is measured, and how the measurement is affected by disclosure."[28]

Measuring impact. At present, there is no defined methodology for measuring the "impact" of impact investments, which can be problematic for investors looking to generate a specific social or environmental outcome on top of their investment return. A 2015 paper from Harvard Business School found that efforts at measuring impact fell broadly into one of four categories: expected return, theory of change, mission alignment, and experimental and quasi-experimental methodologies.[29] While each method offered benefits to the end investor, each had a well-defined list of drawbacks as well.

Portfolio construction. It is important to note that ESG integration may impact a fund's sector and industry allocations, which may have an impact on fund performance. For example, in a December 2015 piece, Goldman Sachs concluded that: "Another consideration in the design of an ESG portfolio is whether to eliminate specific sectors or to emphasize identifying the best companies within each sector. Some sectors, such as energy, are prone to low overall ESG scores, while others, such as technology, may have higher overall scores due to the nature of the underlying business models. An inter-sector approach, which removes low-scoring ESG sectors from the portfolio, ensures exclusion; however, it may lead to additional tracking error from the benchmark. An intra-sector approach, which seeks to select the best ESG companies within each sector, retains exposure to top ESG companies within inherently challenging ESG sectors. An intermediate approach is also possible, whereby a few low-scoring sub-industries, such as coal mining, are eliminated, while the remaining portfolio is constructed using an intra-sector model." [30]

As a result, sector overweighting and underweighting is likely to be more of an issue for passive benchmark investing than for active investing. Generally speaking, it is possible to use ESG that doesn't involve "tilting" toward or away from a particular sector, but the index in question would have to be purposely constructed to avoid such tilts.

[28] "Is Tesla Or Exxon More Sustainable? It Depends On Who You Ask" James Mackintosh for *The Wall Street Journal*, September 17, 2018

[29] "Measuring The Impact In Impact Investing" Ivy So & Alina Staskevicius, Harvard Business School, 2015

[30] "Measuring The Immeasurable: Scoring ESG Factors" Goldman Sachs Asset Management (GSAM) Perspectives, December 2016

Conclusion

The fund managers, investors, and fiduciaries that choose to be early adopters of responsible investment strategies must carefully evaluate their RI goals and desired outcomes, and thoughtfully proceed to ensure the best RI and investment outcomes. Investors need to continually ask themselves a critical set of questions along the way, including:

1) What pressure (regulatory, demographic, investor- and/or trustee-led) is our organization under now? How is it likely to change?
2) What is our local regulatory framework for RI and ESG? How is it evolving?
3) How do we want to express our commitment to responsible investing? Do we want to avoid certain investments (SRI), create social or environmental change (impact investing), extend our mission from our grant-making capabilities to our investment portfolio (MRI), or choose investments based on material ESG considerations?
4) How will our approach affect investment returns? If we are divesting or avoiding sectors, have we accepted any tracking error risk that may be associated with this?
5) Are we (or are our investment managers) capable of managing the portfolio construction, data-related, and other uncertainties in a nascent investment area?

To this end, Aon has a growing RI toolkit for institutional investors interested in incorporating responsible investment strategies and/or ESG analysis into investment decisions. Aon believes that investors can prudently implement RI strategies and achieve desired sustainability outcomes without forfeiting their fiduciary duties. We look forward to working with clients, the industry, and regulators to identify additional responsible investment needs and to create solutions that meet those needs.

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About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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