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Key Considerations for Responsible Investing

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Reasons for heightened investor awareness of RI and ESG

- Demographic changes
- Regulatory changes
- Investor-led initiatives

Types of responsible investing?

Socially Responsible Investing

Selection Process: Negative

Attempts to screen out investments in stocks, companies or industries based on a set of ethical values.

(Anti-pornography, private prisons, carbon, coal, Iran, Sudan, fossil fuel, etc.)

Impact Investing

Selection Process: Positive

Looks for investments that have a positive investment return as well as desired social, economic or environmental outcome.

(MWBE, alternative energy, micro-funding)

Mission Related Investing

Selection Process: Positive

Places investments with companies or funds that complement the investor's mission.

(Healthcare, senior issues, child issues, religious)

ESG Integration

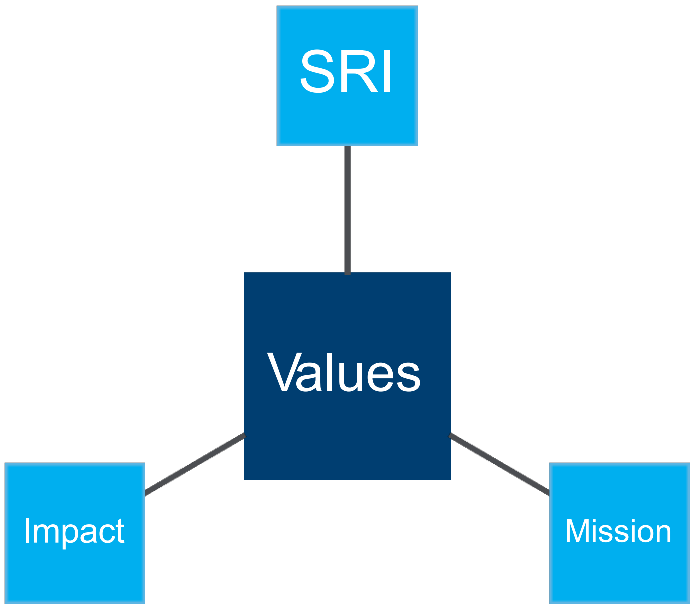
Selection Process: Positive or Negative

Integrates environmental, social and governance criteria into fundamental investment analysis <u>to the extent they are material to investment performance.</u>

(Shorting or not investing in company with governance issues such as bribery, tax evasion Investing in companies with good ESG fundamentals to reduce risk or enhance returns.)

Responsible Investing Subtypes by Investment Decision Criteria

- For three of the four categories of Responsible Investing, individual or entity values drive investment decisions.



- In ESG investing, unlike SRI, Mission or Impact investing, the fundamentals (financial data) of an investment are the first priority.

An ESG consideration would be considered “material” to the extent it is believed to impact (positively or negatively) the investment’s current or future value.

A Sampling of Potential ESG Considerations

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

Socially Responsible Investing and Investment Performance

- Most investors have the greatest familiarity with socially responsible investing, and many may also conflate SRI with poor investment performance.
- Divestment can result in an increase in tracking error, with the associated risk of underperformance relative to a non-divested benchmark,
- Divestment may also reduce portfolio diversification.
- While not an actual "loss," the impact on performance from this increased tracking error can be substantial.
- 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.
- 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.[1]

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

ESG and Investment Performance: Additional Considerations

- Generally speaking, available studies suggest ESG's impact on performance has been neutral to positive.
- 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, and primarily in a bull market environment.

Because of these data limitations, we may not yet know how ESG integration will impact investments in a sideways or bear market environment, but initial studies appear promising.

Conclusion

- Responsible investing is a growing trend, driven by both top-down and bottom-up demand.
- We identify four types of responsible investing, as well as performance data that supports the use of carefully selected RI strategies.
  - Investors that utilize negative screening techniques need to consider both tracking error and shareholder engagement risk
  - Available data suggests that value-neutral strategies, like ESG integration, should have a neutral to slightly positive impact on performance.
- Depending on geography, regulatory requirements are a significant concern for investors. However 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 additional factors to including lingering issues with data, “greenwashing,” and portfolio construction.