ESG Insights

What is Sustainable Investing?

ESG or sustainable investment strategies have attracted considerable interest from investors in the past couple of years. We sat down with Paul Arnold, who manages a series of ESG Asset Allocation Portfolios at Morningstar Investment Management, to learn more about investing in a way that incorporates environmental, social, and governance elements.

What is sustainable investing?

Sustainable investing marries the traditional economic approach (aiming for the best risk-adjusted returns) with a desire to improve corporate practices and benefit society and the environment. It’s come in many forms and by many names over the years, but today the focus is squarely on investment return while still striving to do good.

ESG refers to environmental, social, and governance factors that investors use to evaluate a company. Performing well in these areas can benefit society, but it can also help reduce the risks a company passes on to its share- and bondholders. Environmental factors might include how well a company reduces the pollution it creates, the water it uses, or the carbon it emits. Social factors may include supply chain management, labor standards, or diversity policies. And governance includes corporate board structure and composition, executive pay, and prevention of bribery and corruption.

Exhibit 1 Sustainable Investing Considers Environmental, Social, and Governance Factors

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
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<tbody>
<tr>
<td>Climate change and carbon emissions</td>
<td>Gender and diversity policies</td>
<td>Board diversity</td>
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<td>Air and water pollution</td>
<td>Safety and quality controls</td>
<td>Corporate ethics</td>
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<td>Energy efficiency</td>
<td>Human rights</td>
<td>Executive compensation</td>
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<td>Waste management</td>
<td>Labor standards</td>
<td>Bribery and corruption policies</td>
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<td>Water scarcity</td>
<td>Privacy and data security</td>
<td>Lobbying activities</td>
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<tr>
<td>Biodiversity and deforestation</td>
<td>Employee engagement</td>
<td>Accounting practices</td>
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Source: Morningstar Research Services, Morningstar Investment Management.
Risks to investors are easy to recall—think about BP’s Deepwater Horizon oil spill in the Gulf of Mexico in 2010, Nike’s sweatshop scandal in the 1990s, or, more recently, Facebook’s data privacy scandal. ESG investors seek to avoid these risks by divesting from companies with poor practices or engagement with management to improve them.

What are some of the benefits of sustainable investing for an investor?
Many investors care about ESG issues and want to invest in a way that reflects their views. Sustainable investing seeks benefits for society, supporting things like environmental responsibility, employment equality and fair treatment, and transparency in corporate affairs. But it aims to accomplish these benefits while delivering returns similar to those of traditional strategies. Bad corporate behavior on ESG issues can hurt shareholder value, but sustainable investing seeks to reduce ESG risks and deliver strong performance.

Also, we hear from many advisors who struggle to keep clients invested through good times and bad. Sustainable investing might help here, we believe—if an investor holds a dual goal of doing good and investing well, they may be more dedicated to their portfolio and stand by their investments so as to not affect funding projects or companies they believe in.

What are some benefits of sustainable investing for an advisor?
We believe it can be a differentiator for an advisor’s practice—you may reach different clients than you otherwise would have without offering sustainable portfolios. Given the huge influx of investor cash into sustainable investments, it seems like a significant opportunity for advisors to help more investors.

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How does someone invest sustainably? What are some pitfalls?
Sustainable investing requires an additional layer of data and analysis than traditional strategies use. ESG analysts evaluate a company on a range of factors, typically rolling up those scores into simple metrics that investors may use when making investment decisions.

This data is available mostly for public companies, and the quality of data is better in developed markets than emerging ones. The limited availability of good ESG data has been somewhat of a stumble for ESG investors in the past, but things have improved greatly. Today, all major asset classes are available to ESG investors, however the selection of multi-asset funds is limited. Also, investment managers have grown significant in-house expertise, adding ESG-focused analysts and specialists to do proprietary research (in addition to ESG data from providers like MSCI or Sustainalytics), and help with board/executive engagement and proxy voting.
**Why might an ESG investor choose to invest in a managed portfolio?**

The managed portfolio structure allows for a number of benefits for ESG investors. First, it can provide diversified investment exposure to ESG-friendly assets. That means not just investing in a U.S. equity fund but having broad diversification within equities and bonds. This allows an investor to make the entire portfolio ESG-friendly while being able to help improve risk and return with a larger investment universe.

Also, managed portfolio providers can do deep dives into both actively managed funds and passive or so-called smart-beta ETFs that weight companies based on ESG credentials rather than company size. There’s considerable knowledge and insight among some very capable ESG portfolio managers out there, but you have to be able to find them. Doing so can bring a diversification of ESG philosophies to bear on an investment process, which we believe can be very helpful. With the Facebook example, some fund managers might exclude this company from their portfolio due to governance issues, while others might relish the chance to invest and push for changes at the firm. We believe this diversity creates a more robust ESG approach and better-diversified portfolios.
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