

# DOING WELL BY ‘DOING GOOD’ THROUGH SUSTAINABLE INVESTMENTS

By Barbara Turley, CFA®

Socially conscious investors today have ramped up their expectations for investments that meet criteria for “sustainable” business practices and for transparent positive contributions to society. And without sacrificing on return.

Sounds like a tall order, but companies adhering to these principles are gathering an increasingly larger share of available global investment capital. According to most recent figures from the Global Sustainable Investment Alliance, global assets managed under a socially responsible or sustainable investing approach were \$22.9 trillion in 2016, up 25% since 2014. This figure represented 26% of all professionally managed assets. Europe represented \$12.0 trillion of that total, while U.S. assets stood at \$8.7 trillion, representing almost 22% of U.S. managed assets and an increase of almost 33% from \$6.6 trillion in 2014. (GSIA)

First of all, what is a “sustainable” investment and why is it important to potential investors?

Sustainable investing refers to an investment approach in which ESG (environmental, social and governance) factors are incorporated in the investment strategy. Other terms associated with this type of investing include impact investing, responsible investing, socially responsible investing, socially conscious investing, “green” investing and ethical investing. Each of these terms has its own nuanced meaning, which can vary according to the perspectives of the audience. Although the investment industry does not have agreed-upon standard definitions, these investing approaches generally share a common goal: to “do well” by “doing good.”

Investors interested in “doing well” on a return basis and “doing good” philanthropically are looking for a broad array of possible approaches that can be tailored to their priorities for following sustainable principles. They want to know their investments are being used in a manner consistent with their beliefs.

The commonly listed sustainability factors incorporated into an investment strategy include:

| ENVIRONMENTAL              | SOCIAL                    | GOVERNANCE                |
|----------------------------|---------------------------|---------------------------|
| Carbon emissions           | Human rights              | Board independence        |
| Pollution and other waste  | Workforce safety & health | Board diversity           |
| Natural resource usage     | Workforce diversity       | Shareholder rights        |
| Energy efficiency          | Opportunity equanimity    | Executive compensation    |
| Sustainability initiatives | Privacy & data security   | Ethics policies & history |
|                            | Community initiatives     |                           |



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ESG investing is based on the concept that environmental, social and governance factors can have financial relevance. Typically, ESG investing is applied to stock strategies, but corporate bonds can also be managed through an ESG approach. These factors represent non-financial markers of a corporation's commitment to sustainable practices and good corporate citizenship.

ESG factors often are considered along with other common investment measures. For example, if an asset manager is evaluating two stocks for a sustainable portfolio, each with a similarly favorable profile from a financial standpoint, the stock of a company whose board is well diversified, has an exemplary record in its employment practices, is committed to sustainable environmental practices, and avoids ESG controversies, may be preferred over the other stock.

The roots for ESG investing extend back to the early 1970s in socially responsible investing (SRI). Traditional SRI is an exclusionary approach involving the screening of stocks in order to exclude companies operating in "sin" industries, such as gambling, alcohol, tobacco, nuclear weapons, etc., from a portfolio. SRI can also include screening based on religious values and other institutional frameworks. Typically, individual investors can customize their SRI portfolios based on the specific industries they wish to avoid supporting.

Traditional SRI has been criticized in the past as potentially leading to undiversified portfolios if an investor has an exclusion factor list that is too broad. SRI portfolios often can be properly diversified through investor education and guidance that helps the investor to narrow the exclusion list and emphasize only the exclusionary factors that are of highest importance to them.

At the same time, traditional SRI provides only part of the total solution that a number of investors now desire. Traditional SRI does not address the operating philosophies and practices of all companies. It merely excludes companies whose revenues are tied to certain industries. The emergence of ESG investing allows investors to also include companies across all industries who show that they are committed to the best practices of good corporate citizens (and avoid companies who do not).

Proponents of ESG investing argue that being a good corporate citizen reduces risk and can lead to superior returns. There is an obvious rational basis to suggest that avoidance of negative headlines associated with controversies (such as those related to environmental challenges, data security struggles, workforce litigation, etc.) can help a stock to avoid event-driven volatility. However, skeptics may wonder if excellence from an ESG perspective really does translate into superior financial and stock performance. Numerous studies have been conducted on the return effects of ESG factors and sustainable investing approaches. Many of these studies have concluded that ESG investing does not necessarily require the investor to sacrifice returns over the long term, although exclusionary SRI approaches may underperform if the exclusion list is too broad.

At the beginning of last year, there were 234 mutual funds and ETFs that screened their companies for ESG/SRI factors ("pure play" ESG/SRI funds). (Investopedia/Morningstar) In addition, smart-beta strategies, which seek to add value or provide certain exposures by weighting the companies in a given index based on chosen factors, are increasingly using ESG overlays. ESG investing has been identified as the fastest-growing smart-beta strategy in recent years, with compound annual growth of approximately 55% for the five-year period 2012-2017 (versus 30% for the average smart-beta strategy). (Bloomberg Intelligence/BofA Merrill Lynch US Equity & US Quant Strategy)

Another striking indicator of the demand for ESG investing is reflected in the signatories to the United Nations Principles of Responsible Investment (PRI), which are a set of principles that were developed to provide a global standard for responsible investing as it relates to ESG factors. Today, the PRI have more than 1,900 signatories including consultants, asset managers, intermediaries, institutional investors and others, representing about \$80 trillion in assets. Clearly ESG investing is mainstream and here to stay.

At Commerce Trust, we believe that proper diversification is paramount to reducing risk and protecting capital over time. We also believe that diversification should be incorporated into a portfolio along different dimensions, including asset class, style, and manager. Our beliefs regarding diversification extend to ESG/socially responsible investing. As a result, we are able to construct multi-asset, multi-style, multi-manager ESG/socially responsible portfolios tailored to meet each client's objectives and preferences.

Of course, any sustainable investment should be part of a long-term, strategic asset allocation plan. Your Commerce portfolio manager will play an integral role in helping you to determine a prudent allocation suitable for you and building a diversified portfolio to help meet your goals.

*Contact your portfolio manager at Commerce Trust for more information on the ESG/socially responsible investment solutions available to you and the special risks to consider before investing.*

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Barbara oversees the quantitative and manager research functions of Commerce Trust Company. These groups provide research for asset allocation, manager selection, and performance measurement for institutional and private clients. Barbara was previously employed at Bank of America and its predecessor organizations, where she was most recently vice president and head of the healthcare equity research group. She has more than 20 years of experience in the investment industry in various capacities. Barbara has extensive experience teaching corporate finance and investments at University of Missouri. She also has been interviewed by various financial print and broadcast media. Barbara has a master in business administration degree from Washington University in St. Louis and holds the Chartered Financial Analyst® designation. She is a member of the CFA Institute and the CFA Society of St. Louis.



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