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 33% from $6.6 trillion in 2014. (GSIA)

First of all, what is a "sustainable" investment and why is it important to potential donors?

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 often revisit their donor strategies at the outset of a new year, discussing how they can better redeploy their wealth to support their causes. Those who invest in these sustainable enterprises want to know their investments are being used in a manner consistent with their beliefs.

The commonly listed environmental, social and governance factors incorporated into an investment strategy can be classified in three broad categories, including:

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	

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.

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 socially responsible and ESG investing extend back to the early 1970s. Traditional socially responsible investing (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. Some would argue that SRI portfolios can be properly diversified through investor education and guidance that helps the investor to emphasize only the exclusionary factors that are of highest importance to them.

At the same time, some believe that 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). Some emerging forms of SRI can imply the promotion of environmental stewardship, consumer protection, human rights, and diversity. As stated above, the use of various terms is fluid, and there is overlap in many of the approaches employed today.

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 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 an 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, 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 socially responsible investment should be part of a long-term, strategic asset allocation plan. Your 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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