A High-Level View of ESG Investing

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The idea of investing according to sound Environmental, Social, and/or Governance (ESG) principles continues to gain momentum, yet the terminology itself can lead to confusion among investors. For example, some people use the terms "ESG" and "Sustainable Investing" interchangeably, while others use "sustainable" to refer specifically to environmental issues. Similarly, some use the terms "ESG" and "SRI" (Socially Responsible Investing) as perfect substitutes, while others see a distinction. While we don't expect full agreement on what each term means, we suggest avoiding using the terms interchangeably. Perhaps through widespread education and usage, the industry may arrive at a degree of consensus. Until then, we suggest trying to be as specific as you can when discussing this topic. For this piece, we will generally refer to the term ESG purely for simplicity and consistency purposes.

Beyond the challenges with the definitions, there are mountains of data, hundreds if not thousands of academic pieces, and a seemingly infinite number of opinions on the topic, yet it seems there may never be agreement on whether to employ it, or perhaps more importantly, how.

We are not here to settle any debates or draw definitive conclusions, but we would like to shed some light on the topic and introduce some different aspects and approaches to ESG investing. For the purposes of this piece, we will focus on equities, but most of it also applies for investing in bonds, real estate, etc., which have unique challenges of their own when it comes to ESG.

Approaches to Incorporating ESG Preferences

There are various approaches to incorporating ESG preferences into one's investments. One of the most debated points is whether it is better to exclude companies from the portfolio if they do not espouse one's ESG principles or values (known as a "negative" screening), or to channel assets only to the leaders in certain areas ("positive" screening).

Another approach altogether is to invest and take an active role to influence the companies' policies and practices (sometimes called "activist" investing or "shareholder engagement"). This method got a lot of attention in 2021 when the activist investor Engine No. 1 won seats on the board of ExxonMobil to influence the energy giant to diversify further into renewable energy. If you are using a professionally managed investment vehicle, like a mutual fund or ETF, you may want to inquire with the manager about their engagement practices in regard to their portfolio holdings. Nuveen, for instance, regularly publishes a *Responsible Investing Engagement Report*, which describes their policies in detail, as well as provides data on their activity and case studies.

Still another version of ESG implementation is known as "impact" investing. That is, investing in projects that are exclusively focused on a specific positive outcome. An example of this is buying a "green bond" issued by a firm to fund construction of wind

and solar projects to power its facilities. Another example is an investment in a company that locates its production facilities in impoverished areas, thereby bringing employment opportunities to the local population.

All of these approaches have merit, for sure, and many strategies may overlap. The decision of which one(s) to choose depends really on investor preferences and the prevailing opportunity set.

Challenges of ESG Investing

While it seems straightforward on paper, one component for consideration is whether or how to weigh one ESG factor over another. For example, what if a company is lauded for its environmental record, but does not do well in governance areas such as gender- or racial diversity? In this scenario, an investor taking the popular "Fossil Fuel Free" approach would likely not want the same thing as one whose primary interest is to see more female directors and officers at their portfolio companies. Once you include all the different preferences investors might have, and consider that the "E," the "S," and "G" have multiple sub-categories each, you can see there are many combinations and iterations of approaches to ESG. Finding companies that score well across all the measures is very difficult.

Even after determining which approach to utilize, a significant challenge for any ESG investor is whether and how they can perform the required due diligence. One only needs to consider the Volkswagen emissions scandal from a few years ago as an example. On the surface, VW looked like a darling of the auto industry for environment-minded investors (not to mention car buyers!) based on their emissions scores, but then it was disclosed that they cheated on the tests. The depth and breadth of the scandal is enough to generate concern that similar "greenwashing" may be happening and going unnoticed. How, then, is a Main Street investor supposed to have the access and knowledge to uncover such a devious plan by the likes of Volkswagen?

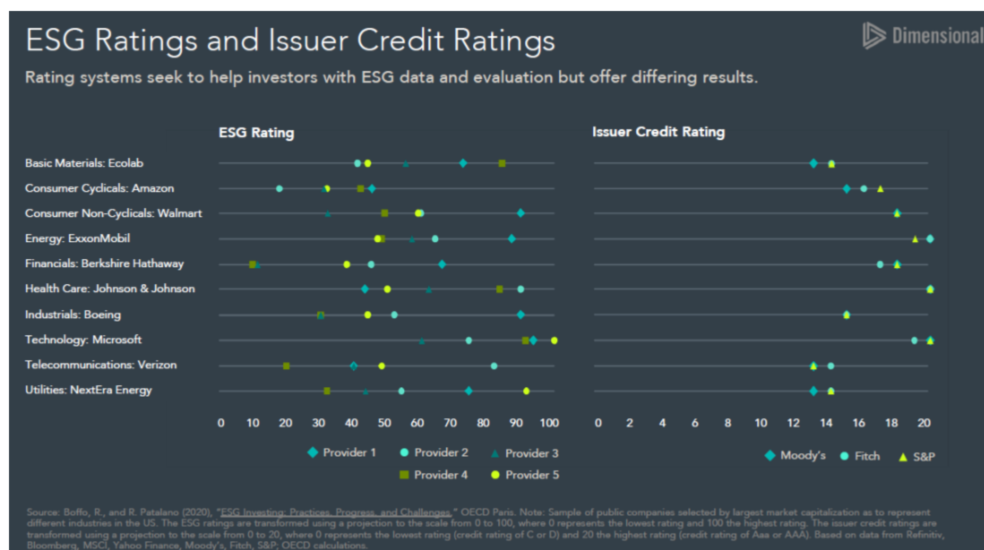
Fortunately, the emergence and increasing acceptance of quantitative scoring services have helped revolutionize the ESG landscape, though their output must be understood rather than blindly implemented. For example, consider a large oil company that gets poor ESG scores because of its fossil fuel production, but the screening tool doesn't give it positive credit for a massive investment in clean energy technologies. This company's investment might have the largest contribution to a clean energy revolution, but it might not be held in portfolios based on quantitative scoring, or it might be blanketly excluded because of its fossil-fuel reserves. Beyond the imperfections in the data, and lack of complete transparency, there are further complications when comparing companies across sectors, or comparing funds or ETFs across categories, and other apples-to-oranges scenarios. That said, as you'll read later, these scoring services can still be helpful when creating and maintaining ESG portfolios.

It should be noted that ESG scoring systems like those of MSCI and Sustainalytics view ESG from an *economic risk* perspective, not purely from a values perspective. On one hand, even if the methodology is based on economic risk, the results of the metrics it uses may still appeal to investors concerned about that factor from a values perspective. For example, they might score a carbon-intensive business unfavorably because of

the potential costs of regulation they might expect to bear someday, regardless of its activities' potential negative impact to climate change. On the other hand, as this article points out, a company like McDonald's, whose supply chain generates a huge amount of greenhouse gas, is not scored poorly by MSCI because MSCI's methodology suggests carbon emissions do not or will not impact McDonalds' bottom line.

Rather than focusing just on ESG scoring, a values-oriented investor should consider reviewing what the industry labels as controversial business involvement (those in industries like tobacco, gambling, and weapons) and controversies within their firm (such as human rights violations or direct environmental harm such as an oil spill). By doing so, an investor can take into account the company's material economic risks (i.e. financial value) and societal values together.

While reviewing these components, note that ESG scoring organizations and ESG funds/ETFs, have different methodologies and levels of stringency that may need to be considered. In fact, there can be a wide disparity among the scoring methodologies as the following chart illustrates.



Implementation Considerations

A practical factor to consider is how investors can effectively implement their ESG views while constructing their portfolios. The past few years have seen a significant increase in interest in ESG among investors and advisors, and the market has responded with a dizzying array of resources to help. What follows are some of the ways one might implement an ESG approach, from most specific to most broad, barring of course, the investor doing his or her own "boots on the ground" research investigating specific companies.

For investors with a very specific value they wish to focus on (say, social justice or renewable energy), or a personalized combination, there are tools and resources available that allow them to screen universes of stocks to isolate companies that fit their criteria, and/or remove those that don't. This has existed for years in the Separately Managed Account (SMA) market, and there are now tools advisors can use to do it themselves. These tools are collectively known as "direct indexing."

While a separately managed account is an option for some, the minimum investments can be too high for others. Furthermore, it may not be possible to invest according to a specific set of values across all parts of the portfolio, such as international small-cap stocks, emerging markets, or REITs. There is also the question about whether the investor wants to

see hundreds or potentially thousands of individual positions on their account statements. The inability to trade fractional shares on custodial platforms also limits the direct indexing approach today.

The next implementation option involves the mutual fund and ETF universe. With the accelerating interest in ESG, we have seen many new fund and ETF launches hoping to quench the thirsts for the vast array of flavors of ESG. For instance, if the investor wants to exclude companies involved with oil production, there's a fund for that (a number of them, actually); if they want only companies with a high ratio of females in their leadership, there's one for that, too. Similar to the situation with SMAs, though, most of the available fund and ETF choices with a particular area of focus only exist for the large cap segment of the US market, so implementing a specific ESG goal across an entire portfolio can be elusive.

In our experience, the most widely used approach to ESG investing among the advisor community is to build portfolios using funds and ETFs that broadly screen their respective investable universe, rather than identifying a specific subset of ESG values. For example, multiple ETF providers have offerings across equity sub-categories (US Large, US Small, Developed Markets, Emerging Markets, bonds, etc.) that leverage benchmarks derived from MSCI's proprietary ESG methodology. This allows advisors to tailor portfolios according to their investment preferences with a consistent and well-documented ESG methodology across investment categories. In some cases, the fund or ETF will go beyond just the ESG score and also exclude companies associated with activities generally deemed objectionable by the broad public, such as tobacco and weapons, and/or those engaged in controversial activities, such as toxic waste spills or a CEO involved in a corruption scandal.

There are clearly some tradeoffs when taking a broad-based approach. Specifically, it is not likely that broad screens will completely satisfy investors wishing to focus on particular values. For example, an energy company might score poorly on environmental factors, but could receive high scores for corporate governance and other issues, and possibly end up with a reasonably positive overall score. Investors with a climate preference, then, might wonder why an oil company is in the portfolio. If they want to focus on a specific issue, a broad-based approach is probably not right for them.

It must be noted that all scoring mechanisms aren't created equal, and the fund/ETF managers themselves might even take different approaches to implementing their methodologies. Therefore, there is still a lot of work to do to find the right methodology and products for you. To make matters more confusing, one well-known ETF provider even offers multiple versions of broadly screened ETFs. One version has more stringent screening, filtering out more companies, and thus has better overall ESG credentials but doesn't track its broad category benchmark as tightly; the other version goes lighter on the screens so that its returns deviate less from its target benchmark. Suffice it to say their naming convention doesn't quite explain these differences, so you really have to dig in to understand what you're getting with each.

In order to refine their search for the product that best meets their needs, advisors and investors have an increasing number of tools at their disposal to evaluate funds and ETFs such as the following, linked for your convenience, though this is by no means an

exhaustive list. Note that some of these tools require a subscription and/or may only be available to advisors.

- ESG Pro
- yourstake.org
- USSIF
- Investyourvalues / asyousow.com
- Morningstar
- MSCI's ESG Funds Ratings Page
- YvesBlue

ESG's Impact on Investment Returns

Another widely debated topic is whether one might expect an ESG portfolio to outperform a non-ESG portfolio over time, all else equal. Sorry to disappoint, but we have no way of quantifying that or making a prediction one way or another. There once was a more broadly held belief that ESG investing led to inferior results. This was a time when there were typically much higher costs associated with ESG investing versus investments that did not require the additional level of research and analysis. Because costs are a major contributor to the reduction of expected return, it would have been reasonable to assume ESG investing might have reduced expected return, and investors would have to choose to accept that tradeoff in exchange for investing in accordance with their values, and/or assume the risk reduction was worth the cost.

With the improvement and increasing standardization around ESG data reported by companies, the emergence of quantitative screens and other advancements in portfolio management, there is no longer such a wide gap between the cost of ESG and non-ESG portfolios. There are certainly exceptions, but in general there are ESG options for cost-conscious investors.

Conclusion

Despite the fact that we cannot know whether an ESG approach will outperform, we find it wise for companies to have an eye toward ESG-related risks, and admirable when investors go the extra mile to invest according to their values, but we highly encourage understanding whether their investments are doing what they expect and want. We continue to survey the rapidly changing landscape for new and improved ways to build portfolios that align investors' portfolios with their values, and we are standing by to help.

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