White Paper
Practice Management

Q2 2020

Aim Higher

Moving from Ambition to Action with ESG Investing

STATE STREET GLOBAL ADVISORS SPDR®

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ESG Investing: Better Decisions Can Create Long-Term Value

ESG investing incorporates the assessment of a company's material environmental, social, and/or governance (ESG) factors into the investment process. We believe that, combined with conventional securities analysis, this approach can add value over the long term.

The $30.7 trillion in ESG assets across five major global markets at the start of 2018 represents a 34% increase in two years.[1] Investor interest is growing, too. Seventy-five percent of Millennials believe it is important for their advisor to help them with ESG and/or Impact Investing. That compares with 63% for Gen X, 55% for Baby Boomers and 53% for the Silent Generation.[2]

Yet, despite strong industry growth rates and high satisfaction from investors with ESG investments, the financial advisor community has been slow to adopt ESG investing. Three key challenges remain:

1. **Confusion around investment performance parity** ESG is not just a "do-good" mentality.
2. **Lack of transparent, standardized data** Better data can lead to clearer outcomes.
3. **Choice Overload** A framework can guide the effective integration of ESG.

Additionally, ESG's evolution has resulted in a mix of terminology across the industry. Phrases such as "Impact Investing" and "ESG integration" have become widespread, but what they actually mean isn't always clear. This lack of clarity can create confusion and impede progress.

Figure 1
Evolution of ESG Investing

1920s	1930s	1990s	2000s
Socially Responsible Investing (SRI) Rooted in religious values and exclusionary screens: tobacco, alcohol and gambling.	**Responsible Investing (RI)** Focused on governance issues after the Depression and corporate scandals.	**Sustainable Investing (SI)** Reflected increased awareness about climate change.	**Environmental, Social, and Governance Investing (ESG)** United Nations' Principles of Responsible Investing requires incorporating ESG issues into the investment process.

Source: State Street Global Advisors, April 2020.

Establishing a standard language to discuss ESG goals and strategies can help advisors communicate clearly with clients. It helps clients understand the features and benefits of ESG investing. Having a clear and straightforward framework for understanding and comparing options is the first step in guiding clients on ESG investing.

Figure 2
Understanding ESG Terminology

ESG Integration	Incorporates ESG data, alongside traditional financial analysis, into the securities selection process.
Environmental	Assesses how a company performs as a steward of the natural environment, including energy consumption, water management, pollution, and other material issues.
Social	Examines how a company manages relationships with employees, suppliers, customers and the communities in which it operates.
Governance	Deals with a company's management, including executive pay, board composition, transparency and shareholder rights.
Sustainable Investing	Takes into account environmental, social, and governance factors throughout the investment process, in addition to conventional factors. Often referred to as ESG investing, and vice versa.
Impact Investing	Targets a measurable positive social and/or environmental impact. Investments are generally project specific.
Exclusionary Screening	Excludes from the investment universe those companies, sectors or countries involved in activities that do not align with the moral values of investors or with global standards around human rights, labor practices, the environment and anti-corruption.
Positive Screening	Tilts portfolio toward one of the following: **Best-in-class** companies outperforming peers in ESG measures **ESG momentum** companies improving ESG measures more quickly than peers **Thematic investing** companies solving specific ESG challenges (climate change, gender diversity, etc.)
Active Ownership	Entails engaging with companies and voting company shares on a variety of ESG issues to initiate changes in behavior or in company policies and practices.

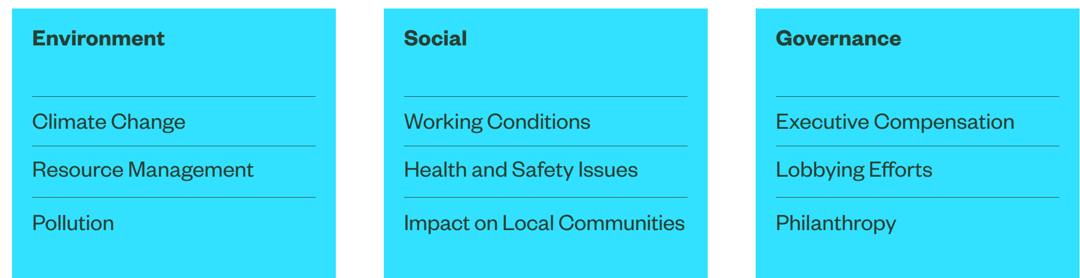
Source: State Street Global Advisors, "Understanding & Comparing ESG Terminology: A Practical Framework for Identifying the ESG Strategy that is Right for You." 2017 Select terminology, this is not a comprehensive list.

Aligning Investments with Client Values

To navigate uncertainty, investors are looking for investment strategies that are sustainable and offer potential for superior risk-adjusted returns.[4] Yet while some focus solely on financial returns, an increasing number of investors also value nontraditional benefits, such as targeting specific social or environmental outcomes.[5] By meeting this growing need, advisors can foster a powerful investment experience that strengthens client satisfaction in a deeply meaningful and personal way.

Because the motivations and goals are unique for each investor, creating the right ESG solution for each client requires identifying suitable strategies, providing useful education, and tracking progress toward long-term objectives.

Figure 3
Most Important ESG Issues for Investors



Environment	Social	Governance
Climate Change	Working Conditions	Executive Compensation
Resource Management	Health and Safety Issues	Lobbying Efforts
Pollution	Impact on Local Communities	Philanthropy

Source: State Street Center for Applied Research Survey of Retail Investors, December 2016.

Successfully incorporating ESG investing hinges on how well it fits with the client's investment goals. The increasing number of ESG strategies reflects the diversity of investor objectives, including:

- Avoiding or reducing ESG risks
- Seeking measurable impact
- Generating higher investment returns

To varying degrees, some of these objectives span different ESG strategies. And they are not mutually exclusive — multiple ESG strategies can be combined within a single investment vehicle to achieve the investor's specific goals. These strategies can be implemented across asset classes, investment styles and investment vehicles.

Types of ESG Strategies

Impact Investing Community investment fund that provides micro financing to low-income or disadvantaged communities.

Exclusionary Screening Equity fund that excludes companies with more than 5% of revenue generated from the sale of tobacco products.

Positive Screening Fixed income fund that holds municipal and corporate green bonds that invest in infrastructure projects to combat climate change.

Active Ownership Any type of fund (including those not labeled ESG) where the asset manager or asset owner engages directly with companies to influence positive change.

ESG Actively managed multi-asset fund that considers ESG factors in combination with conventional securities analysis.

Source: State Street Global Advisors, "Understanding & Comparing ESG Terminology: A Practical Framework for Identifying the ESG Strategy that Is Right for You." 2017

Clearing Hurdles to Focus on ESG's Benefits

Advisors are uniquely positioned to be a change agent in mainstreaming ESG investing. Investors need guidance in defining their ESG objectives and implementing the right solutions. They need informative discussions and compelling materials to help them understand the concepts.

1 ESG Is More Than a "Do-Good" Mentality
2 Better Data Can Lead to Clearer Outcomes
3 How to Integrate ESG Principles Effectively

ESG Is More Than a "Do-Good" Mentality

There is a no-compromise approach when it comes to investors' performance expectations for ESG. These are investments, not donations, and financial performance is what keeps clients interested and invested. Sixty percent of ESG investors cite lower volatility and 54% cite lower downside risk as important reasons for incorporating ESG into their investment process.[6]

Industry and academic studies offer empirical evidence for potentially better long-term risk-adjusted returns, lower downside and improved volatility in ESG strategies.[7] Mutual funds and separately managed accounts classified as sustainable investments have historically often met or exceeded broad market performance, both on an absolute and a risk-adjusted basis, across asset classes and over time.[8] Broader meta-analyses by Mercer,[9] Morningstar[10] and the University of Oxford[11] have found mostly favorable or neutral-to-favorable historical returns on socially responsible investing.

Sensible economic intuition supports this analysis. From a risk perspective, traditional investments that ignore ESG factors may miss capturing information beyond financial statements that indicate higher risk exposure. From a returns perspective, as these strategies continue to expand, a virtuous cycle comes into play where investor interest could reward companies with good ESG scores, motivating other companies toward good corporate citizenship.

69%

of ESG investors say ESG has helped manage volatility[12]

Past performance is not indicative of future results.

90%

of investors who have an advisor guiding them on impact investments are extremely satisfied or satisfied[13]

Better Data Can Lead to Clearer Outcomes

Better company data combined with better ESG research and analytics will lead to more advanced approaches to identifying and addressing material ESG issues. There has been significant progress in the number of companies disclosing ESG data, along with the breadth and depth of their data. But reporting methodologies still vary among companies, index providers and asset managers, creating challenges for investors seeking to compare ESG strategies. Quality and usefulness of data provided is still limited. Continued progress on standardization of reporting for companies should help.

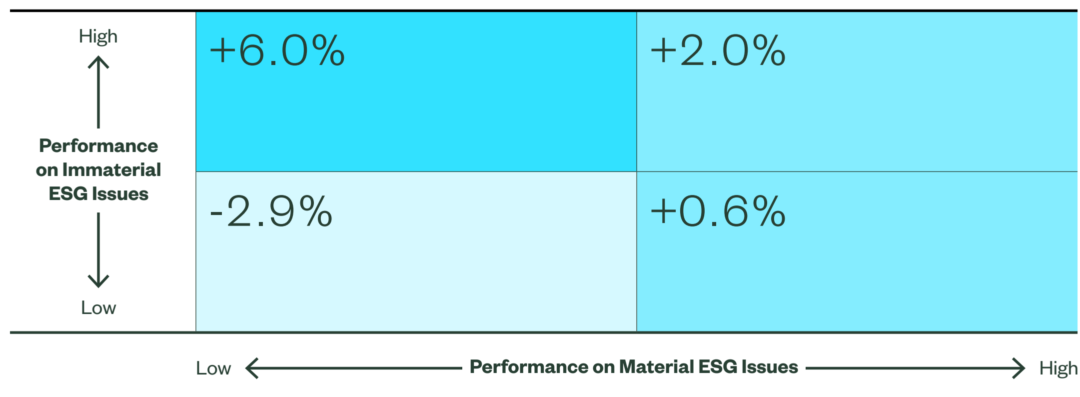
Company-level data on ESG metrics are available from a wide range of providers, such as Sustainalytics, MSCI, Bloomberg and Thompson Reuters. Due to the cost of compiling and analyzing data, most company-level ESG information doesn't end up in the hands of advisors or individual investors. Fund-level information on ESG outcomes is improving — particularly for certain sectors, markets, and investment themes.

Additionally, the lack of consistency in reporting on financially material issues leaves room for some degree of subjectivity. For example, a company's rating on carbon output could be qualitative (management is committed to improving emissions), quantitative (proved reduction in carbon output by 25% by 2020), or binary (yes, the company has goals related to carbon emissions). Efforts to improve data are focusing generally on more quantitative data, along with better application of qualitative data.

Notably, the Sustainability Accounting Standards Board (SASB) framework identifies industry-specific financially material issues. This supports the increasing awareness that material issues vary across sectors and industries. In the financial sector, for example, governance issues (board representation, ethics, lobbying efforts) may weigh more heavily than environmental or social issues. In the energy sector, environmental issues are key (climate change, waste management, air quality). And in health care, social issues often dominate (human capital, diversity and opportunity, customer welfare).

The material ESG issues SASB identifies are likely to affect the financial condition or operating performance of companies within an industry. In fact, analysis using SASB's materiality framework found that companies that address material ESG issues and ignore immaterial ones outperform those that address both material and immaterial issues by 4% and outperform companies that address neither by nearly 9%.[14]

Figure 4
Material Issues Affect Corporate Performance



The illustration shows the effect on financial returns on investors' treatment of environmental, social, and governance (ESG) issues, annualized alpha. The study used data from 1992 to 2012 on companies' ESG performance across 45 industries in six sectors: financial services, health care, telecommunications, nonrenewable resource, services, and transportation. Source: McKinsey & Company, "Sustainability: What institutional investors should do next on ESG," June 2016; Mozaffar Khan, George Serafeim, and Aaron Yoon, Corporate sustainability: First evidence on materiality, Harvard Business School working paper, posted March 9, 2015, revised February 1, 2017, hbs.edu.

Clients increasingly want to know what they own. Just as an actively managed fund may not produce alpha consistently, an ESG fund may address fewer material issues than expected. The reverse is also true — a fund or security that doesn't carry an ESG label may actually support positive ESG outcomes. Improved reporting can help advisors be proactive with their communications and more responsive to specific client inquiries. Institutional and individual investor demand is prompting more uniformity of metrics, increased availability and transparency of data, and better methods to address fund survivorship bias (which can distort comparisons of investment options).

While more work is needed in creating a consistent framework for companies, index providers and asset managers, current limitations are no reason to sit on the sidelines. We must not make the perfect the enemy of the good.

The ongoing challenges in obtaining clear and standardized ESG reporting makes it difficult for investors to determine how their portfolios are doing in terms of the issues they care about. In response, some institutions have embraced the idea of "materiality," derived from the concept of material information in accounting. Much as knowledge that could influence investors' decisions is deemed material, so too are ESG factors, which can have a measurable effect on an investment's financial performance (see Figure 4).

How to Integrate ESG Principles Effectively

While the benefits of ESG investing may be clear, sometimes the best path for clients to take isn't as obvious. Some clients may want to dip a toe into ESG investing; others may want to commit a significant part of their portfolio. A groundswell of investor interest has triggered a large and growing set of ESG options to meet a wide range of investor needs. The investor's need for advice in navigating these options is the advisor's opportunity to add value in a meaningful way.

Whatever the client's goal, advisors will need to optimize ESG investment opportunities across a range of asset classes and the risk spectrum. Consider these practical portfolio considerations:

Scope of the Portfolio Choose exposure across the entire portfolio or by asset class — public equity, private equity, fixed income, alternatives and multi-asset; US only, developed markets, emerging markets or global.

Intended Impact Define objectives to identify the right ESG strategy — thematic (renewable energy), targeted (environmental) or comprehensive (ESG).

Implementation Considerations Determine investment vehicles — mutual funds, ETFs, separate accounts, model portfolio, and full integration.

The nature of this conversation is that it's focused on client goals and it highlights the advisor's value-add. It may not necessarily be a linear process, because these considerations are so interrelated. It's not intended to be a one-and-done achievement. Client motivations will shift over time, and portfolios should adapt to changes.

Focusing ESG Conversations

Effective integration of ESG principles into a portfolio begins with a client-focused process — not a product-focused process. Our framework below can help advisors have rewarding ESG conversations with clients.

Figure 5
Talking to Clients About ESG Investing

Identify a Clear Entry Point	**What are the client's investment objectives?** Determine if integrating ESG considerations fits the long-term plan. **What are the client's ESG priorities?** Educate as part of the discovery process. Clarify the motivation to inform the journey, narrow the focus and shape priorities. **Where are the market opportunities?** Target opportunities to identify resources and select ESG investment strategies.
Keep Risk in Perspective	**What are the client's desired outcome priorities?** (values-based and risk-based aspects of implementation) Select degree of portfolio integration. **How much of a client's portfolio will be allocated to ESG strategies?** Assess the broader asset allocation to keep the investment plan level properly balanced. Avoid introducing sector or style biases. **How inclusive does the client want to be in applying ESG?** Review personal values and risk framework with clients to help them understand ESG investing considerations.
Take the Long-View	**What is the client's time horizon and intended impact?** (identification of tactical opportunities; sleeve of a portfolio or total integration) Understand the client's perspective and align expectations on nonfinancial outcomes and reporting. **How does the client define and measure success?** (strategies; optimization techniques and expense considerations) Define success as part of the investment plan evaluation. Maintain the principle of high-impact investing. ESG does not require sacrificing performance. Modify ongoing reporting to address client's priorities. Reallocate portfolio as motivations shift.

Source: State Street Global Advisors.

Looking Ahead: Ongoing ESG Education Is Key

To help advisors hone their analysis of ESG and get more comfortable having conversations with clients, the CFA Institute, US Forum for Sustainable and Responsible Investment, Money Management Institute and United Nation's Principles for Responsible Investment provide information on incorporating ESG data into security analysis, academic and industry research, and recent trends. Some also offer courses for continuing education credit.

Whether advisors choose to build ESG capabilities in-house or outsource them, effective communication with clients remains the key. Clients need a solid understanding of ESG terminology and its investment rationale to fully appreciate ESG options and benefits. And providing portfolio examples that are relatable and connect back to the client's motivations brings ESG investing to life.

As investors have become more educated on ESG investing, the hurdles to managing an ESG-oriented portfolio have been steadily shrinking:

- Companies are adopting more sustainable business practices
- ESG data is becoming more robust, and transparency is increasing
- More resources are available to help advisors understand, communicate and implement ESG options

Most importantly, the track record continues to show that ESG strategies have the potential for better risk-adjusted returns than do conventional strategies that ignore these ESG factors.

Advisors can provide the clarity that informs the client's ESG journey, narrows the focus, and shapes priorities. ESG promotes investing with greater precision — applying a broader lens to more deeply analyze investments. So whether clients want to identify investments that match their values or pursue better long-term performance, ESG can help them meet their investment goals. It's a new way of valuing the future.

What began as a vehicle for expressing one's values has evolved into a means of adding value to a portfolio. As State Street Global Advisors President and CEO Cyrus Taraporevala observes, *"Addressing material ESG issues is good business practice and essential to a company's long-term financial performance — a matter of value, not values."*

Endnotes

1 Global Sustainable Investment Review, April, 2019. The report describes ESG assets as "sustainable, responsible and impact assets."

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7 The Boston Consulting Group, "Total Societal Impact: A New Lens for Strategy," October 25, 2017.

8 Morgan Stanley Institute for Sustainable Investing, "Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies," 2015.

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ID166045-3077331.1.1.GBL.RTL 0520
Exp. Date: 05/31/2021