WILMINGTON TRUST

Sustainable Investing

Redefining investing for the long term

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The investment world is continuously evolving, with one of the most notable transformations of our generation under way. Increasingly, investors no longer wish to keep their good intentions for society relegated to charitable giving, but are also looking to "do good" with their investments. We think the best way to achieve these personal and financial goals is to apply a set of socially conscious standards that focuses on the long-term sustainability and ethical behavior of a company, which is referred to as "sustainable investing."

Sustainable investing comes in many forms and can mean different things to different people. We seek to clear the air on this changing space and offer some perspective on what we view as one of the most effective ways of investing to generate long-term gains from both the societal and financial perspectives.

Investing in the future

At its core, sustainable investing is redefining what many investors mean by "long-term investing." Historically, "long term" has been consistent with one or more complete market cycles spanning many years. In recent years, we feel like that has *devolved* into an increasingly short-term focus, concentrating on quarterly performance (encouraged by the hedge fund industry over the past two decades). We believe the exceptional growth of sustainable investing has, in part, been a response to the flaws of this short-term thinking. To achieve their goals, investors are recognizing the necessity of maintaining a longer investment horizon that includes the expected impact companies have on society.

As we will discuss in a later section, sustainable investing encourages companies to focus less on near-term earnings targets and more on long–term profitability. Importantly, sustainable investors also believe that, over time, this type of focus from a company will yield higher returns. Said differently, sustainable investing is a way of achieving both social and financial goals.

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Figure 1

Four main ways to invest sustainably

We use sustainable investing as an umbrella term encompassing four main investment strategies in this field (Figure 1):

- Environmental, social, governance investing (ESG)—Investment discipline that considers environmental, social, and governance criteria to help achieve financial objectives
- Socially responsible investing (SRI)—Avoids investing in companies and industries, such as tobacco or energy, that run counter to the investor's set of values
- Thematic—Maintains an emphasis on a specific theme such as the environment
- Impact—Investing with the intention of generating a measurably beneficial social or environmental impact alongside a financial return

The sustainable investing movement

The origins of sustainable investing can be traced back hundreds, if not thousands, of years. However, it wasn't until the 1960s that it developed into a wider movement, as investors boycotted investments in companies associated with the Vietnam War and the apartheid government of South Africa. Over the last 50 years, the scope of sustainable investing has evolved and broadened to become one of the most profound developments in investment management. As of the end of 2017, 26% of all U.S. professionally managed assets—$12 trillion—is governed by a sustainable investing mandate, and the vast majority incorporates ESG criteria, according to the US SIF Foundation's *2018 Report on US Sustainable, Responsible and Impact Investing Trends.*

Since 2016, sustainable investing assets have grown by 38%, and the trend is a global one. According to the UN Principles for Responsible Investment, as of 2018, close to 2,000 asset owners and investment managers controlling nearly $90 trillion in assets have pledged to follow the organization's six principles for responsible investment, the first three of which involve incorporating ESG considerations into their investment decision-making and ownership policies.

The exceptional growth in the integration of sustainable investment criteria has been powered by three primary motivations: 1) a desire to invest in companies that align with an individual's or organization's own values; 2) the recognition that investor dollars can be directed in a way to foster positive environmental and social change; and 3) the need to generate risk-adjusted returns on par or better than traditional investment strategies.

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SRI vs. ESG

The two most prevalent forms of sustainable investing are SRI and ESG, which have subtle but important distinctions in how they aim to carry out the goals of sustainability.

- Where SRI typically takes an *exclusionary* approach, eliminating entire industries that are viewed as harmful to the economy or social well-being from the investable universe, ESG uses an *inclusionary* approach, selecting companies that exhibit superior ESG characteristics relative to industry peers. ESG's inclusion of all economic sectors allows for a more diversified portfolio and improves the portfolio's chances of achieving returns similar to the broader market.
- SRI tends to be more *targeted* in the list of issues it excludes from the portfolio, with tobacco, firearms, and gambling usually front and center. In contrast, ESG takes a *comprehensive* approach, where it looks to invest according to a broader range of issues and rewards improvements relative to peers. An example of an ESG issue would be carbon footprint; every company has a carbon footprint and those making concerted efforts to shrink their footprint is taken into consideration.
- SRI tends to be *static*, where exclusions are generally maintained based on a client's personal standards until such time as the client directs otherwise. ESG is more *dynamic*, with the larger goal of incentivizing good behavior and positive change. It is sometimes easier to effect change through an ESG strategy, as the investor may be more engaged with management and proxy voting than an SRI investor who has no intention of taking a stake in a particular industry.

Figure 2

ESG as a roadmap to potential long-term sustainable returns

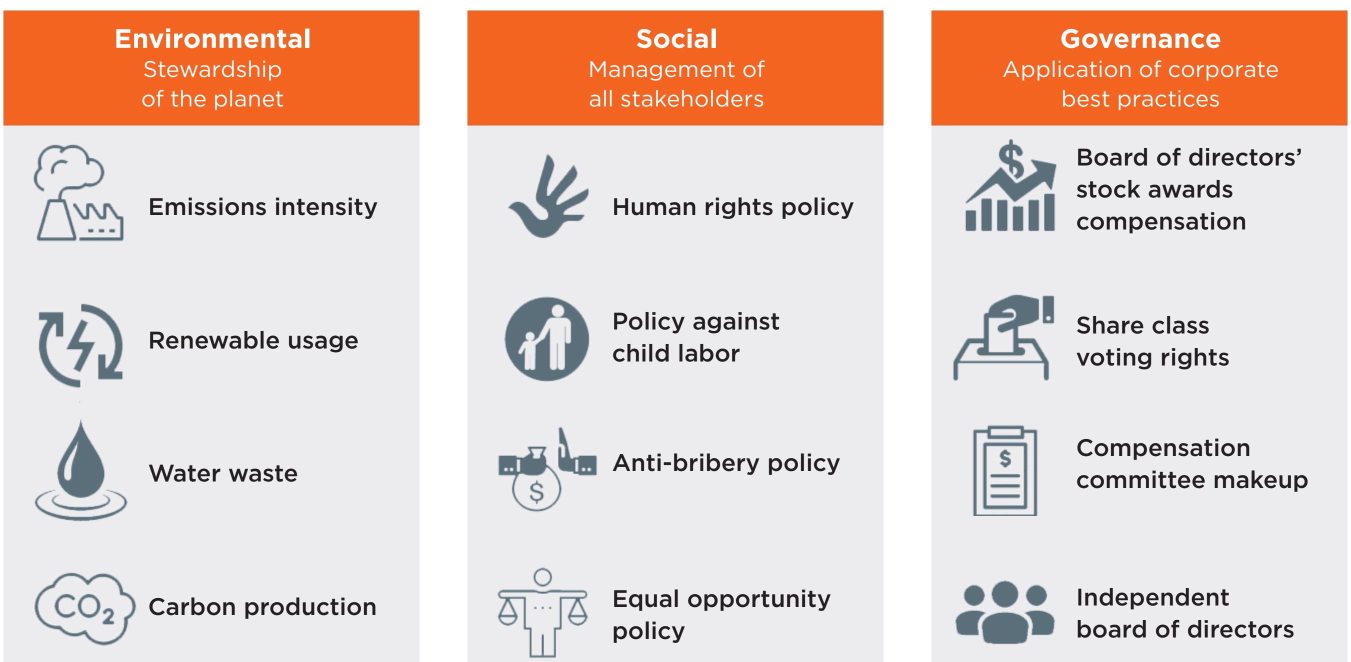

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Figure 3

Higher ESG scores associated with higher returns

Results of more than 2,000 studies on the impact of ESG

Source: Gunnar Friede, et al, "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment*, October 2015, Volume 5, Number 4, pp. 210-233; Deutsche Asset & Wealth Management Investment; McKinsey analysis; the remaining 29% was "neutral." Past performance cannot guarantee future results.

Given these differences, our view is that ESG is a more effective way of investing sustainably (Figure 2). However, we realize sustainable investors are often more personally and emotionally invested in their portfolios than is typically the case, and the right strategy is ultimately based on the individual client.

Can you do good *and* do well?

Many investors harbor doubts about the ability of an ESG portfolio to generate competitive returns. The skepticism is understandable. Any time investors limit their investment opportunity set through additional constraints, they run the risk of generating suboptimal returns. This is true of any constraint imposed by a fund manager, and is not limited to ESG factors.

Academics have struggled for decades with the question of whether ESG factors help or hurt an investment portfolio's performance. There are myriad reasons why answering this question is challenging, including: lack of completeness and accuracy of the data; the relatively short timeframe for analyzing the impact of ESG on returns; and difficulty in determining causality.

A 2015 paper published in the *Journal of Sustainable Finance & Investment* and cited by McKinsey & Company performed a comprehensive review of more than 2,000 studies on the relationship between a company's ESG rating and equity returns. It found that 63% of studies referenced a positive correlation (higher ESG rating coincided with higher equity returns), while only 8% of studies reported negative findings for the impact of ESG scoring on equity performance (Figure 3).

This finding was validated in a research paper published by MSCI, a global provider of financial analytics and market indices, in the *Journal of Portfolio Management*,[1] where ESG scores for companies were positively correlated with their stocks' profitability and dividend yield, and negatively correlated with drawdown risk and volatility (i.e., a higher ESG score coincided with higher profitability and higher dividend yields with lower risk and volatility). They cite the following benefits that highly rated ESG companies have customarily been shown to generate for shareholders:

1. **Higher profitability:** High ESG-rated companies are often more competitive, generating above-average returns and frequently resulting in higher profitability and dividend payments
2. **Lower tail risk:** High ESG-rated companies can be less susceptible to idiosyncratic, event-driven major declines, such as product recalls
3. **Reduced systemic risk:** High ESG-rated companies are often subject to lower systemic risk exposure, lessening overall price volatility

[1] Guido Giese, et al., "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance." July 2019. *The Journal of Portfolio Management.*

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Figure 4

ESG investing in action

Companies that have changed their behavior due to pressure from ESG investors.

Target reduced the use of toxic PVC plastic in children's products in response to pressure from ESG investors. As a result, Target now has a sustainable product standard that scores thousands of products based on toxicity. Other major retailers, like Walmart and Sears, have followed suit.

Kroger makes a portion of their revenue from firearm sales. ESG investors pressured retailers and distributors to take action on the issue of gun violence. As a result, Kroger reviewed their firearms policy, raised the purchase age to 21 and removed firearms from the shelves in one of their subsidiaries all together.

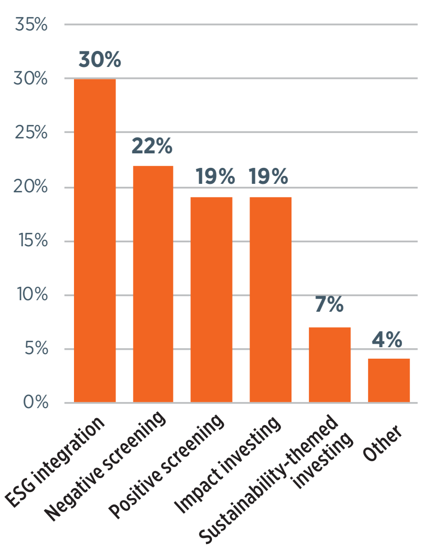
After several food safety issues at Chipotle locations across the country, the restaurant chain promoted "food with integrity" without any accompanying policies or data. ESG investors led a shareholder resolution that pushed the company to publish a comprehensive sustainability report in 2018 as a response.

Figure 5

Wealthy investors and ESG

How high-net-worth practices incoporate ESG factors for clients.

Source: Cerulli Associates.
Data as of December 2019.



The challenge with this, as an investor, is determining causality. That is, are companies with more sustainable practices and, therefore, higher ESG scores able to generate higher profits as a result? Or, are more profitable companies simply able to devote more resources to ESG issues? The former would indicate ESG should be incorporated into every investment process. The latter would say very little about an ESG-friendly company's ability to generate future profitability, other than perhaps there exists some correlation between the two.

While the data remain somewhat inconclusive, there is reason to doubt that integrating ESG criteria causes investment performance to suffer. On the contrary, there is gathering evidence that companies incorporating sustainable business practices may perform better over the long term. It may be that ESG-friendly businesses are often more focused on the long game, making near-term investments succeed long term, both in their sustainability efforts and pursuit of profits. A focus on sustainability is also likely to attract more customers and investors (we find this especially to be the case with the Millennial and Gen Z generations). ESG investors themselves, too, may actually make a difference in the priorities of corporate management through several means of engagement: divestment, proxy voting, dialogue with management, interaction with customers, communication with regulators, and general thought leadership. In this way, we believe ESG investors have the ability to motivate companies to "do better" and encourage those already operating sustainably to continue the investment in our collective future (Figure 4). New Cerulli data show that 58% of high-net-worth-focused advisor practices use ESG and SRI strategies and will increase their allocations in 2020, and 8% plan to introduce these strategies during that timeframe. Clients are relying on a variety of strategies to integrate ESG into their portfolios (Figure 5). The projected rise in ESG incorporation is also reflective of our overall view, as well as our expectation for it to increasingly factor into corporate decision making.

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Based on this, in our view, if ESG factors are incorporated into an already-rigorous investment process, an ESG portfolio should have the ability to generate long-term returns equal to or better than traditional portfolios. In other words, when done right, there may be no need for an investor to choose between investing according to their values and reaching their investment goals.

Sustainable investing and your portfolio

Sustainable investing is yet another evolution in the investment world, one that could end up having as much of an impact on the way we invest as electronic trading platforms or passive (index-tracking) investment vehicles. As the conversation continues, we expect to see an increase in the number and sophistication of solutions to help deliver on sustainable investing goals.

If you are interested in learning more about integrating an ESG framework into your portfolio, please contact your Wilmington Trust advisor.

Drawdown risk measures the potential drop in portfolio asset values from the most recent stock market peak to the most recent stock market trough.