Morningstar

The magazine of independent research for the world's financial professionals

December/January 2016

Sustainable Investing Takes Off

A new generation of investors wants strategies that deliver performance and peace of mind.

Rights and Responsibilities We should be encouraging ESG, not mocking it.

PHILLIPS CURVE

Don Phillips

Environmental, social, and governance, or ESG, concerns are often presented as liberal forces combating the evils of Big Business to somehow make the ugly activity of investing more palatable to good-hearted individuals. This view has been strengthened by right-wing opponents of ESG, such as a noted U.S. business periodical that has long derided ESG investing approaches, claiming that investors should invest for maximum gain and if they feel guilty about how those gains were won to simply make a charitable donation out of some of their winnings to ease their conscience. To me, this explanation of ESG gets it dead wrong, being founded on false premises, most notably that investing is a somehow tainted activity that needs to be cleaned up.

I believe that investing itself is a socially conscious act. It means deferring gratification today for greater security and opportunity for yourself and your loved ones tomorrow. It is, quite simply, what a responsible adult does. Those who can invest and don't do so, such as Vice President Joe Biden, who boasts (falsely) of owning no stock or bonds, are in my eyes irresponsible and poor role models. Conversely, those who step up and embrace the responsibility of becoming investors deserve our respect and should be entitled to fundamental rights as responsible citizens. Our society benefits from having more investors, not fewer.

The Investment Company Act of 1940, the legislation on which the U.S. fund business is based, embraces this notion of investors' rights, choosing a corporate organization of investment companies, rather than investment products, for these vehicles. In embracing the corporate structure, the act defines investors as owners and gives them advocates in the form of a predominantly independent board of directors to represent their interests to the management company that is employed to run the fund. That view is utterly different from the product view of funds where manufacturers make product, which is sold through distribution channels to consumers. Owners have rights; consumers are prey, hence the phrase "buyer beware." Those that treat investors as owners bestow upon them the respect due to those who accept the responsibility of planning for tomorrow rather than just living for today.

Chief among these rights that those responsible individuals who become investors are due is transparency and choice about how their money is invested. They have a right to know who is running the businesses they invest in, what practices they deploy in managing those businesses, and what consequences those activities have on the world in which they operate. Investors have the absolute right to choose which activities they are comfortable embracing and which they desire to avoid. They do not have to buy every stock in the market just because some academic believes buying the whole market is the sainted way to invest. They can—and should—direct their hard-earned money in the ways that they choose.

Of course, that's not always an easy task. It takes great effort to uncover all the activities in which even a single business is engaged. The research for a diversified portfolio of investments can be daunting. Fortunately, the market increasingly offers assistance, as firms are stepping up to provide insights into the practices of different businesses. Morningstar will soon aggregate the insights of one such firm, Sustainalytics, to offer fund investors insights into the ESG footprint of the funds they consider for their portfolios. To me, this transparency is wholly in keeping with the rights due to those individuals responsible enough to live within their means and save and invest for the future.

ESG is a great and powerful movement, not because it rights some wrong inherent in business, but because it removes obstacles that keep people from investing. It's far too easy an excuse to not save for tomorrow because you think investing supports causes you dislike. ESG research empowers investors to make more informed choices, to better align their money with their values, which is their right to do. It gives investors a louder voice to corporate leaders. Over time, the practice, which today is in its infancy, will evolve and become more sophisticated. In the process, it will lead to better behavior and increased accountability. But already it is a powerful force that appropriately reflects investor rights. And that is a very responsible thing. M

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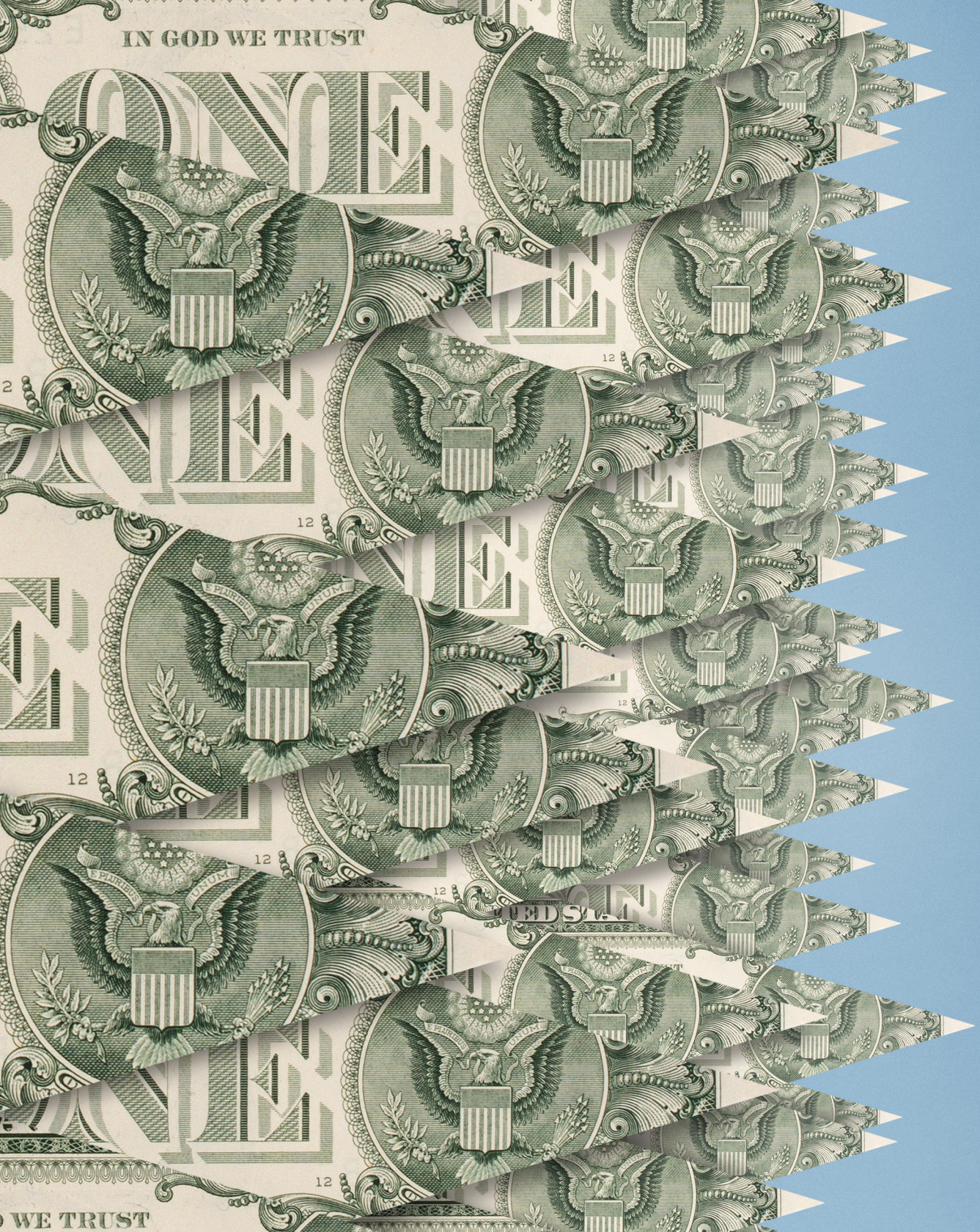
Don Phillips is a managing director with Morningstar. He is a member of the editorial board of *Morningstar* magazine.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UNITED STATES OF AMERICA
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The Appeal of Sustainable Investing

Amid a demographic shift, more investors want to have an impact.

SUSTAINABLE INVESTING

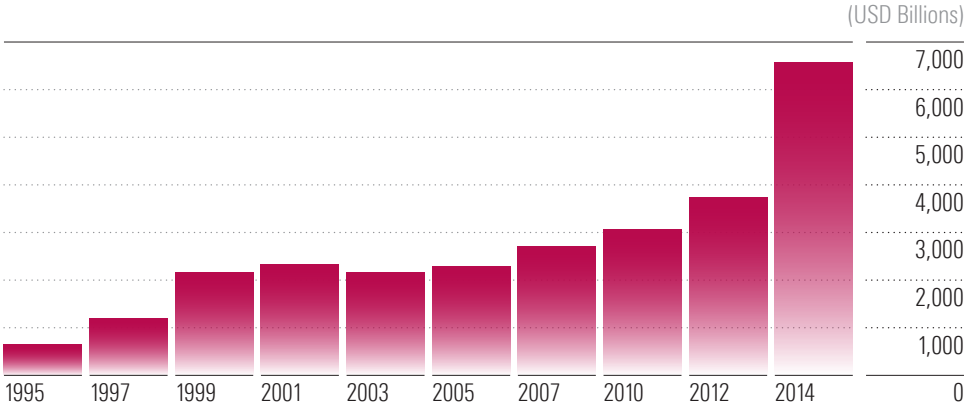
Jon Hale

Sustainability is on a lot of people's minds these days. Jeremy Grantham opened his keynote address at last summer's Morningstar Investment Conference by outlining several issues that he said were "obsessing" him, among them long-term resource limitations, climate problems, food problems, income inequality, and the loss of corporate stakeholders.

Grantham's obsessions reflect widespread concerns of investors over sustainability issues, as well as the growing recognition of the need to move toward a more sustainable global economy. In areas such as consumer choice and workplace satisfaction, surveys report widespread support for sustainability concepts. According to the 2014 Nielsen Global Survey of Corporate Social Responsibility, more than half of consumers surveyed globally said they would be willing to pay more for products and services from companies committed

EXHIBIT 1

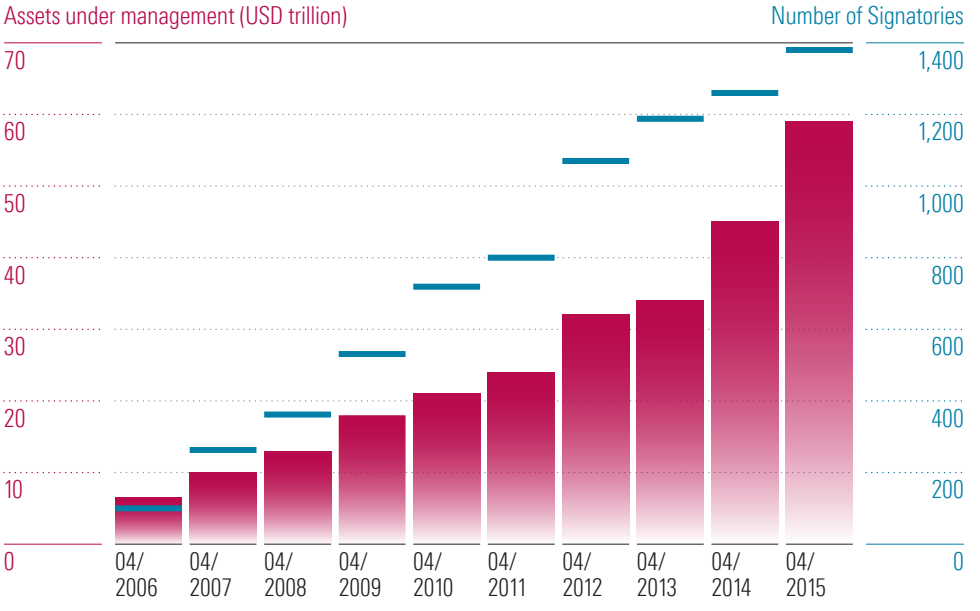
The ESG Landscape Assets in sustainable investments are growing in the United States.



Source: US SIF, The Forum for Sustainable and Responsible Investing.

EXHIBIT 2

Jumping on the Bandwagon Nearly 1,400 asset-management firms, representing $60 trillion in assets under management, have signed the U.N. Principles for Responsible Investment.



Source: U.N. Principles for Responsible Investment.

to positive social and environmental impact.[1] Two thirds said they would prefer to work for a socially responsible company.

Similarly, interest in sustainable investing appears to be growing in the investment world, particularly among women and younger people, two groups who are rapidly becoming more influential investment decision-makers. Recent studies by U.S. Trust[2] and Morgan Stanley[3] found a large majority of female investors, more than 70% in each study, agreed that environmental, social, and governance, or ESG, factors are important considerations when making an investment, while men were more evenly divided. A 2011 Pew Research survey found Gen-Xers and, especially, millennials to be more concerned about environmental issues and global warming than baby boomers.[4] The Morgan Stanley survey found that 84% of millennial investors were interested in sustainable investing and were twice as likely as investors overall to make sustainable investment decisions.

Women and millennials are becoming more influential investment decision-makers. In the United States alone, women now have decision-making control over an estimated 40% of the nation's investable assets.[5] By some estimates, $30 trillion is going to pass from baby boomers to younger generations over the next half century.[6] That money will move into the hands of investors who appear to be significantly more interested in sustainable investing than their elders.

A Growth Industry

With these favorable demographic trends just starting to provide a tailwind, sustainable investing has already seen a significant increase in assets under management (EXHIBIT 1). In its 2014 biennial report on assets under management, US SIF, The Forum for Sustainable and Responsible Investment, identified $6.6 trillion invested in the

1 "Doing Well by Doing Good: Increasingly, Consumers Care About Social Responsibility, but Does Concern Convert to Consumption?" June 2014. The Nielsen Co.
2 "2015 U.S. Trust Insights on Wealth and Worth." 2015. U.S. Trust.
3 "Sustainable Signals: The Individual Investor Perspective." February 2015. Morgan Stanley Institute for Sustainable Investing.
4 "The Generation Gap and the 2012 Election." Nov. 3, 2011. Section 8: Domestic and Foreign Policy Views. Pew Research Center.
5 "Power of Purse Highlights Women's Wealth Leadership." Jan. 23, 2015. Morgan Stanley.
6 "The 'Greater' Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth." 2015. Accenture.

field in the United States, a 76% increase from its 2012 study. That's a big number, and it includes a wide range of approaches, some more comprehensive in their approach to sustainability than others, among mostly institutional investors. The same study showed a much smaller, yet growing, retail segment with just less than $2 trillion invested in various open-end, variable-annuity, exchange-traded, and closed-end funds. The size of that segment, however, more than tripled between 2012 and 2014.[7]

Asset-management firms are showing more interest in sustainable investing. In April 2006, the United Nations-supported Principles for Responsible Investment, or PRI, was launched with 100 signatories, representing $6.5 trillion in assets under management, committing to incorporate ESG factors into their investment analysis and decision-making process, to be active owners engaging with companies about ESG issues, and to report publicly on their activities and progress. Nearly a decade later, the number of signatories is nearing 1,400, and assets under management are nearly $60 trillion (**EXHIBIT 2**). Signatories include many large institutional investors, investment managers, and investment service providers. Among the more than 900 investment managers are 11 of the 15 largest in the world, including BlackRock, Vanguard, JPMorgan, Goldman Sachs, PIMCO, and Franklin Templeton.

Challenges Remain

As it moves toward the investing mainstream, sustainable investing faces several challenges.

Definitional

What exactly is meant by sustainable investing? There are not only varying definitions and approaches, but investors have often been able to define it for themselves and then have asset managers customize portfolios to suit. This can work in the institutional and high-net-worth space, but raises the challenge of scalability in retail investing, where asset managers have to offer standardized, rather than customized, portfolios. That means the conventional asset managers wanting to get into the game will have to decide how to define sustainability.

Overcoming the definitional challenge requires sustainable investing to be defined in a reasonable, easily understood way that reduces the confusion that can derail a conversation from

7 "Report on US Sustainable, Responsible and Impact Investing Trends." 2014. The Forum for Sustainable and Responsible Investing.

What's in a Name?

While we refer to sustainable investing as an approach that incorporates environmental, social, and governance, or ESG, factors in an investment process, there are a number of other terms commonly used to describe the field: *socially conscious* (a term still used in Morningstar's database), *socially responsible*, *ethical*, *green*, and *impact*. The US SIF industry group calls itself "The Forum for Sustainable and Responsible Investment." An annual industry meeting is called "The Conference on Sustainable, Responsible, Impact Investing."

Investors have engaged these kinds of issues since the 1970s, when many faith-based institutions, colleges and universities, and foundations began to better align their investments with their missions. Commonly known as *socially responsible investing*, or SRI, this approach was largely concerned with screening out certain types of products or services that were inconsistent with the values of the investor. Tobacco, alcohol, and gambling were common exclusions from the portfolios of certain religious organizations, for example. Investors also frequently excluded firearms and military weapons manufacturers, and reflecting one of the key environmental concerns of the day, nuclear-power producers. The first retail SRI mutual funds used a similar approach.

Still in widespread use today, exclusionary screening is more investor-centric than outcome-oriented. It is also relatively easy for asset managers to use to address the needs of institutional and high-net-worth investors who want customized portfolios that align with their values. An asset manager can adapt many of its existing strategies by simply excluding companies based on a client's list of concerns and re-optimizing the portfolio. While this approach raised concerns that exclusionary screening would lead to inferior investment results, those concerns have proved to be largely unfounded.

Many 20th century SRI investors did not simply have screened portfolios. As active owners, they also engaged companies on broader issues of corporate social and environmental responsibility through proxy voting, filing shareholder resolutions, and importantly, direct engagement with management. Perhaps the most notable instance of active engagement occurred in the 1980s when investors pressured companies to stop doing business in South Africa as part of the broader anti-apartheid movement, but progress is more typically made in a lower-profile way through discussions with company management.

As more investors focused on engagement issues, these concerns increasingly found their way into evaluations of companies that, in turn, began to be used as part of the security-selection process. Rather than excluding companies based on objectionable product involvement in a traditional SRI portfolio, investors expanded their focus on how well companies were addressing the range of environmental, social, and governance issues that had often been the subject of corporate engagements, and these factors were increasingly seen as material to a firm's financial success.

What we are calling sustainable investing encompasses these broader ESG concerns in portfolios and while many traditional SRI-screened portfolios still exist, the field overall has become increasingly focused on the more comprehensive ESG approach.

Jon Hale

the onset and helps advisors and consultants move their conversations with clients forward.

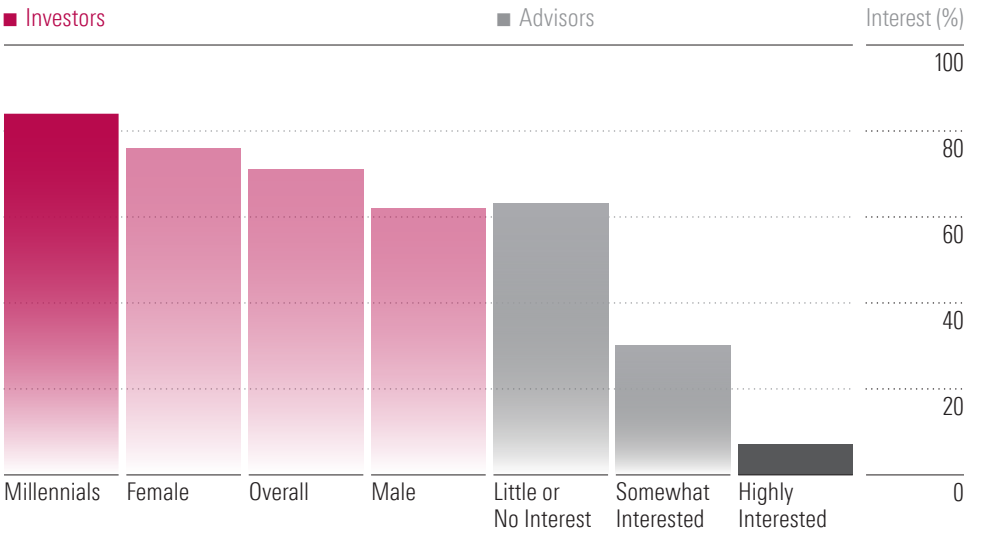
I propose the following basic definition:

Sustainable investing is an approach that takes into account environmental, social, and governance factors and their impact throughout the investment process.

Beyond that, the specifics will vary, just as they do for any investment approach. Value strategies, for example, share the basic goal of investing in undervalued companies, but employ many different approaches to do that. Some sustainable investment strategies may focus on a best-in-class approach by industry. Others may emphasize metrics such as carbon footprint or focus on positive product impacts. Some asset managers may be active owners who publish proxy voting guidelines, pursue shareholder resolutions, and engage directly with companies on ESG issues.

EXHIBIT 3

Different Interests A high percentage of millennials and women say they are interested in ESG investing. Financial advisors? Not so much.



Sources: Morgan Stanley Institute for Sustainable Investing, Cerulli Associates.

Regardless of the specifics, when the would-be sustainable investor walks through an advisor's door, most often with only an inchoate notion of what sustainable investing actually means in practice, the above definition provides a common basis to move forward.

Performance

Performance is a perennial challenge. What should be the performance expectations of sustainable investors? There are theoretical reasons why sustainable investing might be expected to underperform conventional investing. Limiting one's investable universe for nonfinancial reasons can result in outperforming stocks being left out of a portfolio and, in any event, tracking error relative to benchmarks. There is also the argument that stocks that are shunned by investors for whatever reason exact a premium and, therefore, are expected to outperform.

In practice, however, there is little evidence indicating a performance penalty for sustainable investing, particularly among mutual funds. It is also possible that sustainable investing can lead to outperformance because the consideration of ESG issues can point analysts to material issues that may not surface in traditional financial analysis. If anything, the weight of existing research suggests that there is not a performance penalty for sustainable investing and that there may be a performance advantage.

In the final analysis, there are so many possible ways to address sustainability in the investment context that performance ultimately comes down to execution. Some managers will be better at it than others, pure and simple.

Information

Before sustainable investing can enter the mainstream, information and analysis of sustainable investments have to become more readily accessible to advisors and investors. We've seen large firms such as Merrill Lynch, Morgan Stanley, and UBS starting to rectify this problem by creating sustainable-investing platforms for their advisors.

While firms like Sustainalytics are in the business of providing company-level ESG ratings and analysis, their information flows primarily to asset managers to assist them with incorporating ESG factors in their strategies. Very little of this company-level ESG information reaches advisors or everyday investors.

At the portfolio level, there is even less information on how the holdings in a fund stack up on various sustainability criteria. This is the main reason why Morningstar is working on portfolio sustainability scores using data from Sustainalytics. (See our interview with Sustainalytics' CEO Michael Jantzi on Page 44.) These scores, due out in 2016, will give advisors and investors the ability to compare funds based on how well their holdings are handling ESG risks and opportunities. They will allow investors to compare conventional funds with self-identified sustainable funds, as well as to choose funds based on whatever level of sustainability score they desire. The portfolio sustainability scores will help advisors and plan consultants evaluate funds as well as client portfolios and plan lineups.

Supply and Demand

Despite the widespread and growing interest in sustainable investing, the supply of viable strategies in the retail space is relatively limited. Even among the institutional and high-net-worth investors who dominate the space today, options are lacking for truly integrated ESG strategies and for targeted high-impact investments in areas such as private equity and infrastructure. The number of retail mutual

funds tagged in Morningstar databases as socially responsive stands at 175 in the United States and 1,797 globally. Many of these funds are older, more-traditional SRI funds that use exclusionary screening. Not surprisingly, there have been a number of new fund launches in the space in 2015.

Despite these recent gains, however, it remains difficult for practitioners to put together client portfolios that include sustainable options in all parts of the asset allocation. It is also hard for fiduciaries to recommend sustainable investment options that don't have sufficient—and successful—track records. Perhaps these challenges help explain the lack of interest in ESG of financial advisors (**EXHIBIT 3**).

As a result of these difficulties, client demand may not be met with a portfolio entirely consisting of sustainable investment options. In those cases, the Morningstar sustainability scores will help meet the demand by allowing investors to evaluate conventional funds' portfolios on the basis of sustainability criteria and plugging them in alongside more-intentional sustainable strategies to form a sustainable portfolio for the client.

Jury Is Still Out

These challenges, in the end, are not insurmountable, but they show that while sustainable investing may be poised to enter the mainstream, its success is not guaranteed. At the same time, given the demographic trends favoring sustainable investing, investment professionals today have strong incentive to meet that demand as they transition their book to be younger and more female-oriented. Sustainable investing offers advisors a way to add value not just in terms of performance but in terms of aligning client portfolios with a desire to support the transition to a sustainable global economy. This, in turn, ties investors more closely to their investments, making it more likely that they will stay the course for the long run. MI

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ESG Strategies Perform Well

More and more academic and industry studies are demonstrating that sustainable investing does not underperform conventional investing, and there is mounting evidence that incorporating environmental, social, and governance factors can have a positive impact on performance.

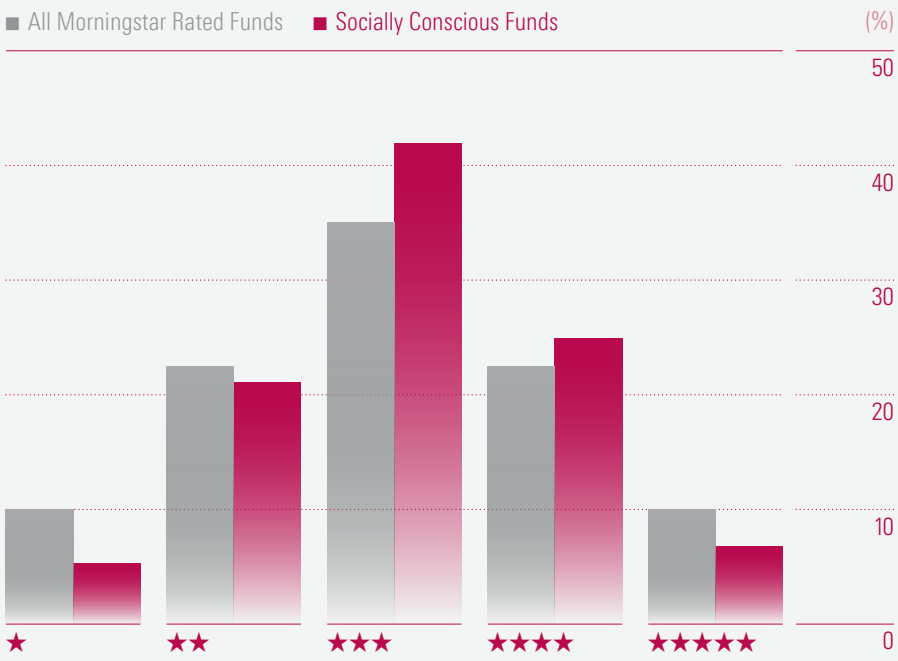
In 2014, researchers at Oxford analyzed nearly 200 studies, reports, and articles on sustainability and found that at the firm level:[1]

- 90% of the studies on the cost of capital show that sound sustainability standards lower the cost of capital of companies.
- 88% of the research shows that solid ESG practices result in better operational performance of firms.
- 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices.

A Morgan Stanley study of U.S.-based mutual funds and separately managed accounts, using Morningstar data, concluded that sustainable investments usually met and often exceeded the performance of comparable traditional investments on both an absolute and risk-adjusted basis.[2]

As of September, there were 1,797 funds in Morningstar's database tagged as "socially conscious." Using the Morningstar Rating for funds as a measure of risk-adjusted return relative to investment category, we see in the chart below that socially conscious funds have a positive tilt relative to the overall universe of funds.

Jon Hale



Source: Morningstar. Data as of 09/30/2015.

1 Clark, Gordon, Andreas Feiner, and Michael Viehs. 2014."How Sustainability Can Drive Financial Outperformance."
2 "Sustainable Reality: Understand Performance of Sustainable Investment Strategies." March 2015. Morgan Stanley Institute for Sustainable Investing.

ESG Thrives in Europe

Continent's institutional investors lead way in making offerings sustainable.

ESG

San Lie

Europe has a large head start over the United States in ESG investing (EXHIBIT 1). According to the 2014 Global Sustainable Investment Review, 58.8% of European invested assets already are invested in a sustainable way, compared to 31.3% in Canada and 17.9% in the United States (EXHIBIT 2).

One of the reasons Europe is leading the way is the fact that European institutional investors see sustainable investing as part of their fiduciary responsibility. A recent example is the Dutch civil service pension fund, ABP, which has about EUR 350 billion in assets and is one of the largest pension funds in the world. Already perceived in the market as one of the front-runners in sustainable investing, ABP announced in October a radical change to its investment policy. In response to members, ABP said it will target sustainable and socially responsible investments. It also now has a number of concrete objectives, including cutting 25% of carbon-dioxide-related investments from its equity portfolio by 2020. Also, investments that contribute to a better and cleaner future are to be doubled from EUR 29 billion to EUR 58 billion by 2020.

Private banks and wealth managers are also in the process of making their offerings more sustainable. Rabobank, for example, decided years ago to limit its offerings to funds that have signed the United Nations Principles for Responsible Investment, have included the UN Global Compact principles in their investment processes, and have developed a policy regarding controversial weapons.

Of course, Europe is not a homogeneous market. Some notable differences and variations in ESG practices can be spotted between different European countries. According to Eurosif, the pan-European sustainable and responsible investment membership organization, the French ESG market is traditionally defined by combining "best-in-class" and "sustainability-themed" strategies. In the United Kingdom, the most practiced strategy is "engagement and voting." In the Netherlands, "exclusions" is the most popular strategy, followed by "norms-based screening" and engagement and voting. The latest trend in most European markets is growth of "impact investing" vehicles.

European governments play a large role, too. In France, public authorities are creating an SRI label for funds applying ESG criteria. In the Netherlands, the government published the Pension Governance Code in September 2013. It gives guidance to pension funds on ESG themes such as transparency, accountability and communication, financial control, diversity, and good governance. The code also requires pension funds to define a "responsible investment" strategy and make it available for stakeholders.

What the United States and European countries have in common, however, is weakness in the retail ESG market. This may be due to the lack of clear definitions, or the view that ESG comes with a performance penalty. This perception should change over time. Academic and industry studies are demonstrating that sustainable investing does not underperform conventional investing, and there is mounting evidence that incorporating ESG factors in an investment process has a positive impact on performance. MI

San Lie is director of manager research, Benelux with Morningstar's EMEA fund research team.

EXHIBIT 1

ESG Assets by Region Europe has twice as many assets in sustainable investments as does the United States. The world total in 2014 was $21.4 trillion, up from $13.3 trillion in 2012.

Region	($ Billion)
Europe	13,608
United States	6,572
Canada	945
Australia/New Zealand	180
Asia	53
Total	21,358

Source: 2014 Global Sustainable Investment Review

EXHIBIT 2

Growth in All Regions The proportion of professionally managed assets devoted to sustainable investments has increased to 30.2% globally.

Proportion of Sustainable Investments Relative to Total Managed Assets

Region	2012 (%)	2014 (%)
Europe	49.0	58.8
Canada	20.2	31.3
United States	11.2	17.9
Australia	12.5	16.6
Asia	0.6	0.8
Global	21.5	30.2

Source: 2014 Global Sustainable Investment Review

Sustaining Success

ESG is a win-win for companies and shareholders, Michael Jantzi says.

SUSTAINALYTICS

Jon Hale

Sustainalytics has provided the global investment community with research and analysis on companies' sustainability performance for more than 20 years. Now commonly called ESG, for environmental, social, and governance, a confluence of factors in the market and corporate world is making this investing theme a mainstream approach. Beginning in 2016, Morningstar will rate the portfolios of mutual funds and exchange-traded funds on environmental, social, and governance factors. Morningstar will base the scores on ESG company ratings from Sustainalytics. The founder and CEO of Sustainalytics, Michael Jantzi, has seen firsthand the development of ESG investing over the past two decades. He has a deep understanding of its history and the roles companies and investors are playing in this burgeoning area of the investment universe. I sat down with Jantzi in October to discuss the state of sustainable investing and what the future holds.

You hear a lot of terms batted around these days describing sustainable investing. How does Michael Jantzi define it?

Michael Jantzi: Sustainable investing is about the discipline of integrating environmental, social, and governance themes or indicators into an investment decision-making process.

There are a variety of reasons that practitioners are going to undertake that sustainable investment process or that integration, and they're not mutually exclusive of one another.

There may be those who are considering ESG factors because they feel it's a part of their fiduciary duty in today's complex investing world. They're looking at environmental and social issues to evaluate risks and opportunities that might otherwise be missed. In other words, they're doing it to have a more informed investment decision with the expectation that it leads to a positive contribution to longer-term shareholder value.

There are other investors who approach sustainable investing through a values lens—while not necessarily committing to an investment mandate, these investors are considering companies that are doing a better job with regard to their environmental and social footprints and integrating these considerations into the investment process. There are other investors that hold a combination of those objectives. But to me, sustainable investing is about the discipline itself and the integration of those things into an investment process or philosophy.

You've been at this a long time. How did this idea of sustainability first occur to you as something you'd end up spending your career doing?

Jantzi: It occurred to me very early in my career. In fact, in Canada, I was in the process of writing my exams, heading down to be licensed by the Interior Securities Commission, and where that would have led me, I don't know.

But I heard a radio interview that focused on some U.S. pioneers in this space that were starting to look at environmental and social issues as part of the investment process. That was like a light bulb going on for me. It brought together my personal interest in environmental and social issues with my passion for capital markets and business. It made a lot of sense to me that if we are going to influence corporate behavior, we could do it through capital markets and directing capital in particular ways. And then it didn't take me long even 25 or 30 years ago to uncover research that was hinting at the fact that by investing money in that way, you could generate positive shareholder returns over the long term.

For me, it was a no-brainer. You could have your cake and eat it, too. Why wouldn't we look at social and environmental issues if it could have a positive impact more broadly and also for shareholders? So, that's what drove me in this direction.

When you think back on the 1990s, some investors were starting to think about sustainability issues, but not that many companies were. Today, we see many more companies addressing sustainability. Why is that? How did that all happen?

Jantzi: You're absolutely right that when I started in this in 1990, there were very few companies talking about sustainability or thinking about it, and certainly not many at all that would actually publish reports or disclose what they were doing in the area. I think it's safe to say that it was the capital markets—investors both retail and institutional that brought these issues to the corporate agenda.

They were brought to that agenda in two ways. In some instances, it was values-based—you shouldn't be doing business in South Africa because of the apartheid regime. But increasingly it became business-oriented—you need to pay attention to how you are managing the risks that seem to be central to your business.

For a long time, it seemed that investors and other stakeholders were dragging companies into the discussion. That's changed wholeheartedly now. Boards of directors and senior management teams are looking at sustainability in a much more sophisticated way now and in fact, in some parts of the world, are bringing investors into the discussion.

For example, in Asia, where we see capital markets lagging behind on sustainability issues, we see some very strong corporate sustainability

reporting, especially out of Japan, that is helping put these issues on both the government and corporate agenda.

We're also seeing today corporate and capital markets working together to address some common challenges, like excessive short-term thinking in markets. For companies or investors, the longer time frame you have, the more likely it is that you'll be identifying ESG risks or opportunities that you need to take account of.

shifts driving this. Especially in the retail high-net-worth market, there's no question that with younger demographics, with women becoming more focused on their financial futures, and so on, we've seen a shift here. We've seen that plan participants and pension funds, as well as individuals, are beginning to understand that the decisions they make on the investing side are important not just from a financial standpoint, but they can have a positive impact on the broader world as well.

social, and governance policies and less to do with actual performance metrics. Is that a fair criticism? Does having these policies and procedures in place indicate something more than just a check the box to get a better sustainability score mentality on the part of the company?

Jantzi: I think it's a fair critique in some ways. But I think that looking at policies, programs, and how certain environmental, social, governance risks are being managed is underappreciated. These disclosures are indicative of actual practices and resulting outcomes. Maybe the starting point is that oftentimes a critique like that is underpinned by a mistaken belief that traditional financial analysis is all science and no art. That simply is not true either.

Generally our approach to ESG analysis and providing insights starts with the idea that any company faces a variety of ESG risks and opportunities. We understand these are going to differ by industry and by sector. But what are those key ESG issues that companies face? Do the companies understand those issues? If so, to what extent? And if there are ESG risks there that we believe can be material to their business, of course we need to understand how those risks are being managed.

> It was a no-brainer. You could have your cake and eat it, too. Why wouldn't we look at social and environmental issues if it could have a positive impact more broadly and also for shareholders?
>
> **Michael Jantzi**

So, it's quite exciting how corporations have come up the learning curve, but it's even more exciting to me to see how capital markets and companies are working together.

There appear to be a number of factors in place today that are increasing demands on asset managers to pay more attention to integrating ESG factors, namely shifting demographics to a younger generation of investment decision-makers who have a greater affinity for sustainable investing. The same goes for women. Public policy in some places is also a driver. What are your thoughts on this idea that sustainability is becoming a more mainstream investment theme?

Jantzi: There's no question that the mainstreaming of responsible investment is real, and it's probably something that you can date back to the mid-2000s with the formation of the U.N.-backed Principles for Responsible Investment. I think you've highlighted one of the key drivers of the mainstreaming. We've seen demographic

I think another driver, though, is the understanding that environmental issues and social issues are not just values issues, that these are and can be material risks and opportunities for a business. So, quite apart from what the market demand might be telling them, again it's this idea that—wow, we're living in a much more complex world, and I am charged, as a portfolio manager, to come to a judgment and make a decision in an increasingly uncertain world and that by looking at ESG datasets and insights, I can make more informed decisions. There are some very powerful forces, both from the market but also within the organizations themselves, that are heading towards that same end point, which is a mainstreaming of sustainability investing.

I've heard the criticism that a lot of the ESG indicators that Sustainalytics uses in its company ESG ratings have more to do with companies documenting and disclosing various environmental,

For us, looking at environmental management systems, looking at supply chain issues, looking at what level within the company those issues are managed, these are important indicators for us to understand not just whether the company understands these risks, but how seriously they're taking them, and then it gives us an indication of how they will manage these risks if they hit the radar in a real way. If we see a gap between the exposure to these issues and what we think is their ability to manage them, then yes, we think that's something investors need to know about.

Measuring performance is also a critical part of the equation. There are an increasing number of themes and indicators that we can quantify. They can be on the environmental side, so it can be looking at carbon output, or intensity. It can be on the human capital side of the equation, looking at key indicators like turnover, absenteeism—those types of things. That quantitative side is getting more sophisticated every year. But then

there also is the qualitative side of looking at performance and controversies. We not only look at the number of controversies occurring but also where they are happening within the organization, and how often they are happening, and how companies are managing those controversies.

So, really it's about taking that 360-degree view of a company and coming, at the end of the day, to our final call on whether it's well positioned to manage ESG-related risks. It's not just about checking a box.

Sustainalytics designates the top 5% in each industry as industry leaders. What is it that companies are doing today to make themselves sustainability leaders?

Jantzi: The first thing to understand is there's no single definition. As I've alluded to, companies in different sectors and in different industries face different challenges and have different opportunities, so leadership varies differs by sector. But generally speaking, a leader is going beyond putting that environmental management system or auditing procedure in place. It's going beyond just being transparent and disclosing what it's doing on the sustainability front. It's taking ESG to the strategic level and saying this is helping us uncover risks that have the ability to blindside the business; it's helping us stay ahead of the curve.

But more important is the opportunity side of the equation. Is sustainability being used to drive business innovation or product development? Is it being used to drive competitive differentiation, whether that's on the branding side or the human capital side. If you're in an industry that relies on the best and the brightest, you want to make sure that you're attracting the best and the brightest from the widest possible talent pool. You want to know that vis-à-vis your competitors, you're bringing people in and providing them career development opportunities. That's what leaders are doing. They're integrating the ESG indicators we look at into their strategic and operational decision-making. That's really what separates the leaders from those that are considering ESG factors at a more basic level.

I've heard you use the roadmap versus GPS analogy that I thought was insightful.

Jantzi: There's no one set course on how to become a leader, even within the same sector. I'm an old-fashioned guy. I like holding a roadmap in my hand. GPS is nice, but it gives you the illusion that there's only one way to your destination. You do this, that and this, and it's very easy to follow. But when you look at a map, you understand that there are a variety of ways that you can get to your destination, and there may be trade-offs along the way, and I think that's what sustainability is about. You need to find a way, from a corporate perspective, that fits your culture, that fits your competitive positioning, that fits your broader industry plans. It's really about integrating ESG considerations into your business decision-making that provides you the advantages that you need and hopefully then helps you identify and avoid potential risks down the road.

What about the global picture? Are there significant regional differences over how companies address ESG issues?

Jantzi: Broadly speaking, European companies are ahead of North American and Asian companies. The regulatory environment in Europe has done a lot to spur the interest in sustainability. You can then ask, well, why have regulations been advanced in Europe? Probably because people living in a more dense environment have demanded it. But the reality is, from a product innovation standpoint, from a lifecycle standpoint, from a supply chain standpoint, European companies are ahead of the curve. But I think that the gap between Europe and North American companies is narrowing. The fact is that American companies are global in nature. They understand that as consumers become more attuned to these issues, they understand that as their supply chains or they themselves directly are operating in more challenging parts of the world, whether that's from a community relations standpoint, a human rights standpoint, or an environmental standpoint, that these are issues that they have to understand and manage. So, I think American companies, because they are global citizens, are impacted not just by what American government or American consumers are saying, but what their consumers are saying in other parts of the world.

And then when you go to Asia, there's a misunderstanding that sustainability issues are not on the agenda at all. That's simply not true. In some

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> **Michael Jantzi**

sectors, real estate for example, there's global leadership in Asia. You have some very progressive Asian real estate companies. You have strong sustainability reporters out of Japan.

Asia is not homogeneous. It's a collection of different cultures and we can't expect them to adopt a European or North American model of sustainability. Asia will find its own way forward on what sustainability means. I think what they'll do is take the best practices in Europe and North America and Australia and other parts of the world, adapt it for their own situations, and move forward accordingly.

What about smaller companies that don't have sustainability policies and practices in place because they don't have the resources or scale to do so? How should investors evaluate that?

Jantzi: It's a great point and an important theme for responsible investment going forward. I think the fact that we have focused on large caps is appropriate. They're the companies that are going to have the largest environmental and social footprint.

But small caps are obviously important for the investment community. Responsible investors and those of us who are charged with providing insights into company performance need to continue to find effective ways to measure how smaller companies are doing.

It's not fair to compare a small-cap company to a large cap. From a Sustainalytics perspective, we understand that and have developed an analytical framework that reflects that. By the same token, whether you're small or large, if you're operating in a high-exposure industry, you want to know that management understands the risks that may be coming down the pike. Those risks may not be there at this particular moment, but you want to understand whether that management team is looking ahead. For us, it's finding that balance between having lower expectations than you would for their larger-cap brethren, but still understanding that the same issues can be out there lurking.

And then it's part educational process on our part to say to smaller companies—you need to think about putting management structures in place, even though at this point your exposure may be several levels below what you're seeing for your larger-cap competitors.

Let's talk more specifically about the big question of whether sustainability creates shareholder value. What's the evidence for that from your perspective?

Jantzi: First of all, that's a question that will never be settled. I think, though, that there's been a very important shift. When I started in this business, the idea was, if you want to look at ESG issues as part of your investment decision, God bless. Good for you. Just as long as you understand that achieving a competitive financial return is on absolutely the other end of the spectrum. Today, there is a much better understanding that they're not on opposite ends of the spectrum. Actually, these two themes are sitting side by side. In fact, increasingly, the mainstream understands that they're dependent upon one another.

Two and a half decades ago, people would say it's against your fiduciary duty as a portfolio manager or an investment professional to look at anything but the bottom line. Today, that's flipped on its head. If you're not looking at ESG issues as part of the investment process, you may be transgressing your fiduciary duty.

So, the debate is still out there. But there's an overwhelming amount of evidence that's showing a positive correlation between sustainability and shareholder value. The burden of proof is now on those who think these issues are not important to prove to us why they're not. That's a huge shift.

Looking ahead, what are some of the challenges surrounding sustainability and what issues will characterize the field, do you think, in the next decade?

Jantzi: We're going to continue to see growth globally. We're going to start to see sustainable investing extending beyond traditional equity and fixed-income asset classes. We're already seeing ESG being embraced in areas like private equity, real estate, and infrastructure.

We'll see continued growth on the institutional side. Sovereign wealth pension funds have long-term horizons that fit well with sustainability issues. On the retail side, we've talked about demographic changes and transfers of wealth. Individuals are looking for ways now to align their personal financial decisions with their values, and that's going to continue to drive retail demand.

What are the challenges going to be? We are living in a world that is more and more data-rich. We have overwhelming amounts of data coming at us from every direction every single second. So, the challenge for the field of ESG research will be to cut through that noise—that vast amount of information and data—to provide real insights to our clients. That's a challenge we've had for 25 years, and that's just going to be ratcheted up more as we move from being large-cap-focused to include smaller companies, as we include additional asset classes and other parts of the world.

One final question: 20 years ago, I recall a fairly dubious attitude toward corporate ESG practices on the part of sustainable investors. Is that mood more optimistic today?

Jantzi: Yes, it is more optimistic, because more companies are paying more serious attention to ESG issues. Fewer companies are treating sustainability as marketing or window-dressing and more are integrating these issues into their strategic decision making.

But let's step back for a moment and understand that we still have issues, like Volkswagen recently, that highlight the fact that no matter how good a job we're doing, there are still going to be instances out there where companies are not meeting the sustainability standards we expect from them. We're a long way from where we need to be, but certainly we're heading in the right direction and have been for the past two decades. **M**

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