



The Future of Investing

Key Takeaways

- ▶ There are numerous studies and even meta studies documenting the long-term performance benefits of investing consistent with ESG principles.
- ▶ The emphasis of ESG has shifted from exclusionary screens to finding companies that will have a positive impact on future shareholder value.
- ▶ Despite steady growth in ESG assets, many investors remain skeptical of the benefits of a sustainable approach or misunderstand the drivers of ESG performance.

ESG Portfolios: Changing Beliefs, Perceptions and Goals

Investing consistent with environmental, social and governance (ESG) principles can no longer be dismissed as a short-term fad. Assets under management are growing steadily, accompanied by a rise in the number and type of investment options across asset classes. The negative consequences of ignoring ESG principles have become obvious, and certain large global consulting firms have even explicitly incorporated ESG into their investment belief statements. There are still those, however, who view ESG investing with deep skepticism. In this update, ClearBridge explores the evolving philosophy of ESG investing with an emphasis on how different investment organizations apply ESG principles. The perspectives captured here reflect online survey responses and telephone interviews with diverse sources, including asset owners, consultants, financial advisors and ESG experts.

"We are in the middle of a transition. Ten years from now people won't be having conversations about ESG as a separate discipline. ESG will be part of how one does business in the investment world."

- Jane Ambachtsheer, Mercer Investments

"We believe that ESG principles will be incorporated into almost all investments in the future. Looking back, I can see a time when my grandkids might say, 'You mean you knowingly invested in companies that were polluting or using sweatshop labor?'"

- Mark Callaway, The Indigo Group at Morgan Stanley

Comments like these indicate a dramatic change in investor attitudes toward ESG investing, an approach that currently captures more than \$1 of every \$5 in U.S. assets under management, which represents an increase of 40% since 2014.¹ ClearBridge

survey respondents indicate many reasons for the continued growth of investment strategies incorporating ESG.

Reasons for Rising Interest in ESG Strategies

There is greater evidence that ESG principles have a positive impact on long-term risk-adjusted returns. People have been investing this way and studying this approach to investing for decades now. There are numerous studies and even meta studies documenting the long-term performance benefits of investing consistent with ESG principles. One 2012 study² examined more than 100 studies of sustainable investing and found that high ESG ratings were correlated with lower cost of capital in 100% of the studies; with market-based outperformance in 89% of the studies; and with accounting-based outperformance in 85% of the studies. Another meta study concluded that of 36 performance studies, 20 found evidence of a positive relationship between ESG factors and financial performance and only three found evidence of a negative relationship.³ Says Jane Ambachtsheer, “There is still a big part of the investment community concerned that ESG will jeopardize returns. That concern is based on old information.” Many more investors now believe that a focus on ESG principles will contribute to what all investors seek to accomplish: superior, risk-

adjusted performance over the long term. Says Bruce Graham of CAPTRUST Financial Advisors, “I believe in ESG from an investment point of view as opposed to a change-the-world point of view.”

Implementation has evolved toward strategies focusing on positive attributes. The investment focus of ESG has moved far beyond its origins in the late 1800s, when this approach was primarily about avoiding “sin stocks” in portfolios held by religious organizations. ESG is no longer merely about passive avoidance of companies in industries such as tobacco or firearms (Exhibit 1). Instead, the emphasis is on finding companies with certain quality attributes – e.g., environmental and product safety, workforce diversity, employee retention and strong corporate governance – that will have a positive impact on future shareholder value (Exhibit 2). Through proxy voting and shareholder engagement, investment managers now also seek to improve ESG practices among companies being considered for investment. “The strongest portfolio managers addressing ESG principles may look like any traditional asset manager,” says Sarah Cleveland of Sarah Cleveland Consulting, “but they are intentional and systematic in their risk and opportunity assessments around ESG, and that’s what really matters.”

The number of high-quality ESG investment options is increasing within and across asset classes. ESG has grown not only in assets under management but also in the number of choices being offered. Consultants and financial advisors tell ClearBridge that there has been an explosion in new ESG-oriented investment strategies and vehicles – from index and smart beta funds and ETFs to ESG quant strategies and those offering different approaches to shareholder engagement. As a result, it is becoming easier to build an entire asset allocation consistent with ESG principles, including public and private equity, fixed income and alternative assets. The choices have increased both in number and in quality. Where financial advisors used to have to search for investment options, ESG investment managers are now actively targeting prospects. Increasingly, the world of ESG is coming to mirror the world of non-ESG, and this trend will only gain momentum based on demand from investors.

Demand is growing. More people want ESG in their portfolios and continued growth is likely to come from a number of different sources. University endowments are responding to student demands for fossil fuel divestment, and foundations are coming to see ESG as a way to extend their influence on issues that they care about. “In the past,” says Noelle Laing with Cambridge Associates, “few endowments were talking

Exhibit 1: Growth of Assets in Negative Attribute Strategies

Strategy	2014	2016	Growth
Norms-based screening	\$4,385	\$6,210	42%
Negative/exclusionary screening	\$12,046	\$15,023	25%

Source: 2016 Global Sustainable Investment Review. Figures are in billions. Norms-based screening is based on compliance with international norms and standards such as those issued by OECD, ILO, UN and UNICEF and may include exclusions or underweighting of investments not in compliance with norms or standards.

Exhibit 2: Growth of Assets in Positive Attribute Strategies

Strategy	2014	2016	Growth
Impact/community investing	\$101	\$248	146%
Sustainability themed investing	\$137	\$331	142%
Corporate engagement and shareholder action	\$5,919	\$8,365	41%
ESG integration	\$7,527	\$10,369	38%
Positive/best-in-class screening	\$890	\$1,030	16%

Source: 2016 Global Sustainable Investment Review. Figures are in billions.

about screening, ESG or impact investing. But now with an increased focus on climate change and its related risks, many institutions are discussing ESG and how they might integrate those factors into the management of their investment portfolios. Just during the past year, we have seen more interest in ESG than ever before.” Says Eric White of Cogent Consulting⁴, “After grant making was constrained due to the financial crisis, foundations started seeing ESG investing as another way to broaden total impact.” In addition to extending impact, ESG investing may prevent the inevitable public outrage when an organization invests in ways that explicitly contravene its mission.

People, especially Millennials, want to invest the way they live. The logic behind this source of demand is blazingly simple. If you strive not to waste water and energy at home, you likely want to invest in companies that are finding new ways to conserve resources. If you boycott the products of known polluters at your local supermarket, you are unlikely to endorse their presence in your portfolio. Several of those interviewed told us that trends in consumer behavior extending to investor behavior are particularly acute among Millennials, who stand to inherit \$59 trillion by 2060.⁵ Says Justin Rockefeller, a trustee of the Rockefeller Brothers Fund and Cofounder of The Impact, “you also are seeing ESG awareness in the employment choices made by younger people. They are much less likely to continue to work for a company over many years if that company has, for example, a deleterious effect on the environment or is poorly run with no women on the board.” The \$880 million Rockefeller Brothers Fund committed to ESG several years ago with a mandate to invest in companies and funds that are aligned with its program work. In September 2014, the foundation announced its decision to divest from fossil fuels and increase its investment in alternative energy sources. “On the program side of the foundation,” says Mr. Rockefeller,

“we are funding work on climate change, so we do not want to be hypocritical. We also want to amplify the impact of our program work.”

Investors are embracing a broader definition of fiduciary duty. Investing in companies that apply ESG best practices increasingly is seen as part of an expanded definition of what it means to be a fiduciary. Many of those interviewed by ClearBridge now view fiduciary responsibility with a significantly longer time horizon, as opposed to the standard one-, three- and five-year industry metrics. This new interpretation of fiduciary duty partially reflects a growing understanding of the negative effects of short-termism – the maximize-returns-in-the-short-term-at-any-cost mindset that still prevails in many boardrooms, especially in the U.S. As a result, the U.S. commitment to ESG strategies, while large in absolute terms, is small in relation to the commitments being made in Europe and Canada (Exhibit 3).

Why Some Investors Are Still Skeptical

Some believe that ESG limits the universe of investments and potential performance opportunities. Many U.S. institutional investors still see ESG as some form of constraint on the ability to pursue returns, and there is some limited truth to this view. If you are invested in an ESG portfolio that is underweight energy at a time when energy stocks outperform, you might underperform due to this sector underweight – just as you will outperform when energy stocks perform poorly. Says Craig Metrick of Cornerstone Capital Group⁶, “ESG investing can result in sector or style biases that will cause ESG strategies to outperform or underperform in a given time period, but over the long term we expect tilts toward sustainability and governance will pay off.” Yet the belief persists that ESG constrains performance. Says a consultant who has focused on ESG for the past decade, “there is some kind of mental block. The broad Principles for Responsible Investment say nothing about screening or prohibiting

A Note about Terminology

There are many different ways to describe strategies for investing consistent with environmental, social and governance best practices. These include “sustainable investing,” “socially responsible investing” and more recently “impact investing,” among others. The term “ESG” represents the latest stage in the evolution away from merely screening out certain industries or companies. ClearBridge ESG portfolios do not simply avoid certain industries; we integrate industry-specific ESG factors into our fundamental research process for the entire

firm and favor companies that promote best practices on environmental, social and corporate governance issues. Starting in 2014, all companies considered for investment across the platform were given an ESG rating, to be updated annually, and only companies rated “A” or better can be included in the ESG portfolios. We also work actively with companies seeking to improve their ESG performance through direct engagement and proxy voting. In addition, ClearBridge can build custom portfolios based on specific client mandates.

Exhibit 3: Where ESG Is Gaining Momentum – Relative Proportion of ESG Assets in Total AUM By Region



Source: 2016 Global Sustainable Investment Review.

investments, yet the initial reaction from many U.S. institutional investors is, ‘Well, this is just like tobacco or other sector screening and we know that limiting our universe will cause us to lose money.’ The evidence really does not support either assumption.”

The market sometimes misunderstands ESG performance drivers. Public equity portfolios managed consistent with ESG principles can underperform precisely because they are filled with high-quality growth companies. Explains Noelle Laing, “ESG factors tend to correlate to quality – stable earnings, quality management teams, lower debt – while the opposite of quality tends to be favored in a risk-on environment. I am less concerned when ESG managers underperform in such an environment. It is a near-term phenomenon, and many of these higher-quality managers have provided investors with protection on the downside.”

While growing, the universe of ESG managers remains small and undiversified relative to the universe of non-ESG managers. It may be getting easier to build an entire ESG portfolio diversified across asset classes. But it’s still not easy. And while the choice of investments may not be limited, the choice of institutional-quality investment managers with an established track record still is limited in relative terms. While ESG is definitely growing in terms of the number, type and quality of choices, there still is a broader manager opportunity set outside of ESG, particularly in certain asset classes. This makes it challenging to build a portfolio that is 100% consistent with ESG principles.

Implementation in a total portfolio context can be difficult. Depending on the goals of the organization, ESG implementation can occur across the entire portfolio or selectively as opportunities arise in certain asset classes. One financial advisor who

recommends ESG told us that his clients “are looking at ESG strategies in different asset classes when a search comes up.” In addition to the relative scarcity of quality managers noted above, another brake on total portfolio implementation may be the view that ESG is an asset class as opposed to a way of investing across asset classes. As recently as 2012, a study of 1,065 financial advisors found that 41% viewed sustainable investments or ESG strategies as a new asset class while 44% saw such strategies as being applicable to the entire portfolio.⁷ Even investors who want to apply ESG across the portfolio have yet to do so owing to a scarcity of ESG managers in asset classes such as international, emerging markets, small cap and alternatives.

Many investors still want more proof. While evidence is strong that ESG can pay off at the company or security level, the benefits are more difficult to prove at the portfolio level where returns are heavily influenced by a key variable that affects returns in any portfolio: manager skill. Lauryn Agnew of Seal Cove Financial, who serves on several boards and investment committees, including for a \$3.5 billion public pension plan and several nonprofits, summarizes the situation this way: “There is growing interest, but 80% of investors in the U.S. are still hell bent on getting the highest returns regardless of how they are achieved. They are still skeptical, believing that ESG somehow hurts performance, and they are just going to need more proof.” Those who remain on the fence specifically want more proof that ESG leads to opportunity as opposed to merely preventing risk. Even card-carrying proponents of ESG, we learned, sometimes view it primarily as a risk mitigation tool (no fines, lawsuits or negative press for polluting) as opposed to a source of opportunity (new companies and technologies that prevent pollution).

What ClearBridge Believes and How We Invest

ClearBridge believes that ESG is the future of investing and that someday it won't even be called "ESG" or designated as a separate discipline; it will become an integral part of the way investors analyze companies. At ClearBridge, ESG is not merely a screen or an overlay; it is part of how we conduct fundamental research and it defines how we think about all companies considered for investment in all client portfolios. Our clients, whether or not they desire

a portfolio explicitly labeled "ESG," are all responsible for investment goals – growing pensions, funding grants or delivering retirement income – to be achieved far into the future. They deserve to invest in companies that plan carefully for what's ahead, companies that care about the environment, their employees, their customers and their community. We believe such companies are most likely to provide the kind of performance our clients need to meet their long-term goals.

1 The Forum for Sustainable and Responsible Investment 2016 Report on US Sustainable, Responsible and Impact Investing Trends. The report indicates that \$9.21 trillion, or one in every five dollars (22.8%) in U.S. assets under management, is invested in sustainable, responsible and impact investment strategies.

2 "Sustainable Investing: Establishing Long-Term Value and Performance," Deutsche Bank Group, June 2012.

3 "Shedding Light on Responsible Investment: Approaches, Returns and Impacts," Mercer, November 2009. Of the 36 studies reviewed by Mercer, 20 showed evidence of a positive relationship between ESG factors and financial performance, two showed evidence of a neutral-positive relationship, three showed evidence of a negative-neutral relationship, eight of a neutral relationship and three of a negative relationship.

4 When interviewed for this article, Eric White was with Slocum.

5 "A Golden Age of Philanthropy Still Beckons: National Wealth Transfer and Potential for Philanthropy," Boston College Center on Wealth and Philanthropy, May 2014.

6 When interviewed for this article, Craig Metrick was with Mercer Investments.

7 Industry Survey of Financial Advisors on Sustainable and Impact Investing," Gateways to Impact, June 2012.

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