Sustainable Investing

Lisa Schneider, CFA, Head of Non-Profit & Healthcare
Important Information

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Indexes/benchmarks are unmanaged and cannot be invested in directly. Past performance is not indicative of future results

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Discussion topics

› Trends in Sustainable Investing
› Russell Investments’ Approach
› Appendix
Commonly used Terminology

- **Sustainable Investing**: A broad spectrum of investments and strategies that hope to generate both financial return and non-financial returns.

- **ESG Integration**: Integration of ESG (environmental, social and governance) factors in selection of investments. ESG factors are a subset of non-financial performance indicators.

- **SRI: Socially responsible investing**: Term that generally describes screening of investments in the portfolio. Screening can either be positive (inclusionary) or negative (exclusionary). NB. Some now define the “S” as “Sustainable” not “Socially”.

- **MRI: Mission Related Investing**: Investments that directly align with the mission and social beliefs of the organization.

- **Engagement**: Direct involvement between one group and another. Such that, shareholder engagement is between an owner of the stock and the company’s management.

- **Impact Investing**: Targeted investments in companies, organizations and funds with the intention to generate measurable social and environmental impact alongside financial return.

- **Others…..**: The list goes on…double bottom line, triple bottom line, green investing, economically targeted investing.
Which is the right approach?

It depends! - on where you sit on the *value* vs. *values* spectrum

<table>
<thead>
<tr>
<th>VALUE</th>
<th>VALUES</th>
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<tbody>
<tr>
<td><strong>ESG integration</strong></td>
<td><strong>Exclusionary screening</strong></td>
</tr>
<tr>
<td>- Sustainable financial value</td>
<td>- End-investor has values beyond only financial goals</td>
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<tr>
<td>- Increasingly mainstream</td>
<td>- Often leads to security exclusion</td>
</tr>
<tr>
<td>- Aligns with fiduciary role</td>
<td>- Pooled fund challenges</td>
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<tr>
<td>- Internalise economic</td>
<td></td>
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<tr>
<td>externalities</td>
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What are key drivers of growth

› Performance impact
  › Increasing number of studies showing that many forms of Sustainable Investing are not prohibitive to performance. And may, indeed, drive better performance (i.e. good stock picking leads naturally to high ESG criteria)

› Religious beliefs, for example:
  › Jewish Faith – Israel
  › Baptists – Alcohol, Tobacco

› Social “Pressures”/norms, for example:
  › Climate Change
  › 350.org
  › General views on what is “best” for the world.

› Significant regulatory influences
  › 2014 Ontario Canada Parliament ruled that by 2016 all pension plans need to include information in IPS on how ESG factors considered
  › U.S. DOL October 2015 bulletin clarifying pension fund fiduciaries may consider ESG factors
  › November 2015 COP21 Paris Climate Change Conference, Financial Stability Board announced formation of Task Force on Climate-related financial risks. Expect to see more investors looking at carbon footprint
Global trends

United States – “Sustainable Investing” - ESG integration, fossil fuel divestment, much discussion still on governance and fiduciary liability. Segmentation based on type of organization (e.g. religious organizations and screening)

Europe – “Responsible Investing” - climate change, responsible investing, ESG integration, ex-weapons

Australia/NZ – “Responsible Investing” – significant attention to climate change, fossil fuels, growth in ESG integration, screening of portfolios (ex-tobacco popular)
Why do some investors take ESG issues into consideration in their investment analysis/decisions?

To help manage investment risks
Clients/investors demand it
ESG performance is a proxy for management quality
It's my fiduciary duty
My firm derives reputational benefit
Regulation requires it
Other

SOURCE: CFA Institute survey, June 2015

The survey had 1,325 “valid” responses of CFA institute members that are portfolio managers and research analysts
## What ESG issues are many investors valuing most?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Issue</th>
<th>Category</th>
</tr>
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<tbody>
<tr>
<td>78%</td>
<td>Board Accountability (G)</td>
<td></td>
</tr>
<tr>
<td>62%</td>
<td>Human Capital (S)</td>
<td></td>
</tr>
<tr>
<td>61%</td>
<td>Executive Compensation (G)</td>
<td></td>
</tr>
<tr>
<td>54%</td>
<td>Environmental Degradation (E)</td>
<td></td>
</tr>
<tr>
<td>52%</td>
<td>Resource Scarcity (E)</td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td>Demographic Trends (S)</td>
<td></td>
</tr>
<tr>
<td>47%</td>
<td>Supply Chain (S)</td>
<td></td>
</tr>
<tr>
<td>41%</td>
<td>Board Diversity (G)</td>
<td></td>
</tr>
<tr>
<td>40%</td>
<td>Climate Change (E)</td>
<td></td>
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</tbody>
</table>

**SOURCE:** CFA Institute survey, June 2015
Russell Investments’ Approach
Russell Investments’ five pillars of Sustainable Investing

- **Capital markets insights**
  - Research of indices and universes using third-party data

- **ESG integration in investment process**
  - Integration of ESG issues and considerations in investment process

- **Active ownership**
  - Commitment to best practices in ownership and alignment of interests

- **Thought leadership**
  - White papers and conference presentations

- **Industry collaboration**
  - Continual capability enhancement, in partnership with our clients and others
ESG issues – how material are they?
And what metrics are available?

For illustrative purposes only
Evaluating ESG characteristics of Russell Investments’ equity universes

- Active managers generally prefer higher ESG scoring stocks
  - This preference may be unintentional in many cases
  - Lower ESG scores may be consistent with other risks that are discovered in active security selection
  - Selecting active management is an easy way to increase ESG scores
  - ESG scores have tended to improve over time
    - Risks associated with poor ESG may be clearer than in the past
  - Intentionally boosting ESG score may introduce new risks
    - Sector exposures and factor exposures closely linked to ESG
  - ESG not about short term returns, but possibly long term value-add

Source: Russell Research. Leola Ross, Peiyuan Song, Will Pearce; Are ESG tilts consistent with value creation? July 2014
Incorporating ESG factors in manager research

- Manager’s approach to assessing the financial materiality of ESG issues
- Quality of manager’s process for identifying, researching and acting on ESG issues
- Nature of third party ESG information input to investment process, and effectiveness of its capture
- Support evaluation by review of manager’s voting policy on ESG issues and engagement activity
- Membership of any Sustainable/Responsible Investment initiatives (e.g. UN PRI)
- Subscribe to Sustainalytics’ ESG data since 2011
Investment approach to ESG considerations

A separate ESG category in manager research for ranking quality and competitive edge

**SCALE OF 1 to 5**

1. **Manager does not demonstrate awareness** of potential risks and return impacts of ESG issues on portfolio holdings
2. **Meaningful discrepancies** between target ESG guidelines and portfolio holdings
3. Manager’s perspective and analytical **inputs on ESG issues lack rigor**

4. **The manager demonstrates adequate awareness** of the potential risk and return impacts of ESG issues on individual holdings and the portfolio structure
5. **The manager's perspective and analytical inputs on ESG issues is undifferentiated** from peers.
6. **The manager demonstrates strong awareness** of the potential risk and return impacts of ESG issues on individual holdings and the portfolio structure.
7. **The manager can clearly demonstrate** how portfolio positioning reflects the management of relevant ESG risks and/or how ESG exposures can add value
8. **The breadth of perspective and analytical inputs on ESG issues are superior to peers.**
# Russell Investments’ commitment to industry initiatives

## Voluntary

<table>
<thead>
<tr>
<th>UN Principles for Responsible Investment (UNPRI)</th>
<th>Global Investor Statement on Climate Risk</th>
<th>Carbon Disclosure Project (CDP)</th>
<th>Investors Group on Climate Change (IGCC)</th>
<th>Responsible Investment Academy (RIA)</th>
<th>Tomorrow’s Company</th>
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<tbody>
<tr>
<td>2011</td>
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## Regulatory

<table>
<thead>
<tr>
<th>UK &amp; Japan Stewardship Code</th>
<th>Dutch Regulation Exclusion Controversial Weapons</th>
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<tbody>
<tr>
<td>2010 - Survey 2011 - Survey</td>
<td>Effective 1 Jan 2013</td>
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<tr>
<td>2010</td>
<td>2011</td>
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<td>2012</td>
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**SOURCE:** Russell May 2016
Summary

› Russell Investments is strongly committed to sustainable investment, supported by UN PRI signatory status

› Many clients have growing ESG integration requirements
  › Client perspectives vary by country, and are evolving
  › Regulation is encroaching
  › ESG integration is becoming mainstream

› Russell Investments is well-positioned to address these requirements, and to contribute thought leadership
Thought Leadership

- Tamera Larsen; It’s not personal, it’s business (May 2016)
- Manisha Kathuria; Energy Sustainability: Trends, investment opportunities and risks in sustainable energy (December 2015)
- Heather Myers, Manisha Kathuria; Evolution of Sustainable/Responsible Investing (January 2016)
- Leola Ross, Peiyuan Song, Will Pearce; Are ESG tilts consistent with value creation? (July 2014)
- Heather Myers, Manisha Kathuria; Governance considerations for sustainable investing (June 2014)
- Manisha Kathuria, Steve Murray; Mission-related Investing for Non-profits (July 2013)
- Will Pearce, Mike Clark; Integrating Environmental, Social and Governance issues (January 2011)
- Tamara Larsen; Themes on ESG Current Practice: US and Pan-European core real estate open-end fund managers (May 2010)
- Greg Liddell; Climate Change: From Kyoto to Copenhagen (November 2009)
- Bob Collie, Heather Myers; Responsible Investment: Five tests of an SRI/ESG Policy (August 2008)
Industry resources

- The Association for the Advancement of Sustainability in Higher Education (www.aashe.org/)
- PRI: Principles for Responsible Investment (www.unpri.org)
- USSIF: The Forum for Sustainable and Responsible Investment (www.ussif.org)
- GIIN: Global Impact Investing Network (www.thegiin.org)
- Mission Investors Exchange (www.missioninvestors.org)
- Initiative for Responsible Investing (http://hausercenter.org/iri/)
- Interfaith Center on Corporate Responsibility (www.iccr.org/)
- FSInsights (www.fsinsights.org)
- TruCost (www.trucost.com/)
- Ceres (www.ceres.org)
- Carbon Disclosure project (www.cdp.net/)
- United Nations Global Compact (www.unglobalcompact.org)
- Tellus Institute (www.tellus.org/)
- Global Investor Statement on Climate Risk (http://investorsonclimatechange.org/)
- Montreal Pledge (http://montrealpledge.org/)
- Stranded Assets Programme (http://www.smithschool.ox.ac.uk/research/stranded-assets/)
- Carbon Tracker Initiative (http://www.carbontracker.org/)
- Divest-Invest Philanthropy (http://divestinvest.org/philanthropy/)
- GoFossilFree.org; (http://gofossilfree.org/commitments/)
Why ESG: The Changing Face of Business

Secular Trends Favor ESG

- Consumers increasingly favor companies with strong sustainability practices
- Stakeholder engagement is high and rising
- Senior executives are exhibiting a growing recognition of the role of business in society

ESG Factors as Business Drivers

- Firms with stronger performance on material ESG issues tend to outperform peers\(^1\)
- ESG is viewed as a business opportunity
- Smart ESG practices can lead to significant annual cost savings for companies\(^3\)

This is a unique opportunity for investors to embrace the changing landscape and get ahead of the curve

Sources:
Why ESG: The Changing Face of Risk

Business Value and Risk Has Shifted

Intangible assets are now a critical component of company value

Short-term management practices can significantly impair long-term valuations

More Comprehensive Assessment is Critical

Traditional analysis fails to acknowledge key extra-financial risks and opportunities

GAAP accounting often misses critical extra-financial value drivers

In conjunction with traditional investment research, ESG analysis is used to evaluate management’s stewardship of financial and extra-financial assets and risks
Corporate: ESG Research Approach

**External Indicators**
- Bloomberg
- CDP
- Corporate Equality Index
- Ethisphere
- MSCI
- Newsweek Green Rankings
- Sustainalytics
- UN Global Compact

**Quantitative Assessment**
- Environmental
- Social
- Governance
- Reputation/Disclosure

**Quantitative Score (0-100)**

**Qualitative Assessment**

**Sustainability Rating (S1-S4)**

- Review of company reports discussing key ESG and sustainability initiatives
- Scan of any publically available information about the company and its ESG efforts
- Engagement calls that focus on a range of ESG and credit-related issues
- Sector-level research and analysis pertaining to material ESG factors

*Our ESG integration methodology combines a quantitative assessment of ESG factors alongside a rigorous review of qualitative ESG considerations to derive a composite Sustainability Rating*

*Examples are for illustrative purposes only and data shown represents a sample of factors considered.*
Municipal: ESG Research Approach

<table>
<thead>
<tr>
<th>Category</th>
<th>Sample Indicator</th>
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<tbody>
<tr>
<td>Environmental</td>
<td>• Air Quality</td>
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<td></td>
<td>• Long-Term Planning</td>
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<td></td>
<td>• Qualitative Assessment</td>
</tr>
<tr>
<td>Social</td>
<td>• Population Change</td>
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<tr>
<td></td>
<td>• GINI (Income Distribution)</td>
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<tr>
<td></td>
<td>• Qualitative Assessment</td>
</tr>
<tr>
<td>Governance</td>
<td>• Degree of Disclosure</td>
</tr>
<tr>
<td></td>
<td>• Executive Governance</td>
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<tr>
<td></td>
<td>• Qualitative Assessment</td>
</tr>
<tr>
<td>Economy</td>
<td>• Employment Sector Diversity</td>
</tr>
<tr>
<td></td>
<td>• Trend in Median Income</td>
</tr>
<tr>
<td></td>
<td>• Qualitative Assessment</td>
</tr>
</tbody>
</table>

*Examples are for illustrative purposes only and data shown represents a sample of factors considered.*
Company Description

- Merck is a leading global pharmaceutical company that provides various health solutions and over-the-counter products.

ESG Strengths

- Strong emphasis on reducing environmental footprint of its operations.
- Clear commitment to product quality and safety, with limited recalls.
- Industry leadership in access to medicine, which addresses key global health issues.

ESG Challenge

- Merck’s ESG efforts have room for improvement, given the company’s size and reach.

Percentile Rank vs. S&P500

- 90.7%

Percentile Rank vs. Sector

- 96.4%

Notes:
(1) Qualitative commentary based on internal Breckinridge ESG analysis.
(2) Quantitative percentile rank calculated based on Breckinridge’s internal sustainability scores.
Company Description

• PepsiCo is the world's second-largest manufacturer of soft drinks, and holds leadership positions in the non-carbonated beverage and snack industries

ESG Strengths

• Commitment to improving the health and nutrition profile of its products
• High standard of business ethics within a global supply chain
• Strong focus on sustainable water management practices

ESG Challenge

• Growing regulatory scrutiny around marketing sugary beverages to children

Percentile Rank vs. S&P500

93.2%

Percentile Rank vs. Sector

87.5%

Notes:
(1) Qualitative commentary based on internal Breckinridge ESG analysis.
(2) Quantitative percentile rank calculated based on Breckinridge's internal sustainability scores.
Description

- University of California is one of the largest public university systems in the U.S., with its most prominent campuses in Los Angeles and Berkeley

ESG Strengths

- High graduation and student diversity rates
- Commitment to education affordability through scholarships and student discounts
- Strong LEED policy and healthy waste diversion efforts across campuses

ESG Challenge

- Recent budget challenges are leading to strained employee relations

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Notes:
(1) Qualitative commentary based on internal Breckinridge ESG analysis.

University of California’s strong sustainability rating is informed by its favorable ESG metrics and its focus on education
New York City Water & Sewer System (NY)

Description

- The New York City Water & Sewer System provides water to approximately 9 million people and treats 1,250 millions of gallons of waste water per day

ESG Strengths

- Emphasis on water conservation through public education efforts such as newsletters and events
- Efforts to reduce water consumption by encouraging residents to install low flow appliances
- Clear steps to assess, disclose, and mitigate any significant environmental impacts of the system

ESG Challenge

- Consistently high demand for water due to population concentration

<table>
<thead>
<tr>
<th>Bond Purpose Designation</th>
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<tbody>
<tr>
<td>Affordable Housing</td>
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<tr>
<td>Environmental</td>
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<tr>
<td>Economic Development</td>
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<tr>
<td>Healthcare</td>
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<tr>
<td>Education</td>
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<tr>
<td>Infrastructure</td>
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</table>

General Purpose

New York City Water & Sewer System’s strong sustainability rating is informed by its favorable ESG metrics and its focus on delivering environmentally safe water

Notes:
(1) Qualitative commentary based on internal Breckinridge ESG analysis.
Sustainability Committees:
Made up of members from across the firm, these committees mobilize our staff to scrutinize our practices, identify areas of risk and brainstorm areas for improvement.

- Environmental Committee
- Social/Charitable Committee
- Governance Committee

Sustainability Affiliations:
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Breckinridge’s sustainability rating is based on third party objective data and Breckinridge credit analysts’ subjective internal analysis. The quantitative percentile rank calculation is based on Breckinridge’s internal sustainability score. A high sustainability rating does not mean a bond will provide positive returns.
ESG Investing: Environmental, Social and Governance Factors and the Prudent Investor Standard

Professor Susan N. Gary
Orlando J. and Marian H. Hollis Professor
University of Oregon School of Law
Socially Responsible Investing

- Negative Screens
  - Apartheid
  - Divestment
- Positive screens - best in class
- Shareholder advocacy (proxy voting)
Environmental, Social and Governance Investing

**Goals:**

- Improve financial performance by expanding information considered
- Invest in a sustainable and responsible manner
ESG Investing

- Traditional financial analysis
- Material ESG factors that have financial implications or effects
- Sustainability reporting and integrated reporting
ESG Investing – Example

- BP had troubling environmental and safety controls and prior incidents
- 2010 Deepwater Horizon oil spill had serious financial consequences for BP
- A decision to remove BP from a portfolio based on earlier safety and environmental problems would have had financial benefits for investors
There Must Be a Cost

• Any restriction on diversification results in a cost to the portfolio
• UPIA Comment reflects this concern
• Idea persists
No form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.
Data

- **Meta-studies**
- **High sustainability companies**
- **Financial companies**
  - (Goldman Sachs, Russell Investments)
- **Financial analysts**
- **Transparency as proxy for good management**
Fiduciary Duties

- Duty of Loyalty
- Duty of Care or Prudence
- Duty to Act as a Prudent Investor
Duty of Loyalty

Duty to act in the best interests of

• Charity – mission
• Pension – participants
• Private trust – beneficiaries
• University endowment - university
Mission-Related Investing

- Investment that has a dual purpose: mission and financial
- Restatement of Trusts: “Social considerations may be taken into account in investing” if the social issue or cause relates to the charitable mission or if the decision can be justified as advancing, financially or operationally, a charitable activity conducted by the trust.
Private foundations can invest in program-related investments (PRIs)

• “primarily” program-related

2015-62: mission-related investment is ok
• even if not primarily program-related
• even if returns are less than expected for investments unrelated to mission
Duty of Care: Prudent Investor Standard

Manage the property as a prudent investor would:

- Purposes of charity
- General economic conditions
- Appropriate risk and return
- Diversification
Does ESG Investing Breach Fiduciary Duties?

- Does not necessarily result in lower returns
- May improve returns on risk-adjusted basis
- Changes focus of investment decisions to long-term benefits
“fiduciaries should appropriately consider factors that potentially influence risk and return” and “environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment.”
“In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”
Duty to Monitor Investments


Continuing duty to monitor, and remove imprudent, trust investments.
A prudent investor can consider ESG factors as part of an overall investment strategy that considers financial and material extra-financial information.
Institutional investors face a moment of truth about their commitment to environmental, social, and governance (ESG) factors. Many have long realized that these issues—including climate change, workplace diversity, and long-standing corporate concerns such as executive compensation—can drive risks and returns. In fact, many large institutional investors have publicly committed themselves to integrate ESG factors into their investing. The UN-backed Principles for Responsible Investment (PRI) have been signed by more than 1,500 investors and managers, representing nearly $60 trillion in assets under management.

Yet look a little deeper, and it’s clear that many investors have struggled to convert their commitment into practice. For example, less than 1 percent of the total capital of the 15 largest US public pension funds is allocated to ESG-specific strategies, such as ESG-screened passive indexes, active management using ESG insights, or private-market management with a fully integrated ESG strategy. Moreover, many institutional investors continue to treat ESG as a sideshow rather than an integral part of their investing. While ESG and corporate-governance teams are commonplace, they are often held at arm’s length from core...
investment activities. Even the most successful funds have integrated ESG unevenly. While sustainable-equities strategies (such as low-carbon indexes) are no longer oddities, most funds haven’t expanded ESG integration to other asset classes. Members of the PRI agree that more is required. Its board is considering a change that would allow it to remove signatories that haven’t made sufficient practical progress.

This is not to say that the industry has been standing still. In fact, three big problems have recently been cracked, setting the stage for continued growth. First, investors have struggled for some time to determine which ESG concerns are relevant to particular investments. In response, some leading 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 that will have a measurable effect on an investment’s financial performance. According to a recent study using the materiality framework of the Sustainability Accounting Standards Board (SASB), companies that address material ESG issues and ignore immaterial ones outperform those that address both material and immaterial issues by 4 percent and outperform companies that address neither by nearly 9 percent (exhibit). Generation Investment

Exhibit

A focus on material ESG issues drives greater returns.

Effect on financial returns of investors’ treatment of environmental, social, and governance (ESG) issues,\(^1\)

<table>
<thead>
<tr>
<th>Performance on material ESG issues</th>
<th>Performance on immaterial ESG issues</th>
</tr>
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<tbody>
<tr>
<td>High</td>
<td>+6.0%</td>
</tr>
<tr>
<td>Low</td>
<td>−2.9%</td>
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<tr>
<td>High</td>
<td>+2.0%</td>
</tr>
<tr>
<td>Low</td>
<td>+0.6%</td>
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\(^1\)The study used data from 1992 to 2012 on companies’ ESG performance across 45 industries in six sectors: financial services, healthcare, telecommunications, nonrenewable resources, services, and transportation. The study tested the effects of the Sustainability Accounting Standards Board’s material factors while accounting for the effects of firm size, market-to-book ratio, profitability, leverage, and sector fixed effects.

Source: Mozaffar Khan, George Serafeim, and Aaron Yoon, *Corporate sustainability: First evidence on materiality*, Harvard Business School working paper, Mar 9, 2015, hbs.edu
Management, a sustainable-investing specialist founded by David Blood and Al Gore, put ESG materiality at the heart of its global equity strategy and has reportedly exceeded its benchmark by an annualized 500 basis points for over a decade.

Second, many institutions have found it hard to measure external managers’ regard for ESG issues; they need a kind of “greenwashing” detector to see through the obfuscation that plagues some managers’ activities. A number of institutions are now successfully deploying new mechanisms to increase accountability. The New York Common Retirement Fund, for example, recently developed a comprehensive scoring system based on the best available benchmarks. Managers that don’t disclose information receive poor marks, hammering home the idea that transparency is paramount when someone else’s capital is on the line.

Third, some board members and trustees of institutional investors have worried about whether, as part of meeting their fiduciary duties, they are considering ESG factors. Recently, the US Department of Labor revised its ERISA guidance to say explicitly that consideration of ESG concerns is a part of the pension plans’ fiduciary duty. The department also specified that when a fiduciary considers two investments that are similar from a financial perspective, it should select the one that’s better from the standpoint of ESG. Such cases come up frequently. In France, the Ministry of Finance recently announced new rules that require investors to measure their portfolios’ exposure to carbon, among other ESG considerations. With the regulatory drumbeat picking up tempo, investors will probably soon adopt sound practices to determine materiality and evaluate managers.

**Accelerating progress**

Materiality, scorecards, and clearer definitions of fiduciary duty are only a launchpad. A commitment to ESG integration will remain merely symbolic unless institutions change their investment and capital-allocation processes in the ways required for this kind of investing to lift off. Investors should consider six steps to broaden and enhance their ESG impact.

“Environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment. In these instances, such issues are not merely collateral considerations or tiebreakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”

—US Department of Labor, 2015
Require uniform corporate ESG-reporting standards based on the principle of materiality
Considerations of materiality ought to be a two-way street: publicly traded companies as well as investment managers should disclose material ESG information. Some institutional investors have already been working with groups such as the Carbon Disclosure Project to push companies to report their ESG metrics (for instance, their carbon footprint or water usage), but more must be done.

Requiring companies to share all material information in a standardized, comparable way is necessary if institutional investors and their external managers are to assess the meaningful ESG-related risks and opportunities companies face. Institutional investors can work with the groups that have sprung up to advance the cause. The Sustainability Accounting Standards Board, for example, has rigorously defined materiality factors at sector and industry levels and is pushing for disclosure of material ESG factors in IPO and 10-K filings. Institutional investors should also collaborate with the Financial Stability Board’s task force on climate-related financial disclosures (led by Bank of England governor Mark Carney and Michael Bloomberg) and support the efforts of the International Integrated Reporting Council to encourage more comprehensive corporate reporting, including reporting on material ESG factors. They may also wish to comment on the US Securities and Exchange Commission’s recent consultation about whether investors would like to see more formal disclosure requirements for companies’ sustainability measures.

Build a shared ESG-rating system for external managers
Institutional investors usually have a rigorous due-diligence process for evaluating their external managers, yet too many treat their assessment of the managers’ approach to ESG as merely an exercise in box ticking. Farsighted institutions are already building systems to rate external managers more thoroughly, but a shared system would multiply the benefits considerably. Rather than duplicating one another’s work, funds could both cut the effort needed to make informed decisions and hold managers to a high standard for their ESG performance across the board.

A shared rating system should consider the sources of a manager’s ESG insights and the ways it seeks to engage with the companies in which it invests. The system will need to reflect the nuances of different asset classes and investment styles; ESG factors will be less material for many hedge-fund strategies than for managers investing in real assets or global equities, for example. Over time, a shared rating system should help prime the market for ESG-informed investment strategies. Many of them have historically struggled to gain allocations because of their short investment histories or skepticism about whether the alpha they generate will endure. That’s why institutional investors should invest in building a shared, open standard that their investment professionals will understand rather than simply outsourcing this task to investment consultants.

Work together to engage with corporations
Most investors recognize that as patient capital, engagement is for them both a social responsibility and a source of long-term returns. Yet most have small corporate-engagement teams that can work with only a few companies each year. Leaders such as the Canada Pension Plan Investment Board, the Ontario Teachers’ Pension Plan, and Calpers have built relationship-investing strategies—they back engagement with dedicated capital and sometimes board seats. Large external asset managers such
or that need to invest heavily in training to expand a peer-to-peer sales force should reveal these ESG-related dependencies. Investors might slap proxy motions on companies slow to respond.

Stress-test portfolios for ESG risk factors
Since 2008, many institutional investors have strengthened their risk management—for example, by adding tools and skills needed to run scenario analyses on how their portfolios might behave in times of stress. Yet most focus narrowly on “tail” value-at-risk scenarios driven by broad macroeconomic volatility. They ought to complement this approach with considerations of unpredictable shocks, such as regional water shortages, avian-flu pandemics, and increases in (or the introduction of) externality pricing.

Other institutions are embracing risk-factor investing: they evaluate their exposure to root sources of risk, such as currencies and interest rates, and then set limits for them. In both stress-test and risk-factor investing, material ESG considerations are not always taken into account, but they should

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“We recently introduced an ESG risk assessment to make sure our external managers are integrating ESG into their investment decisions and doing so on the basis of materiality. For all of our external managers, we can now take a fact-based view on whether they are simply ticking the ESG box or are considering ESG in a rigorous, thoughtful way that addresses material risks to our capital.”

—Vicki Fuller, chief investment officer, New York Common Retirement Fund
be. A risk-informed decision-making process allows institutional investors to fulfill their fiduciary duty as stewards of university and foundation assets or of the retirement savings of public-sector employees.

Public concern over climate change is a particularly acute risk factor and source of value at risk. Many institutional investors are considering whether to reduce the carbon exposure in their portfolios or even to divest out of fossil fuels entirely. We realize that some fiduciaries view this as a moral decision. Nonetheless, it is important for institutional investors to have a nuanced understanding of the actual ESG risks they are exposed to, so that they can choose whether and how to respond.

Some institutional investors have decided against divestment in the short term but plan to test their portfolios continually for climate risk. They are setting clear limits that, when triggered, will require them to reduce their exposure, to encourage companies to return cash rather than invest in exploration, or ultimately to divest fully.

Use a long-term ESG outlook to unlock new investment opportunities

All investors ought to consider material ESG factors. But the long time horizons and broad market exposure of institutional investors mean that they are particularly vulnerable to the good or bad ESG decisions of the companies in which they invest. Some institutions have developed innovative investment strategies to deal with this issue. For example, several have created indexes that either screen out worst-in-class ESG companies or weight toward best-in-class companies. Since 2012, the Swedish pension plan AP4 has been running a low-carbon fund that excludes the 150 worst polluters in the S&P 500, thereby producing an index whose carbon footprint is about 50 percent lower than that of the broader index.

While differing liability profiles may make custom indexes the optimal solution for institutions, they should consider the scale benefits of collaborating with others. A good example is the $2 billion
Innovative approaches to integrating ESG

Four investment managers demonstrate that environmental, social, and governance (ESG) investing is an area of innovation.

Affirmative Investment Management is one of a handful of investors that are exploring how best to integrate sustainability into credit strategies. It focuses solely on fixed-income and cash investments with explicit positive ESG outcomes. The company believes that ESG factors bring an additional layer of insight to fundamental credit analysis and can materially reduce default risk. It also sees itself as a market builder, helping to expand the demand for “green bonds.” In addition, Affirmative is committed not only to measuring its financial performance but also to reporting on the use of proceeds, including the known environmental and social impact of the activities funded.

Arabesque Partners, founded in 2011, integrates ESG data into the construction of its portfolios, including a “smart beta” fund and long-only alpha strategy. Alongside fundamental equity analysis, Arabesque thinks it has an edge by more thoroughly understanding the quality and limitations of the increasing volume of corporate ESG data: it believes that big data techniques can identify the material ESG factors that will shape risks and returns at a granular level. Both of Arabesque’s strategies have outperformed their benchmarks since inception and rank within the top 20 percent of their Morningstar peer group.

Breckinridge Capital Advisors, with $23 billion under management, is more established than the other investment managers in this group, yet it demonstrates how an established manager can develop cutting-edge approaches to ESG integration. In 2011 Breckinridge enhanced its rigorous credit-research process through the systematic analysis and integration of ESG factors. It argues that this integrated approach has provided it with a more comprehensive and forward-looking evaluation of each borrower’s risk/return profile and helps it keep a keen eye out for links between a borrower’s ESG efforts and its financial performance.

Ownership Capital, formerly an in-house manager at PGGM, is a long-only active equity manager with a long-term horizon and an explicit approach to integrating extrafinancial factors such as stakeholder and sustainability management. With a concentrated portfolio, it can actively engage with the companies it invests in and help to encourage improvement in ESG performance. Since its inception, in 2008, Ownership Capital has outperformed its benchmark by an annualized rate of more than 500 basis points.

committed by six big institutions to the Long-Term Value Creation Global Index, designed for them by S&P. Investors should also think beyond passive equities and consider how they can use ESG factors to reduce risk or identify alpha across a range of asset classes. An obvious possibility is direct investments in companies and real assets where institutional investors have enough influence or control to upgrade the ESG management.

Finally, only a handful of ESG managers have ten-year track records. Institutional investors shouldn’t
wait passively for such track records to turn up—they ought to use their emerging-manager programs to seed and support innovative ESG-informed strategies. Several managers are pushing the boundaries of ESG-informed investing (see sidebar, “Innovative approaches to integrating ESG”).

Confront the skepticism and misunderstanding that surround ESG head-on
Successful investment organizations have strong cultures, but strengthening a culture takes time. At many institutions, ESG investing is caught in a cultural trap. For decades, conventional wisdom has held that ESG and its forebears, such as socially responsible investing, are merely a sideline, something to be worked on separately from the true business of investing. Changing this mind-set requires concrete action.

Chief investment officers must direct a cultural change within their investment teams. For a start, they can model the right behavior by leading the integration of ESG into the investment committee’s risk/return discussions. Institutional investors should also consider whether training and certifications may advertise the value they place on ESG fluency. Just as the CFA Institute’s Claritas certificate gives investment professionals a measure of credibility after only 100 hours of study, an industry-wide ESG certification could become a signal of qualification to institutional investors as they hire and invest. Bloomberg, the CFA Institute, the SASB, and many universities already offer ESG courses, and some consolidation around a clear industry qualification would benefit everyone.

Turning a symbolic commitment to ESG into daily practice will not be easy. But faced with rising stakeholder demand for meaningful action, there is little choice. Institutions that get out in front of the growing wave will be the first to reap the benefits of sound ESG investing: better returns, lower risk, and—should these ideas be widely adopted—a more sustainable world.

1 Employee Retirement Income Security Act.

Jonathan Bailey, formerly of Generation Investment Management, is an associate principal in McKinsey’s New York office, where Bryce Klempner is a principal and Josh Zoffer is a consultant.

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