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In This Issue: **Sustainability and Shareholder Value**

The Evolution of Integrating ESG Analysis into Wealth Management Decisions

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As a financial advisor, I work with individuals and institutional asset owners to develop sustainable investment portfolios. I became interested in this emerging discipline because of what I believe is the dramatic increase in the availability of high-quality ESG research and the growing body of academic studies showing correlations between strong investment performance and ESG factor integration.[1] I believe that we now have abundant research documenting the effects on corporate performance and values of non-financial factors, such as gender diversity, which I think can no longer be ignored in portfolio construction.

In his latest book *Antifragile: Things That Gain from Disorder*, bestselling author Nasim Taleb praises systems and institutions that have a quality that he calls "*antifragility,*" which "is beyond resilience or robustness. The resilient resists shocks and stays the same; the antifragile gets better."[2] In the pages that follow, I will propose that ESG Factor integration enhances the antifragility of portfolios, moving beyond "resists shocks" to "getting better" by providing glimpses into important non-financial criteria that often evade the scrutiny of traditional security analysis.[3] I will also suggest that corporations making long-term commitments to developing "sustainability cultures" increase their antifragility by presenting a compelling vision to their non-investor stakeholders of their commitment to making good on two in some ways competing agendas: the intense pressure to maintain acceptable levels of near-term profitability while at the same time communicating and carrying out long-term strategies designed to increase enterprise value for the next several decades and beyond.

Tracing the Rise of Sustainability

The majority of asset owners delegate investment management to portfolio managers with a mandate to maximize risk-adjusted returns.[4] In some cases the owners choose to place restrictions on certain investments, directing the manager screen out objectionable companies or industry classes. The practice of restricting ownership of assets in a given category is referred to as "negative screening."

For early faith-based organizations such as the Quaker Friends Fiduciary Corporation, these restrictions required the avoidance of "sin-stocks," a policy that reflected their decision in 1898 to adopt a "no weapons, alcohol or tobacco" investment policy designed to align their investment funds with their core values.[5] As negative screening investment practices were adopted by a wider class of mission-based investors such as endowments and foundations, the nomenclature broadened into "socially responsible investing" (SRI).

Over time, what has emerged is a demand by classes of asset owners for investment strategies designed to make their holdings consistent with their values. Consider, for example, the following quote from the investment policy statement of The Gates Foundation:

> *When instructing the investment managers, Bill and Melinda also consider other issues beyond corporate profits, including the values that drive the foundation's work. They have defined areas in which the endowment will not invest, such as companies whose profit model is centrally tied to corporate activity that they find egregious. This is why the endowment does not invest in tobacco or Sudan-related stocks.*[6]

The recent proliferation of ESG research has provided the mission-based investment community with the means to continue to strengthen the alignment of their values with their portfolio holdings. And as a growing body of studies have begun to suggest, this can be done–not only without sacrificing their returns on investment–but while even increasing those returns.[7]

Until fairly recently, the bulk of SRI investing has been conducted by large institutional asset owners with the motive

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1. "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," Calvert Investments http://www.calvert.com/nrc/literature/documents/WP10013.pdf.
2. Nassim Nicholas Taleb (2012). *Antifragile: Things That Gain from Disorder.* Random House. p. 430. ISBN 9781400067824.
3. "The Relevance of ESG Integration in Fixed Income Investing," Calvert Investments -http://www.calvert.com/nrc/literature/documents/br10093.pdf.
4. "By the Numbers: The Quest for Performance," State Street Center for Applied Research at The Fletcher School, Tufts University - http://www.statestreet.com/content/dam/statestreet/documents/Articles/CAR/BytheNumbersQuestforPerformance_report.pdf.
5. Quakers Friends Fiduciary corporation investment policy. http://www.morganstanleyfa.com/public/facilityfiles/mssb135092/dd4ada2a-0748-4c2a-9fa1-ff68819d921f.pdf.
6. "Gates Foundation Investment policy," http://www.gatesfoundation.org/Who-We-Are/General-Information/Financials/Investment-Policy,
7. "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," Calvert Investments http://www.calvert.com/nrc/literature/documents/WP10013.pdf,

and means to access third-party analytics, perform their own research, and build extensive ESG datasets. But as I discuss in more detail in this article, the growing community of sustainability-focused retail investors is now, for the first time, being afforded similar access to a rich and growing database of ESG metrics.

Three Requirements to Make ESG Factor Integration Work for Retail Investors: Portfolio Managers, ESG Data Providers, and ESG "Investments" and Disclosure by Public Companies

For retail investors, the journey from "socially responsible" to "sustainable investing strategies" has involved important contributions by three main sets of participants: portfolio managers, ESG data providers, and publicly traded companies.

Portfolio Managers

In the past, SRI proponents have experienced resistance from "mainstream" investment community peers because early versions of the discipline appeared to underperform benchmarks and violate the basic tenets of a broadly-accepted portfolio construction framework called Modern Portfolio Theory (MPT).[8]

The core thesis of MPT, which was first introduced in 1952 by Nobel Prize winning economist Harry Markowitz, is that investors can reduce portfolio risk just by holding combinations of instruments whose returns are not completely correlated. In fact, MPT went so far as to claim—and those claims have been largely vindicated by empirical research—that the vast majority of risk adjusted returns generated by a portfolio are attributable not to superior stock selection, but to investors' prior decisions to allocate their assets among different classes. And as a consequence of the general acceptance of MPT, diversification across multiple asset classes and regions has become the rule for portfolio managers.

Armed with these assumptions and insights, many portfolio managers view the benefits of "socially responsible" investing with understandable skepticism. A likely response from one of these managers might go something like this:

Look, it's all about the math. Though Bill Gates can afford to "consider other issues beyond corporate profits," we cannot. He has enough money to sacrifice returns to advance his mission. Our mission is to make money for our clients. Any strategy that reduces our diversification by screening out sectors and regions will increase risk and lower returns, relegating it to a position forever on the fringes. Please leave the "do-good social responsibility" to the philanthropic sector. We have to maximize returns for our investors or we get fired.

Portfolio managers fight for every basis point of risk-adjusted return. Most asset managers are evaluated according to their ability to produce "alpha," which is typically defined and measured as the excess returns of a fund relative to the return of a benchmark index. Generating such alpha is considered the Holy Grail on Wall Street, a quest that is carried out in large part using quantitative methods and analysis. And in the debate between SRI and MPT on Wall Street that has been waged in the past, the math has favored MPT, thus casting widespread doubt on the claims of the SRI advocates that managers can "do well by doing good."[9]

In sum, the MPT camp has, until very recently, remained largely unconvinced that SRI could be made compatible with maximizing risk-adjusted returns. What was needed to break the stalemate was a broader, more nuanced strategy designed to identify and choose the "best in class ESG" public companies *representing all sectors* so as to satisfy the diversification requirements of MPT. Below is one sample outline of how a portfolio manager might incorporate ESG factors and considerations into an MPT portfolio construction process.

Hypothetical "Best-in-class ESG Factor Integration" Portfolio Strategy for Retail Investors

If we assume that a manager's mandate is to invest in U.S. Large-Cap stocks with the S&P 500® as the benchmark index, a "best-in-class ESG" strategy will own all ten sectors of the market. In addition to the fundamental and quantitative tools the manager has at her disposal, her stock selection process will now include an ESG "overlay" that allows a comparison of ESG factor ratings for companies within each sector.

To show how this process is likely to work, let's go through the progression of questions—and some possible responses to them—from the top down:

Step one: Macroeconomic analysis

- "What is our portfolio sector weighting versus the S&P 500®?"
  > "Our macroeconomic data indicates that we should overweight sectors A/B/C and underweight sector D/E/F."
  > "Within the ten sectors, which sub-sectors and industries do we prefer?"

Step two: How is the fundamental research guiding us for stock selection?

- "Do we tilt more towards growth or value stocks?"
- "Do we tilt towards Mega-cap or Large-Cap?"

Step three: What is quantitative analysis telling us for each sector and stock?

- "How close is the current price to the 50-day moving average? 200-day moving average?"

8. "The Performance of Socially Responsible Mutual Funds," by Luc Renneboog, QFinance - http://www.financepractitioner.com/asset-management-best-practice/the-performance-of-socially-responsible-mutual-funds?full#s1.

9. Ibid,

- "How close is the stock to breaking through a resistance level?"

Step four: What ESG factors will be included in the selection criteria?

Our manager wants a six percent (6%) allocation to the utility sector. She has five stocks that have made her "finalist" list based on her fundamental and quantitative analysis and now wants to apply an ESG overlay to act as a tie-breaker for a final decision on which three stocks to include. She begins by insisting that each of the three companies meet all of the following requirements:

- An overall ESG ranking in the top quartile of the sector.
- Positive momentum: Based on the findings of the latest research on material ESG factors and stock returns (which I discuss below),[10] she decides to make ESG momentum a factor in her stock-selection process (based on her understanding that it can take companies several years to fully integrate a successful ESG strategy). The critical questions here are whether ESG rankings have been improving over time, and, if so, do the improvements reflect a significant upward trend?
- Diversity: Persuaded by recent research indicating that gender diversity on boards and top management teams is a material ESG factor in all industries,[11] she decides to include only those finalists that have at least one woman on the board of directors.

Of the five finalists, one did not have a woman on the board and was eliminated. Another had a bottom quartile ESG rating and negative momentum and was eliminated. The remaining three stocks met the criteria and were included.

ESG Research and Data Providers

A second major contributor to the rapid growth of ESG integration in portfolio construction is the improved quality and quantity of academic and sell-side ESG research. Asset managers and owners are now paying a premium for a new kind of research that measures the value of both the tangible and intangible assets (and aspects) of public corporations. Portfolio managers have determined that the current ESG research offerings have reached a tipping point of efficacy that justifies inclusion in their analysis.[12]

ESG research and data providers have played an important role in helping portfolio managers reach this tipping point. This role was well described several years ago by Bloomberg's Curtis Ravenel and Andrew Park when emphasizing the importance of accurate and relevant quantitative data for financial analysts, and the perceived shortcomings of ESG metrics at the time:

> *As far as mainstream analysts are concerned, until a concept comes to them in quantitative form, it tends to lie on the margins of their conceptual reality. If the idea fails to translate, the analyst might decide not incorporate it into his or her analysis—and thus it essentially fails to exist. The process of bringing ESG into existence and overcoming its lack of financial legitimacy is, therefore, essentially a challenge of measurement—measuring to get data, measuring to price more accurately, which in turn should lead to more efficient allocation of capital… Therefore, as stated earlier, ESG analytics must demonstrate itself to be fundamentally indistinguishable from mainstream financial analytics, thereby sharing a common language with the financial industry and, in time, establishing its own bona fides.*[13]

Although it's probably too soon to declare that ESG "bona fides" have been established, one research provider recently announced that 2015 was a "record year of growth" for their ESG research product, with revenues growing 33% over the previous year and clients for the product including 47 of the world's largest 50 asset managers.[14]

Academic Research on ESG Materiality

I believe that after years of evolution, the "best-in-class" approach shows promise in helping to resolve the tension between the MPT and Sustainable camps, allowing them to move forward together as allies instead of adversaries. This delicate détente owes much to an important study conducted by George Serafeim, Associate Professor at the Harvard Business School. Serafeim's study, which was published in 2015 with the title "Corporate Sustainability: First Evidence on Materiality,"[15] has generated considerable optimism about finding a way to use ESG factors that results in a successful integration of sustainable investing principles with traditional MPT frameworks.[16]

Summarized as briefly as possible, the main finding of the study is that companies that do a good job of managing their most "material" ESG risks (and opportunities)—as defined using criteria and guidelines provided by the Sustainable Accounting Standards Board (SASB)—outperform their competitors by as much as 600 basis points per year.[17] The main takeaway from this research is that the effectiveness

10. George Serafeim, "Corporate Sustainability: First Evidence on Materiality," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912.
11. "Why it Pays to Invest in Gender Diversity" - http://www.morganstanley.com/ideas/gender-diversity-investment-framework
12. For the MSCI Press release that includes this information, see https://www.msci.com/documents/10199/b3d456db-353a-4eea-8f08-c12447427940.
13. "Integrating Sustainability Into Capital Markets: Bloomberg LP And ESG's Quantitative Legitimacy," by Andrew Park and Curtis Ravenel, Journal of Applied Corporate Finance, Volume 25, Number 3, Summer 2013, pages 63-64.
14. For the MSCI Press release that includes this information, see https://www.msci.com/documents/10199/b3d456db-353a-4eea-8f08-c12447427940
15. George Serafeim, "Corporate Sustainability: First Evidence on Materiality," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912.
16. "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," Calvert Investments http://www.calvert.com/nrc/literature/documents/WP10013.pdf.
17. "Corporate Sustainability, Making Better Investment Decisions," © George Serafeim, 2015.

with which companies emphasize material sustainability concerns—and engage with the stakeholders most affected by those concerns—is a reliable indicator of management's ability to identify and then train a laser focus on those critical ESG factors. By so doing, management increases the long-run viability and value of the firm.[18]

Another way to think about materiality in the sustainability context is to view it as providing a guide to a company's understanding of its core "strategic priority areas." Asset owners and portfolio managers have always sought assurances that a firm's leadership had a proper focus on strategic priorities. The consideration of materiality adds the lens of sustainability to that focus. While it may seem obvious that a computer hardware manufacturer would have a very different materiality footprint than a financial services firm, the analysis, compilation, and prioritization of the materiality data takes considerable long-term commitment and vision on the part of the firm.

Sustainability Disclosure by Public Companies

The third component that has been critical to attracting retail investors to ESG investing strategies derives from the accuracy, transparency, and materiality of the ESG data that is provided voluntarily by publicly traded companies.[19]

In certain instances, such as those involving the disclosure of CEO-to-median pay and other executive pay ratios, the SEC has adopted rules aimed to satisfy Dodd-Frank statutory requirements that are "designed to provide investors with information regarding the compensation of a company's CEO as compared to the median compensation of that company's employees."[20] For the most part, however, investors and portfolio managers must continue to rely on voluntary company disclosure of ESG data and related information.

Partly in response to greater investor and stakeholder demand for ESG information companies have developed "Corporate Social Responsibility" (CSR) departments that, among their other responsibilities, are charged with providing voluntary disclosure of ESG data. From 2011 to 2013 the number of S&P 500 firms issuing CSR or Sustainability reports increased from less than 100 to 360. According to a study by the Governance and Accountability Institute,

> *Seventy-two percent (72%) of the companies included in The S&P 500 Index® were found to have published a sustainability or corporate responsibility report [in 2013]. In 2011, just under 20% of S&P 500 companies had reported… We are seeing clear indications over the past three years that senior corporate management understands the importance of adopting and implementing strategies that reflect the rising interest of investors and stakeholders in corporate sustainability.*[21]

In the absence of new legislation and regulatory rules that would mandate such reporting, investors must rely on companies to disclose ESG data voluntarily.

In a recent *New York Times* article, current Labor Secretary, Thomas Perez, was vocal about finding common ground between the government and companies that he believes "exemplify social and environmental responsibility."

While companies cannot yet be forced into full disclosure, there does appear to be a "halo effect" that accompanies effective integration of sustainability principles in corporate culture. And as the article went on to say of Secretary Perez, "He is singling out "high road" employers. He is promoting B Corps, companies that adhere to lofty social and environmental standards. In doing so, he hopes he can persuade less enlightened corporations to change."[22]

Moving Forward: The Response by Retail Investors

A recent survey of active individual investors by Morgan Stanley finds "millennials and women at the front edge of sustainable investing and sustainability. Millennial investors, in particular, index the highest of any demographic on these topics." As the survey report also states,

- *Millennials are the most receptive to the idea of sustainable investing (84%), more so than Gen X (79%) and Baby Boomers (66%).*
- *Millennials are twice as likely both to invest in companies or funds that target specific social/environmental outcomes and to divest because of objectionable corporate activity.*
- *Women are also leading the way, with 76% of surveyed investors showing interest in sustainable investing, as compared to 62% of men.*[23]

When I reflect on the rapid adoption of sustainability I'm reminded of the early days of the personal computer revolution. As a grad student in the 1980s, I attended a presentation in which Rod Canion, co-founder of Compaq Computer, demonstrated the first portable computer. Notice I did not say "laptop"; his invention was not something you would want on your lap. It was a bulky box with a clunky removable keyboard, tiny screen with orange letters (remember DOS?), and no battery.

For all its shortcomings, Rod's invention marked a sustainable inflection point, the beginning of a new phase of

18. "The Role of the Corporation in Society: Implications for Investors," Calvert Investors http://www.calvert.com/NRC/literature/documents/wp10012.pdf.
19. Ibid.
20. http://www.seyfarth.com/publications/MA082815-CORP.
21. Governance and Accountability Institute website http://www.ga-institute.com/nc/issue-master-system/news-details/article/flash-report-seventy-five-percent-75-of-the-sp-index-published-corporate-sustainability-rep.html
22. New York Times, May 14, 2016, "Thomas Perez, a Labor Watchdog Who's Not All Bite."
http://www.nytimes.com/2016/05/15/business/thomas-perez-a-labor-watchdog-whos-not-all-bite.html?_r=0.
23. "Morgan Stanley Survey Finds Sustainable Investing Poised for Growth"- http://

PC product development and innovation. We have all since benefitted from a gusher of smaller, faster, and cheaper portable computers that now double as phones and wrist watches. I doubt anyone in the room with me that day watching Rod Canion's demonstration grasped the full significance of the event. We knew it was a milestone that would change how we did business, but we could not have predicted the scope of creative disruption it would unleash.

I am convinced that ESG Factor integration is at a similar sustainable inflection point. After an event I helped organize several years ago, one of the speakers pulled me aside and said, "Sometimes after I'm finished speaking at an event I have the sense I was "tolerated"; other times I feel like I was 'celebrated.' Today I felt celebrated—thank you!" Sustainable investing is on a similar path, moving along the credibility spectrum from "barely tolerated" to "highly celebrated."

I am excited about the future of retail investing as viewed through the sustainability lens. Bestselling author Brene Brown is fond of quoting a proverb attributed to the Asaro tribe of Papau New Guinea: "Knowledge is only rumor until it is in the muscle."[24] Portfolio managers are advancing the viability of ESG Factor Integration so that the former "rumors" are becoming muscular knowledge.

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www.morganstanley.com/press-releases/morgan-stanley-survey-finds-sustainable-investing-poised-for-growth_06490ef0-a8b2-4a68-8864-64261a4decd0.

24. Jimmy Nelson website, http://www.beforethey.com/journey/indonesia---papua-new-guinea.

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