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Focus Article

# Beyond the bottom line: The ESG investing advantage

By using a different investment lens, investors can enhance upside potential and buffer against risk.

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All values in U.S. dollars and priced as of June 30, 2018, market close, unless otherwise noted.

Wealth Management

Focus article

# Beyond the bottom line: The ESG investing advantage

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More companies are realizing that they can strengthen their operations by looking beyond the bottom line. Likewise, by using a different investment lens—one based on Environmental, Social, and Governance criteria—investors can enhance upside potential and buffer against risk.

In the *Johns Manville 2011 Sustainability Report*, legendary investor Warren Buffett wrote, "Today our world is changing faster than ever before—economic, geo-political, and environmental challenges abound. However, taking shortcuts is not the pathway to achieving sustainable competitive advantage, nor is it an avenue toward satisfying customers. In times such as these, a company must invest in the key ingredients of profitability: its people, communities, and the environment."[1]

Socially Responsible Investing (SRI) was born in the 1970s out of opposition from some religious groups to holding investments that did not align with their values, such as companies deriving revenue from alcohol, gambling, pornography, tobacco, or weapons.

Environmental, Social, and Governance (ESG) investing represented a step beyond SRI. Instead of negatively screening out securities that don't fit the mold, it searches for companies that meet predefined criteria within the ESG categories. The approach looks to integrate non-financial factors with traditional financial data. While ESG criteria are often not considered in traditional financial analysis, recent research argues that integrating this data can both enhance the return and buffer against risk in investment portfolios. If a company ignores these factors and, for example, seeks to increase profits at any cost (e.g., abusing employees or significantly polluting the environment), at some point the company—and shareholders—will bear the brunt of reputational damage, fines, sanctions, or potentially criminal charges.

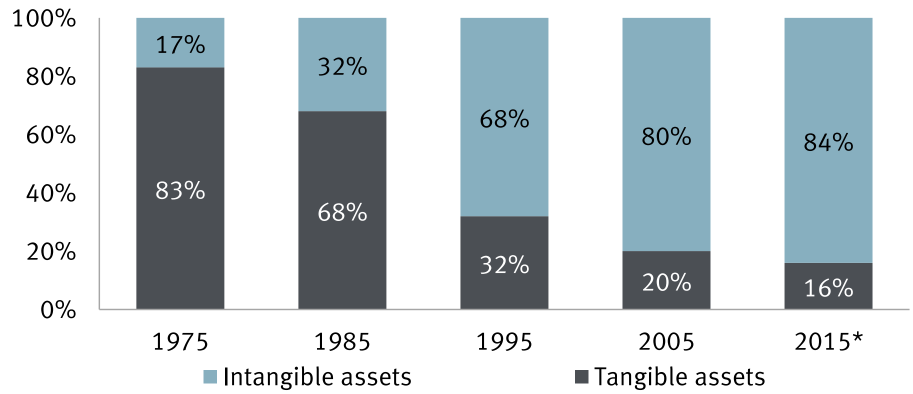
## Investing reimagined

Decades ago Benjamin Graham, often known as the father of modern investing and a famously long-term thinker, laid out how most investors evaluate companies in his seminal books, *Security Analysis* and *The Intelligent Investor*. For years, investment analysis has heavily relied on the evaluation of tangible assets and traditional financial data.

However, think tank Ocean Tomo found that tangible data makes up a surprisingly small percentage of the market value of the S&P 500 Index.[2] Rather, the majority

1 "Johns Manville 2011 Sustainability Report" *JM.com*. Johns Manville, 03/2012. Web.
2 "Annual Study of Intangible Asset Market Value from Ocean Tomo, LLC." *OceanTomo.com*, Ocean Tomo, LLC. 5 March 2015. Web.

Components of S&P 500 market value




*January 1, 2015
Source - Ocean Tomo, LLC; Intangible Asset Market Value Study, 2018; *http://www.oceantomo.com/intangible-asset-market-value-study/*

of the value for companies within the index is comprised of goodwill, reputation, customer and employee relationships, environmental performance, brand, and other intangible assets.

Investors who consider this data have an advantage over those who do not. We can see the impact that ignoring ESG factors can have on the value of a stock from examples like Transocean after the Macondo oil spill, Volkswagen and the discovery of its fuel efficiency deception, and Experian following its massive data breach. Avoiding these types of controversies can have a significant impact on the performance of an investment portfolio.

What kind of impact can ESG factors have on returns?

Companies can outperform when they have superior ESG characteristics.

This was the topic of a research paper published in 2015 in the *Journal of Sustainable Finance & Investment*. The article pulled data from 2,200 previously published studies dating back to the 1970s that addressed ESG factors and their relation to corporate financial performance. In a meta-study that pooled the findings of these other works, the authors pinpointed that only some 8% of the studies found that ESG factors had a negative impact on stock performance.[3]

This meta-study broadly shows that companies can outperform when they have superior ESG characteristics. But what does this mean when a portfolio is created considering ESG factors in the investment process?

Morningstar published its inaugural *Sustainable Funds Landscape* report in 2018. This was Morningstar's first report that focused on managers who proactively consider ESG in their investment process. They found that, within the U.S., there are now mutual funds in every major asset class that intentionally consider sustainability. Going one step further, Morningstar evaluated the performance of these funds versus its investment universe.

First, Morningstar evaluated short-term, annual performance over the last three years. In 2015–17, managers who considered sustainability in their investment

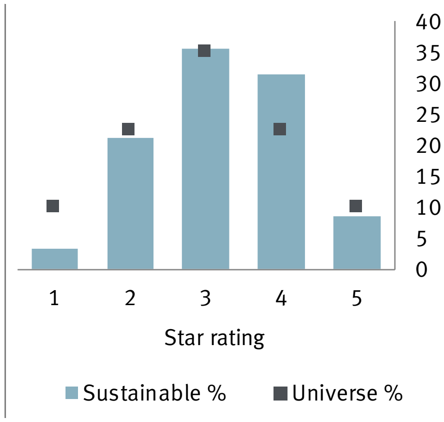
[3] Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917.

process outperformed their Morningstar category by 57%, 55%, and 54%, respectively.

Morningstar also evaluated longer-term performance of these same funds. Morningstar assigns a 1–5 star rating based on long-term performance. As of the end of 2017, 40% of the sustainable funds had 4 or 5 stars, while only 24.5% had 1 or 2 stars (the mutual fund universe had 32.5% of funds in the top two categories combined).[4] This research is rather a definitive indication that ESG factors can have a positive impact on performance across multiple asset classes over multiple time frames.

### Sustainable funds Morningstar ratings skew positive

| Star rating | # |
|---|---|
| ★★★★★ | 10 |
| ★★★★ | 37 |
| ★★★ | 42 |
| ★★ | 24 |
| ★ | 4 |



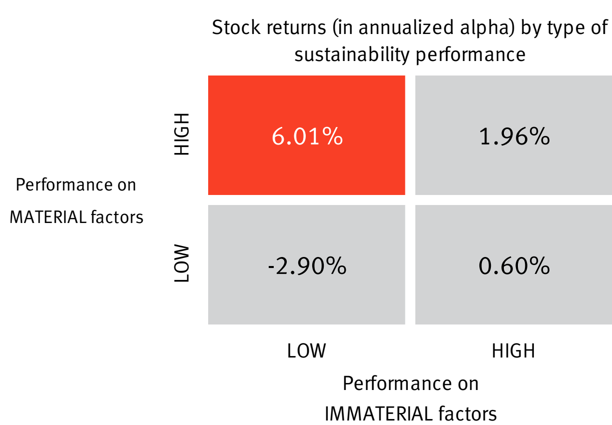

Forty percent of funds with "sustainability" in their process scored in Morningstar's top two categories.

Source - Morningstar Direct; data through 12/31/17
Note: Oldest share classes, n=118

### Informational advantage

What makes it possible for companies to outperform their peers when they address ESG factors? The Sustainable Accountings Standards Board, or SASB, is working to answer that question. The SASB was formed with the idea of setting standards for corporate reporting of sustainability (ESG) information and in doing so address the issue of "materiality." The U.S. Supreme Court defines information

### Material ESG factors impact performance




When companies focus their attention on the ESG factors that are most important to their business and ignore those that are not important, their potential for outperformance is high.

Source - "The Jury is In: Materiality Matters" Jerome Lavigne-Delville. *sasb.org*. SASB, 03/2017. Web. Accessed 05/2018

[4] John Hale Sustainable Funds U.S. Landscape Report, *Morningstar.com*, Morningstar, January 2018, Web.

as material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Greenhouse gas emissions aren’t likely to matter too much to a health care company but they are of vital importance to a transportation company, while water usage is a major risk for a health care company but of almost no importance to the same transportation company.

Companies that see changes in the world and business environment as opportunities rather than obstacles should be better positioned to thrive in this changing environment.

The 2015 paper, *Corporate Sustainability: First Evidence on Materiality*, compared the stock returns for firms that scored well on the factors the SASB had identified as material for their sector versus firms that had scored poorly on the same factors. The high-scoring stocks significantly outperformed their lower-scoring peers. What the paper also found, and perhaps surprisingly, was that firms that did well on material issues but poorly on immaterial issues performed even better.[5] This showed that firms that focus on what is important to their industry, rather than wasting time on issues that are not, perform better.

Investing in companies that operate in a way that improves society certainly offers some psychological benefits, but without a strong case for financial benefit, an ESG approach could be a hard sell to most investors. However, study after study has now shown that not only does an ESG approach—when combined with traditional financial analysis—benefit return, it can also decrease risk.

Logically, we think this makes sense as well—companies that cut corners tend to reap the penalty of those practices in the end. Companies that see changes in the world and business environment as opportunities rather than obstacles should be better positioned to thrive in this changing environment, in our view, and investors who look to identify these companies can potentially boost their portfolio’s performance.

[5] Mozaffar Khan, George Serafeim, and Aaron Yoon (2015) Corporate Sustainability: First Evidence on Materiality, Harvard Business School

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|---|---|---|---|---|
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