



# ESG Investing in Practice



A GUIDE TO PORTFOLIO IMPLEMENTATION



INVESTMENTS

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# Implementing ESG investing into your portfolio

*Even as ESG investing continues to grow as a new opportunity set, it can be difficult for individual investors to understand how best to allocate to these strategies.*

ESG investment approaches—investment strategies that incorporate environmental, social, and governance factors alongside traditional financial analysis—have seen dramatic increases in attention and assets under management over the last few years. Globally, more than \$40 trillion in assets was managed using an ESG-related process to drive investment decisions in 2022, with \$8.4 trillion of that in the United States.<sup>1</sup> ESG factors offer significant and enduring potential to drive returns. We believe this approach represents the future of investing.

But despite ESG investing's growing opportunity set, it can be difficult for individual investors to understand how best to allocate to these strategies. In this guide, we aim to tackle that problem by offering an overview of the many ways to implement ESG investing in your portfolio. In our view, investors should assess both how an ESG approach plans to meet their goals and whether the manager truly “walks the walk” on ESG investing.

# Defining the opportunity set

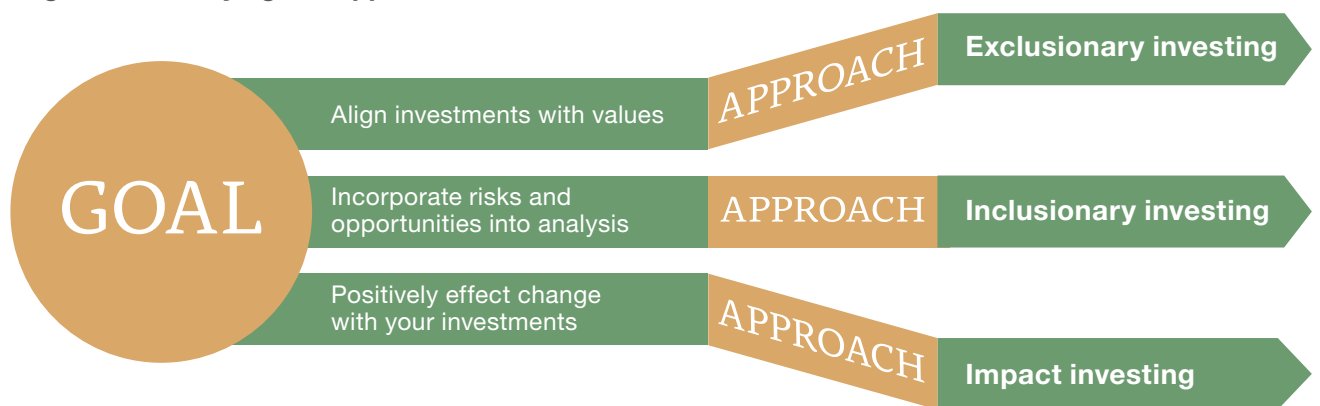
As ESG investing has evolved, a variety of approaches to implementation have emerged. The most established form, both in history and assets, is **exclusionary investing**—also known as “negative selection.” In this approach, certain investments are excluded from a manager’s universe, often due to controversial companies or sectors that do not meet certain sustainability criteria. Exclusionary investing is frequently used to help clients match their investments with their values, preferences, or ethics.

**Inclusionary investing** or “positive selection” is the next most prevalent form. Managers using this strategy aim to add value for their clients by selecting companies based upon their ESG profiles in their sector. An inclusionary, or positive approach invests in sectors, issuers, or projects selected for positive ESG characteristics relative to industry peers.

For investors looking to have their assets address pressing global problems more directly, **impact investing** is a smaller but growing form of ESG investing that can provide that opportunity. Unlike philanthropy, impact investing seeks to couple financial returns with doing good. Through this approach, investors can target their investments to align with broader goals, such as protecting the environment or helping to fight poverty.

To help identify the right ESG investment path for you, we believe it is vital to outline your goals for the allocation, as depicted in **Figure 1** below. By clarifying which goals match your preferences, you can narrow the number of potential investment strategies. However, it’s important to bear in mind that these approaches are not mutually exclusive; in fact, all three can be used in a portfolio.

**Figure 1: Identifying the Approach that Matches Your Goals**

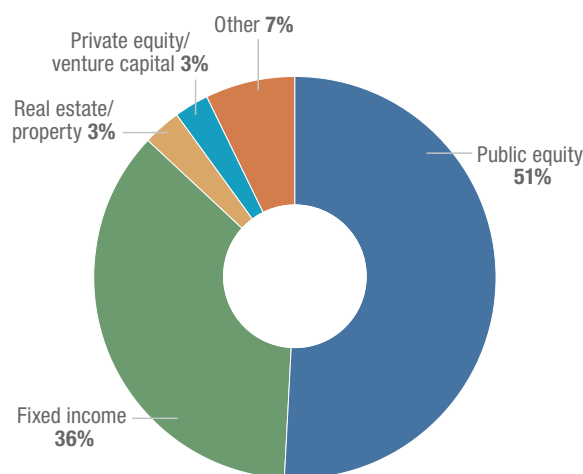


# Implementation in practice

Prospective ESG investors may also benefit from a review of the practical implementations of these approaches. Given the wealth of available options, each of the three predominant forms of ESG investing could have strategies that fit your needs. Notably, ESG

strategies can be employed using active and passive investment styles and across asset classes, as shown in **Figure 2**.

**Figure 2: Integration of ESG Strategies Across Asset Classes (as of 2018)<sup>2</sup>**



Additionally, according to Morningstar, of the 598 sustainable funds available as of December 2022, 418 were equity funds, 129 were fixed-income funds, and 49 were allocation funds. Investors have the most choices in U.S. equity with 193 funds. Another 153 funds were either world-stock or international-equity funds. Among fixed-income funds, 26 were intermediate-term funds. Overall, investors can find sustainable funds in 69 Morningstar categories.<sup>3</sup>

Fixed-income funds commanded the lion's share of 2022's sustainable fund flows. Flows into sustainable bond funds surged to three fourths of overall flows, up from 16% in 2021. Although down from their record \$11.1 billion acquisition in 2021, these funds' net annual \$2.4 billion intake set them apart from conventional peers in 2022.<sup>3</sup> While fixed-income assets managed following ESG guidelines still lag their equity counterparts due to the lack of data and standardization, the recent increase in fixed-income ESG funds suggests this area has room to grow.

## Opportunities across asset classes

Exclusionary, inclusionary, and impact investing approaches can be accessed through equity, fixed-income, or alternative investments. Each asset class has its own ESG considerations and can address distinct ESG investment issues, as shown in **Figure 3**.

For example, consider both inclusionary and exclusionary investing. While a public company could have social risks that affect its stock price, a country could likewise have a governance issue that impacts the creditworthiness of its sovereign debt. In each approach, ESG factors can be used to help determine if it should be included or excluded from the investment universe.

Similarly, an impact investment could be the private equity of a company promoting renewable energy, or it could be a green bond. Green bonds are a growing form of fixed-income impact investing that finances projects that aim to have a beneficial environmental effect. According to Bloomberg, during the first half of 2021 alone, \$294 billion was raised through the sale of green bonds—almost surpassing the \$309 billion sold in all of 2020.<sup>4</sup>

ESG investing is also steadily expanding beyond owners of public and private equities to include bondholders.<sup>5</sup> Overall, ESG factors are increasingly relevant inputs to nearly every kind of investment analysis.

**Figure 3: Different Asset Classes Address ESG Investment Issues in Distinct Ways<sup>6</sup>**

Asset Class	Exclusionary Investing	Inclusionary Investing	Impact Investing
<b>Equity</b>	Excludes stocks with negative ESG factors from the investment opportunity set.	Incorporates ESG risks and opportunities into equity analysis.	Invests in public companies making an environmental or social impact.
<b>Fixed income</b>	Removes bonds with problematic ESG factors from universe. Passive exclusionary options are less common in fixed income but are increasing in prevalence.	Actively incorporates ESG factors into bond analysis. Increasingly, this process is helping to evaluate metrics such as a company's or country's creditworthiness.	Invests in debt instruments such as green bonds to allocate assets to specific issues directly.
<b>Alternatives</b>	Screens for ESG risk factors in private and real estate investment universes.	Integrates ESG research into the analysis of private companies, real estate, infrastructure, etc.	Seeks to effect positive change through direct investment in private companies. Invests in sustainable real estate and infrastructure.

## A role for both active and passive investing styles

Traditionally, much of the active versus passive debate has focused on the versus part of the phrase. In contrast, we believe ESG investing offers opportunities for both active and passive strategies to thrive.

Index providers are creating increasingly sophisticated ESG indices across asset classes. These may offer best-in-class, exclusionary, or theme-based approaches to ESG investing. New ESG indexes make it easier for managers to create corresponding, passive ESG approaches. Importantly, these also represent new and improved benchmarks for active managers.<sup>7</sup>

Stewardship and engagement are also an essential part of this discussion. These activities are often thought to be active-specific and include using voting proxies, engaging in dialogue with company management (and other industry groups), and collaborating with other investors. But a World Bank report on ESG investing noted: "Passive asset owners can use active ownership and engagement to help manage their ESG risks. However, they need a policy and systems to ensure that different investment managers do not take opposing positions."<sup>5</sup>

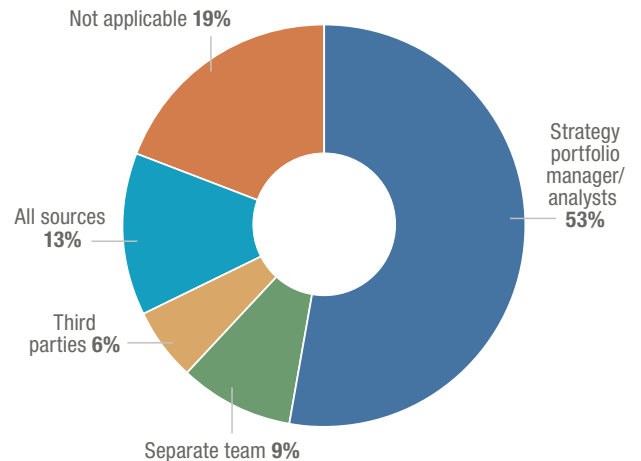
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## Integrating ESG research

Investment managers incorporate ESG research through a variety of sources into their strategies. Understanding how a specific manager uses this ESG research in their investment process is critical to the evaluation of the potential allocation. Their investment process may integrate ESG factors through internal analysis and portfolio manager analysis via a dedicated ESG team within the firm, or by leveraging the expertise of external research and oversight providers.

**Figure 5** shows the prevalence of each of these research sources. Each method has the potential to offer valuable insights but, regardless of the source, it is essential for a manager to have a robust and transparent process for integrating ESG research.

**Figure 5: ESG Research Sources Can Vary<sup>8</sup>**



## Ensuring managers “walk the walk”

Along with evaluating a manager’s approach to implementation, it is also necessary to consider their expertise in and commitment to ESG investing. Some ESG investment specialists have raised concerns over managers rebranding strategies as “sustainable” without truly possessing the skill sets necessary to incorporate an effective ESG investment approach.

This practice—termed “greenwashing”—has become more common as investors aim to capitalize on the growing ESG trend. To avoid allocating to a greenwashed strategy, investors should evaluate the ESG investment pedigree of their prospective manager.

Greenwich Associates notes clients should seek managers who are able to “clearly articulate their firm’s overarching philosophy on ESG, as well as the specifics of its ESG investment process.”<sup>9</sup> In addition, a paper from the Money Management Institute and The Investment Integration Project offers guidance on further best practices to help identify managers who are “walking the walk” on ESG investing,

summarized in **Figure 6**. We believe these are key inputs into the due diligence of a sustainable investment manager.

**Figure 6: Best Practices for a Sustainable Investment Manager<sup>10</sup>**



**Participate** in coalitions that set industry-specific sustainability standards.



**Advocate** for the availability and quality of ESG data across asset classes.



**Support** sustainable investment-related public policy.



**Integrate** their sustainable and financial investment annual reporting into a single publication.

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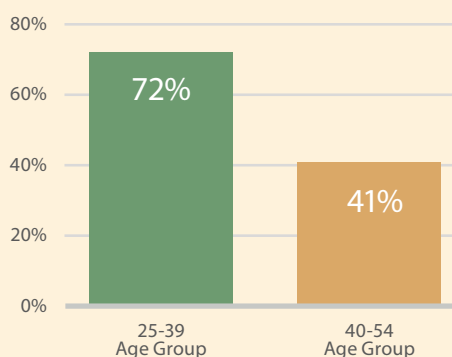
# The evolution of investment management

*In a 2022 New York Life Investments study, when survey respondents already working with a financial professional were asked WHY they decided to invest in a sustainable asset, 55% stated it was because their financial professional made the recommendation.<sup>11</sup>*

At present, ESG investing is simply a growing investment style, but we think it represents the future of investment management. We believe ESG factors offer new sources of inefficiency that have significant potential to drive returns. Although implementation may differ across the breadth of ESG investing strategies, we think these factors ought to be incorporated into the analysis of new and ongoing investments. After all, managers who choose not to integrate ESG factors may miss material opportunities and risks.

In our view, individual investors evaluating a manager must consider the proposed strategy's distinct approach to ESG. Prospective investment managers should have a view about how these factors impact their strategy, be transparent about how ESG research is incorporated into their process, and be able to clearly articulate their firm's commitment to ESG investing.

**Percentage of respondents who expressed an extremely high interest in making a future investment in ESG products<sup>11</sup>**



For more information on ESG investing, visit us at: [newyorklifeinvestments.com](https://www.newyorklifeinvestments.com)



1. Sources: The Forum for Sustainable and Responsible Investment (US SIF), "Trends Report 2022". The modified methodology, as well as the change in asset manager reporting, has resulted in the sustainable investment AUM in this report coming insignificantly lower—\$8.4 trillion.
2. Source: Global Sustainable Investment Alliance, "2018 Investment Review." NOTE: "Other" includes hedge funds, cash, commodities, infrastructure, and unclassified assets. It does not include asset breakdown for Australia and New Zealand. Asset class allocation reported in Europe, the United States, Japan and Canada in 2018.
3. Source: Morningstar Sustainability Landscape Report, 12/31/22.
4. Source: Bloomberg Green, 2021.
5. Source: "Incorporating Environmental, Social, and Governance (ESG) Factors into Fixed Income Investment" by Georg Inderst and Fiona Stewart, 2018.
6. Sources: New York Life Investments, 2019; "Fundamentals of Sustainable Investment: A Guide for Financial Advisors" by Money Management Institute and The Investment Integration Project, 2019; and "Incorporating Environmental, Social, and Governance (ESG) Factors into Fixed Income Investment" by Georg Inderst and Fiona Stewart, 2018.
7. Source: "Fundamentals of Sustainable Investment: A Guide for Financial Advisors" by Money Management Institute, The Investment Integration Project, 2019.
8. Source: InterSec Research, "ESG Investing by Global Managers," 2015.
9. Source: "ESG Investing: The Global Phenomenon," Greenwich Associate, 2018.
10. Source: "Fundamentals of Sustainable Investment: A Guide for Financial Advisors" by Money Management Institute, The Investment Integration Project, 2019.
11. Source: New York Life Investments and RTi Research, August 2022. Results based on survey questions asked of 300 respondents, both men and women, ranging in age from 25-39; 40-54; and 55+.

## ABOUT RISK

Investing involves risk, including possible loss of principal. Asset allocation and diversification may not protect against market risk, loss of principal, or volatility of returns. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors, and each investor should evaluate their ability to invest long term, especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal, or tax advice. You should consult your tax or legal advisor regarding such matters. This material is not intended to be relied upon as a forecast, research, or investment advice, and is not a recommendation, offer, or solicitation to buy or sell any securities or to adopt investment strategy.

Impact investing and/or environmental, social, and governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviation. Opinions expressed are current opinions as of the date appearing in this material only and are subject to change.

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## DEFINITIONS

**Alpha** is a term used in investing to describe a strategy's ability to beat the market or provide excess return. **Active investing** is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity in order to exploit profitable conditions. There are typically higher fees associated with active investment management. A **green bond** is a type of fixed-income instrument that is specifically earmarked to raise money for climate and environmental projects. **Greenwashing** is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. **Passive investing** is an investment strategy that aims to maximize returns over the long run by keeping buying and selling to a minimum. The idea is to avoid fees and the drag on performance that frequent trading can potentially cause.



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