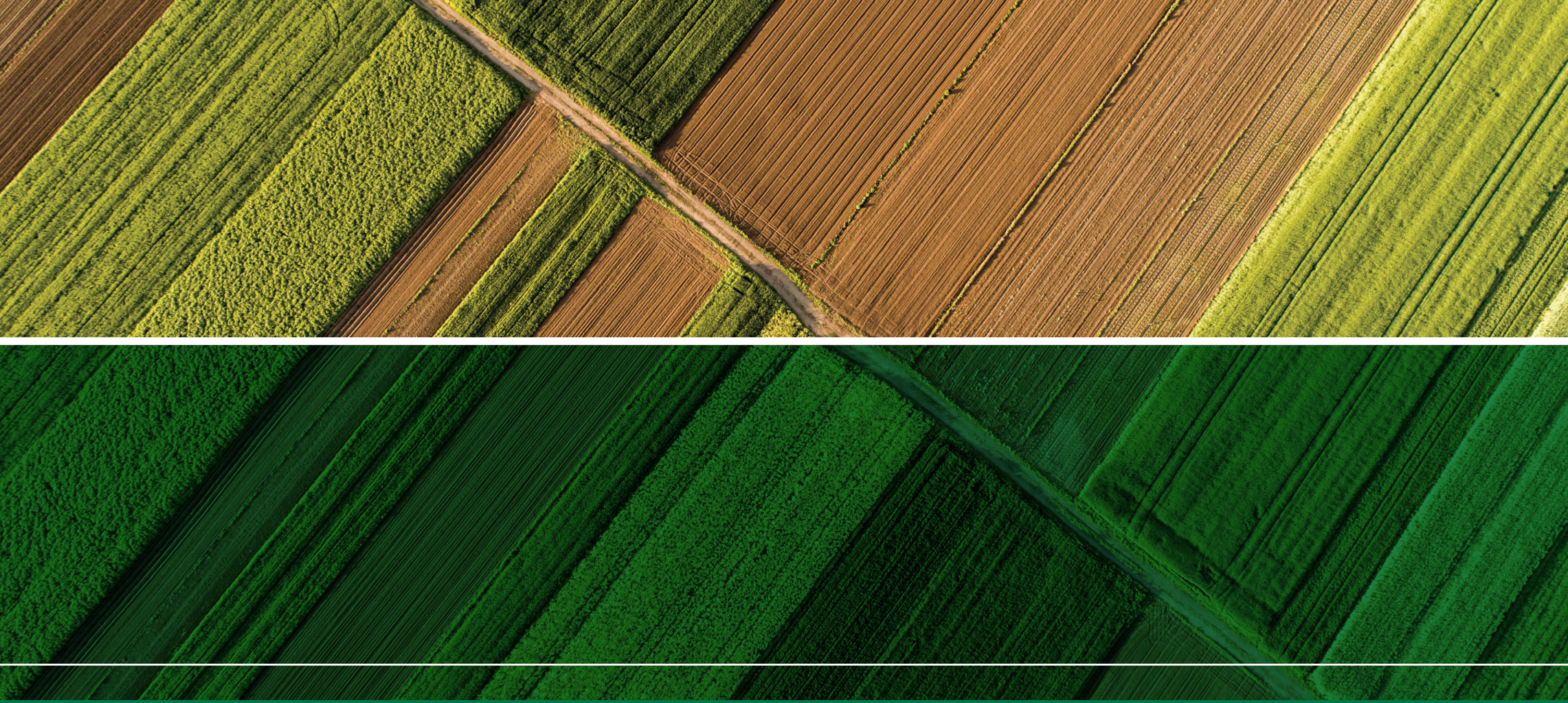


Exclusionary and Inclusionary Approaches

A GUIDE TO ESG INVESTING

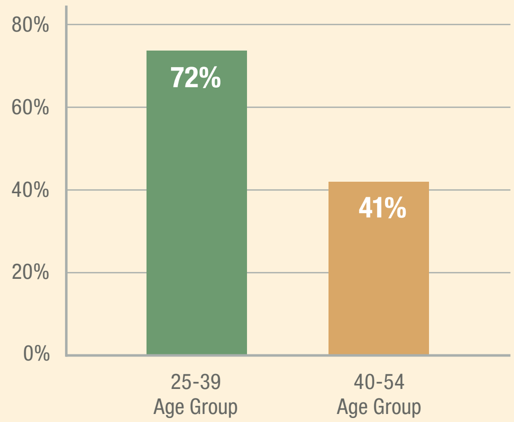
New York Life Investments

Strong growth in ESG investing strategies

In recent years, "ESG investing"—meaning investment strategies that incorporate environmental, social, and governance factors alongside traditional financial analysis—has grown considerably in popularity and assets. According to a 2022 study, more than $8.4 trillion in assets in the U.S. alone was managed using an ESG-related investment approach, compared to $639 billion in 1995.[1]

As you would expect with that level of asset growth, there's been a significant increase in the number of ESG investment strategies offered as well. At the end of 2022, Morningstar recognized 598 sustainable open-end funds and ETFs, up 12% from 2021. There has been nearly a fourfold increase in product development in the ESG space over the past ten years, with the most significant growth beginning in 2015. According to Morningstar, sustainable funds ended 2022 in positive territory—a departure from the broader U.S. fund universe, which suffered the worst flows year on record—their $3.1 billion net annual inflow was well below the average $47 billion annual collection these funds had enjoyed over the previous three years.[2]

In a survey conducted by New York Life Investments, the following respondents expressed an extremely high interest in making a future investment in ESG products[3]



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.*[3]

Two approaches to ESG investing

Two approaches to ESG investing involve looking at the investment universe from either an exclusionary or inclusionary perspective.

ESG investing comes in many "flavors," and the industry has introduced several terms that may be confusing. Two approaches to ESG investing involve looking at the investment universe from either an exclusionary or inclusionary perspective.

An **exclusionary** approach uses a set of criteria to identify companies, sectors, or activities ineligible to be included in a specific portfolio. These criteria might be based on an investor's preferences, values, and ethics. For example, a screening process might be used to exclude the highest emitters of greenhouse gases from a portfolio (i.e., negative screening).

An **inclusionary**, or positive approach invests in sectors, issuers, or projects selected for positive ESG performance relative to industry peers. Investment managers following an inclusionary approach purchase stocks or bonds they believe will outperform, at least in part, due to a company's positive ESG practices.

These approaches are not mutually exclusive. In fact, both can be used in a given portfolio. In **Figure 1** below, we'll explore the nuances of these two approaches in more detail.

Table 1: Exclusionary and Inclusionary Investing — The Two Primary Approaches

Approach	Industry Terms	Definition	Primary Purpose	Example
× Exclusionary	• Socially responsible investing • Negative selection • Negative screening	Excludes controversial companies or sectors that do not meet certain sustainability criteria	Aligning investments with an investor's values, preferences, or ethics	Eliminating tobacco or alcohol companies from a portfolio
+ Inclusionary	• Positive selection • Positive screening • Best-in-class	Investing that seeks positive ESG outcomes by selecting companies based upon their ESG profiles in their sector	Investing in sectors, issuers, or projects selected for positive ESG performance	Investing in companies with the best ESG scores/profiles in their sector

Exclusionary investing

Aligning investments with values

The original ESG investments date back to at least the 18th century, when the Methodists and Quakers refused to invest in companies involved in the slave trade. In modern investing, some religious organizations, charities, university endowments, and pension plans have adopted exclusionary approaches to manage all or part of their investment portfolios. This approach often involves negative screening, which eliminates investments that do not meet certain criteria—whether due to ethical reasons or poor ESG profiles.

Excluding the stocks or bonds of specific companies or industries allows investors to align their investments with their values. In many cases, investors exclude stocks and bonds from companies in "controversial" industries, such as tobacco, alcohol, gambling, fossil fuels, and weapons, among others. Religious organizations may also exclude companies that produce contraceptives or other medical devices that do not meet their ethical guidelines. In addition, negative screens can eliminate the "worst" companies in certain sectors, such as companies with poor human rights records or bad environmental practices.

Negative screening does not necessarily exclude certain sectors in totality. In some cases, there may be "materiality thresholds" to determine if an investment will be excluded. For instance, if a diversified company generates 10% of its revenues from alcohol sales, that company may be included in the investment universe, whereas a company that generates 100% of its revenue from alcohol would be excluded from a portfolio.[4]

Exclusionary investing may exclude the following types of companies and industries:

Managing risk by avoiding "bad" stocks

Active managers can manage risk by excluding certain sectors, issuers, or securities with heightened risks that may be evident in their ESG scores. For example, managers may avoid particular products/services, regions, or business practices, or avoid "sin" industries, such as alcohol, tobacco, gambling, military weapons, fossil fuels, or nuclear energy.

Figure 2 shows three examples of companies with high-profile accidents or scandals. In each of these cases, the company's ESG rating was downgraded prior to the negative event. While accidents and other scandals are bound to happen in the future, these examples demonstrate that managers who integrate ESG into their investment processes may have an advantage versus managers who rely solely on financial metrics in their decision-making.

Figure 2: Three Examples Where Lowered ESG Ratings Anticipated Problems[5]

Company	ESG Factor	Description of ESG Issue	ESG Rating Downgrade?	Outcome
British Petroleum (BP)	Environmental **("E")**	Deepwater Horizon explosion/oil spill in 2010 led to worst-ever environmental disaster in the Gulf of Mexico	**Yes**; two years before accident	BP has spent $40 billion+ on cleanup and penalties so far; credit rating downgrade; stock has underperformed rivals
Equifax	Social **("S")**	Data security breach announced in September 2017; breach exposed the private information of 145.5 million consumers	**Yes**; MSCI downgraded Equifax to its lowest ESG rating in August 2016 and removed the stock from MSCI ESG indices in November 2016	$575 million fine from the Federal Trade Commission (FTC), with the potential to reach $700 million; ongoing reputational damage
Wells Fargo	Governance **("G")**	Fraudulent activity by employee activity led to 1.5 million fraudulent accounts being opened, affecting nearly three million people	**Yes**; MSCI downgraded Wells Fargo in November 2015 due to the high number of customer complaints; subsequent downgrade to its lowest rating in 2016 following the sales scandal	$185 million fine from the Consumer Financial Protection Bureau; class action lawsuit; resignation of CEO

Inclusionary investing

Managing risk through “positive” selection

The other major approach to ESG investing focuses on using ESG factors to find the “best” investment opportunities rather than simply avoiding certain sectors or industries.

In inclusionary investing, investors analyze companies based on individual environmental, social, and governance factors. Best-in-class screening assigns an individual ESG score to each company. Companies that operate within a certain sector, such as oil and gas companies, are then ranked according to their positive ESG performance relative to their industry peers. Investors will then allocate capital to the companies that perform the most favorably. In the example of oil and gas companies, this would likely mean that investors would favor companies that are developing methods of clean energy and are known to accurately disclose the value of their carbon-bearing assets.

Under this approach, companies that do not score highly do not receive an allocation of investor capital. However, this approach is generally sector-neutral, as investors are still maintaining a capital allocation to certain sectors, such as oil and gas, rather than excluding such companies completely. To score companies under this approach, managers can use proprietary research and scoring systems and supplement that with third-party data.

Recently, we have also seen strong growth in thematic investing, which focuses on structural trends that transcend traditional sectors to access the “new normal” of the economy. Thematic investing is a top-down investment approach focusing on long-term trends or themes. These macro trends don’t have to be ESG-specific. For example, aging demographics, robotics, and artificial intelligence (AI) are all mega-trends that investors can invest in. An ESG-themed investment may focus on environmental or social trends or challenges. They may align with one or multiple United Nations (UN) Sustainable Development Goals (SDGs), such as good health, gender equality, education, clean water, or climate action.

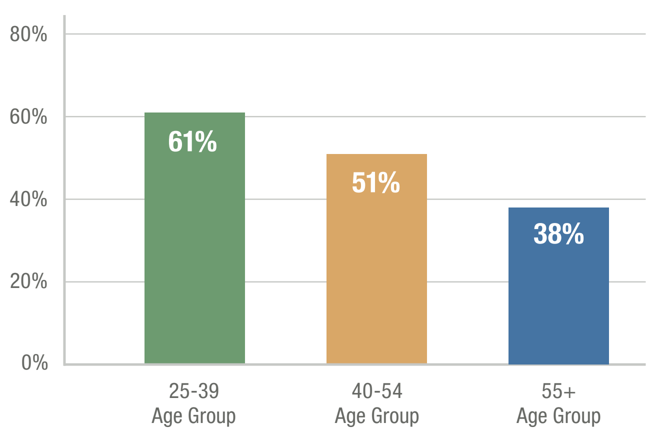
When we consider that thematic investing looks to include companies based on whether they fit a certain environmental or social theme, this investment style could be considered a type of inclusionary investing. However, a thematic strategy may also use ESG integration or exclusionary investing if, for example, the strategy excludes companies that engage in certain controversial businesses, such as alcohol, tobacco, or firearms. Additionally, a thematic strategy could be considered an impact investment if it looks to deliver measurable social or environmental impact—for example, by investing in green projects, medical research, or certain charitable causes.

The next trend in ESG investing

Looking forward, it's likely that investors will want to take ESG investing even further by actively seeking to use their investments to influence the world in a beneficial manner. The rise of "impact investments"—which seek to directly align an investor's financial investments with broader goals, such as protecting the environment and helping to fight poverty—has grown to represent around $1.2 trillion in assets, as of December 2021.[6] The ESG investment universe is expected to grow, with client interest in ESG investing likely to keep increasing as well.

*In a study conducted by New York Life Investments, we found that **56% of the general population surveyed represented what we have defined as a "Values-Driven" investor**—one whose portfolio is highly diversified, and who has taken action against a brand (e.g., boycotting) or changed the types of products purchased (e.g., stopped using plastic straws or now owns an electric vehicle).[3]*

According to a study conducted by New York Life Investments, the following respondents, across multiple age groups, stated they were willing to sacrifice some return to ensure their investments reflected personal social views.[3]



For more information on ESG investing, visit us at: newyorklifeinvestments.com

1. Source: The Forum for Sustainable and Responsible Investment (US SIF), “Trends Report 2022.”

2. Source: Morningstar, “Sustainable Funds U.S. 2022 Landscape Report,” February 2023.

3. 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+.s

4. Source: For more information on this topic, please see EIRIS Foundation, “Responsible Investment in Pooled Funds: A guide for charity trustees,” February 2013.

5. Sources: Bob Monks, “It’s plain for all to see, ESG research works,” Financial Times, 10/20/12; MSCI, “ESG Ratings May Help Identify Warning Signs,” 2018.

6. Source: GIIN, Sizing the Impact Investing Market, 2022.

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 any 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

Active investing (also called active management) is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions. Active management typically charges higher fees. **Alpha** is a term used in investing to describe a strategy’s ability to beat the market or provide excess return. **Alternative investments** are speculative, are not suitable for all clients, and are intended for experienced and sophisticated investors who are willing to bear the high economic risks of the investment. **Bonds** are subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner. **Commodities** markets are subject to greater volatility than investments in traditional securities, such as stocks and bonds. **Fixed-income securities** are subject to credit risk — the possibility that the issuer of a security will be unable to make interest payments and/or repay the principal on its debt — and interest-rate risk — changes in the value of a fixed-income security resulting from changes in interest rates.

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