

# Positive and Negative Approaches



A GUIDE TO SUSTAINABLE INVESTING



INVESTMENTS

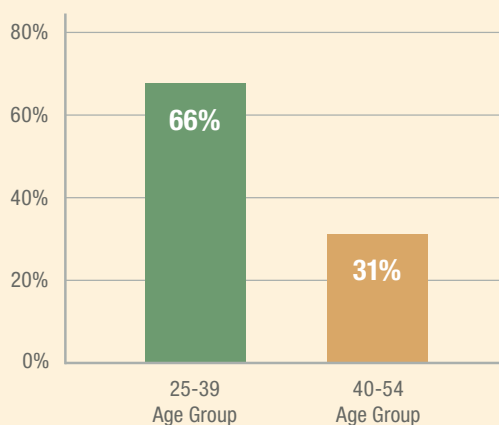
# Strong growth in sustainable investing offerings

*When survey respondents were asked WHY they decided to invest in a sustainable asset, 58% stated it was because their financial advisor made the recommendation.<sup>3</sup>*

In recent years, “sustainable investing”—meaning investment strategies that incorporate environmental, social, and governance (“ESG”) factors with traditional financial analysis—has grown considerably in popularity and assets. According to a 2018 study, more than \$12 trillion in assets in the U.S. alone were managed using a sustainable process, compared with \$639 billion in 1995.<sup>1</sup>

As you would expect with that level of asset growth, there’s been a significant increase in the number of sustainable investment strategies offered as well. At the end of 2018, Morningstar estimated that there were more than 350 mutual funds and exchange-traded funds (ETFs) managed following a sustainable process.<sup>2</sup> This total—which includes equity, fixed income, and alternative funds—reflects a growth of almost 50% from the prior year.

## Percentage of respondents who expressed an extremely high interest in discussing sustainable investment strategies with their advisor<sup>3</sup>



1. Source: The Forum for Sustainable and Responsible Investment (US SIF), “Trends Report 2018.”

2. Source: Morningstar, “Sustainable Funds U.S. Landscape Report,” February 2019.

3. Source: New York Life Investments and RTi Research, September 2019. Results based on survey questions asked of 594 investors, both men and women, with investable assets over \$250k, ranging in age from 25-39; 40-54; and 55+.

# Two primary approaches to sustainable investing

*At its heart, sustainable investing involves looking at the investment universe from either an exclusive or inclusive perspective.*

Sustainable investing comes in many “flavors,” and the industry has introduced several terms that may be confusing. At its heart, sustainable investing involves looking at the investment universe from either an exclusive or inclusive perspective. An exclusive, or negative, approach seeks to avoid certain investments in an investor’s portfolio that do not meet certain criteria. Investment performance is often not the main objective of this approach. Rather, investors generally want to avoid investing in companies that do not align with their values or ethics.

An inclusive, or positive, approach seeks to use ESG factors throughout the investment process in an attempt to add alpha. Investment managers following a positive approach purchase certain stocks or bonds they believe will outperform at least in part, due to a company’s positive ESG practices. The same managers will analyze ESG factors to avoid the stocks and bonds of certain companies with poor ESG profiles. In both cases, managers are using ESG factors not only to meet the stated investment objectives, but to seek to improve investment performance—either by buying the “best” securities or by avoiding the “worst” securities within an investment universe.

This “positive versus negative” dichotomy somewhat oversimplifies the varied landscape of sustainable investing but does provide a helpful way to navigate the broad number of sustainable investments available. **Figure 1** explores the nuances of these two approaches in more detail.

**Figure 1: Positive and Negative—the Two Primary Approaches**

Approach	Industry Terms	Definition	Primary Purpose	Example
<b>Negative</b>	<ul style="list-style-type: none"> <li>• Socially responsible investing</li> <li>• Ethical investing</li> <li>• Values-based investing</li> </ul>	Excludes certain industries, sectors, or companies in an investment portfolio	Align investments with an investor’s values and worldview	Eliminate tobacco or alcohol companies from a portfolio
<b>Positive</b>	<ul style="list-style-type: none"> <li>• ESG integration</li> <li>• “Green” investing</li> <li>• Impact investing</li> </ul>	Uses ESG factors to find the best opportunities in an investment universe	Seeks to add alpha through “best-in-class” ESG investments	Invest in companies with the best ESG scores/profiles

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# Negative approach

## Negative screening—aligning investments with values

The original “sustainable” 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, a number of 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 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.

### Negative screens tend to exclude the following types of companies and industries:



## Divestment—completely eliminating industry or country exposure

In some cases, investors choose to “divest,” or completely exclude, certain investments from their portfolios, again usually to better align their portfolios with their values. For instance, the California Public Employees’ Retirement System (CalPERS)—one of the largest and most influential institutional investors, with assets of more than \$345 billion in 2019—has divested from a number of industries and countries over the years. In 2002, CalPERS decided to exclude tobacco companies from its portfolio, in part because smoking could lead to higher healthcare costs for its members.<sup>4</sup> CalPERS has divested from entire countries as well—for example, it excludes companies that do business in places like Iran and Sudan.

While certain divestments have detracted from CalPERS’ investment performance—particularly its avoidance of tobacco stocks—other divestments have added value. However, CalPERS’ decision was about more than investment performance. Divestment allows CalPERS to use its vast investment portfolio to influence the broader world and to discourage investments in regimes with poor human rights records and other substandard ESG practices. While CalPERS is one of the highest-profile asset owners to exclude entire industries or countries, numerous other charities, endowments, and other organizations also use divestment to align their investment with their values.

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. Source: *Chief Investment Officer*, article “CalPERS Decision to Divest from Tobacco is Costly,” 12/12/18.



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# Positive approach

## Seeking alpha through ESG

The other major approach to sustainable investing focuses on using ESG factors to find the “best” investment opportunities rather than simply avoiding certain sectors or industries. This approach—which has grown significantly in recent years—integrates ESG in the investment process in a number of ways and

generally looks to ESG factors as an alpha source. This often means using external and/or internal ESG ratings throughout the investment process. Before diving into the positive approach, it’s helpful to understand how investment managers access information about individual companies’ ESG profiles through ratings.

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*Investment managers can actively evaluate prospective securities from a sustainability/ESG perspective using “objective” ratings to gain more insight into companies during the investment process.*

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## Finding opportunities using ESG ratings

As interest in sustainable investing has grown, several companies have created ESG ratings to help investment managers invest sustainably. When rating investment products, such as mutual funds and exchange-traded funds (ETFs), Morningstar has launched “Sustainability Ratings” that provide scores of 1 to 5 using company-level ESG ratings.<sup>6</sup> These ratings are used to evaluate portfolios as a whole; then compares those portfolios to peers. The ratings are based on the simple concept that the sustainability of a portfolio is the asset-weighted sum of the sustainability of its holdings. However, when it comes to rating individual companies, index provider MSCI uses an ESG score that provides ratings between AAA (the highest rating) to CCC (the lowest rating).<sup>7</sup> MSCI ratings are assigned based on a company’s exposure to industry specific ESG risks and its ability to manage those risks relative to peers. Even though these are separate and distinct rating approaches, they are considered the top two sustainability/ESG rating systems. The takeaway is that investment managers can actively evaluate prospective securities from a sustainability/ESG perspective using “objective” ratings to gain more insight into companies during the investment process.

In many cases, investment managers seek companies with the highest ESG scores when creating a universe of potential stocks or bonds to include in their portfolio. In this way, managers can select the “best-in-class” stocks or bonds they believe will not only meet the investment criteria, but also help the portfolio to outperform. Even though best-in-class is only one approach (another may be to combine financial and ESG factors into valuation models) there is both academic and real-world support for the “best-in-class” approach. A 2015 academic report that analyzed more than 2,000 other studies found that companies with good ESG ratings outperform over time.<sup>8</sup> The authors state that managers should gain “a detailed and profound understanding of how to integrate ESG criteria into investment processes in order to harvest the full potential of value-enhancing ESG factors.” In addition, Morningstar noted that sustainable funds outperformed their overall universe for four years in a row from 2015 to 2018.<sup>9</sup> The track record of sustainable funds undercuts the notion that investors need to sacrifice performance to invest in ESG-focused funds.

6. Source: Morningstar, “Helping Investors Evaluate the Sustainability of Portfolios,” November 2017.

7. Source: MSCI ESG Ratings Methodology, 2018.

8. Source: Gunnar Friede, Timo Busch, and Alexander Bassen: ESG and financial performance — aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment*, 5:4, 210-233, 2015.

9. Source: Morningstar, “Sustainable Funds U.S. Landscape Report,” February 2019.

# Adding alpha by avoiding “bad” stocks

Managers may use ESG ratings to avoid companies that may appear attractive by standard financial metrics, but lag in ESG scores. Active managers can add value by avoiding stocks or bonds with heightened risks that may be evident in their ESG scores. For instance, perceptive managers integrating ESG into their analysis could have seen red flags in companies that otherwise may have seemed like strong investment candidates.

**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<sup>10</sup>**

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

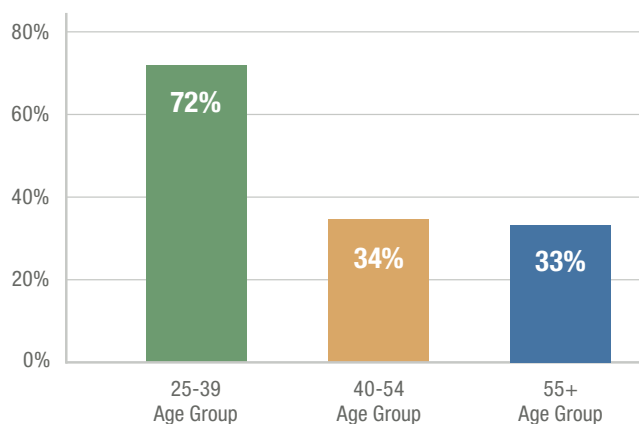
10. Sources: Bob Monks, “It’s plain for all to see, ESG research works,” Financial Times, 10/20/12; MSCI, “ESG Ratings May Help Identify Warning Signs,” 2018.

# The next generation of sustainable investing

While positive approaches to sustainable investing have gained assets and attention, negative approaches clearly have a place as well. Certain types of investors will always look to avoid holding investments that go against their values, so negative screens and “responsible” approaches will almost definitely continue to exist in the future. The widespread adoption of the Principles for Responsible Investing (PRI) by both asset owners and investment managers also indicates that positive approaches that include ESG consideration and integration will also continue to grow. As evidence, PRI signatories represented close to \$90 trillion (with a “T”) of assets under management as of the end of 2018.<sup>11</sup>

Looking forward, it’s likely that investors will want to take sustainable 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—have grown to represent more than \$500 billion in assets.<sup>12</sup> Along with impact investments, numerous thematic ESG investments—such as strategies that invest in companies that produce renewable energy—also have emerged as investment options. The universe is expected to grow, with client interest in sustainable investing likely to keep increasing as well.

**Percentage of respondents who stated they were willing to sacrifice some return to ensure their investments reflected personal social views<sup>13</sup>**



*In a 2019 New York Life Investments study, we found that **53% of the general population surveyed represented what we have defined as a “Values-Driven” investor—one whose portfolio is highly diversified and has taken action against a brand (e.g. boycotting), divested their portfolio of a company that no longer aligned with their beliefs, or changed the types of products purchased (e.g. stopped using plastic straws or now owns an electric vehicle).**<sup>13</sup>*

11. Source: Principles for Responsible Investing, “Annual Report 2018.”

12. Source: Global Impact Investing Network, “Sizing the Impact Investing Market,” April 2019.

13. Source: New York Life Investments and RTi Research, September 2019. Results based on survey questions asked of 594 investors, both men and women, with investable assets over \$250k, ranging in age from 25-39; 40-54; and 55+.

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## ABOUT RISK

All investments are subject to market risk, including possible loss of principal. Diversification cannot assure a profit or protect against a loss in a declining market.

## DEFINITIONS

**Alternative investments** are speculative, not suitable for all clients, and intended for experienced and sophisticated investors who are willing to bear the high economic risks of the investment.

**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. **Bonds** are subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner. **Alpha** is a term used in investing to describe a strategy's ability to beat the market or provide excess return.



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