



# Sustainable Investing in Practice



A GUIDE TO PORTFOLIO IMPLEMENTATION



INVESTMENTS

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# Implementing sustainable investing into your portfolio

*Even as sustainable 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.*

Sustainable investment approaches — investment strategies that incorporate nonfinancial environmental, social, and governance (ESG) factors alongside traditional financial analysis — have seen dramatic increases in attention and assets under management over the last few years. More than \$30 trillion of assets around the globe were managed following a sustainable process in 2018, with \$12 trillion of that in the United States.<sup>1</sup> We believe this represents the future of investing as ESG factors offer significant and enduring potential to drive returns.

But despite sustainable 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 sustainable 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 sustainable investing.

1. Source: Global Sustainable Investment Alliance, "2018 Global Sustainable Investment Review."

# Defining the opportunity set

As sustainable investing has evolved, a variety of approaches to implementation have emerged. The most established form — both in history and assets — is negative screening.<sup>1</sup> In these strategies, certain investments are excluded from a manager’s universe, often due to controversial products or practices. This approach is generally the lowest cost and easiest option to employ. Negative screening is frequently used to help clients match their investments with their values.

Using a positive integration approach is the next most prevalent form. Manager’s utilizing this approach aim to add value for their clients by incorporating ESG factors into investment analysis. This seeks to include potential ESG risks and opportunities in valuations and provide insights into best-in-class (or worst-in-class) ESG investments. Relative to negative screening, this approach offers more opportunity for investment in areas with improving ESG metrics.

ESG integration can be a separate approach to both negative and positive selection and/or used with both, providing even greater flexibility to engage on these issues.

For investors looking to have their assets more directly address pressing global problems, impact investing is a smaller but growing form of sustainable investment that can provide that opportunity. Through this approach, investors can directly align their investments with broader goals, such as protecting the environment or helping to fight poverty. Unlike philanthropy, impact investments seek to balance financial returns with those nonfinancial goals.

To help identify the right sustainable 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.

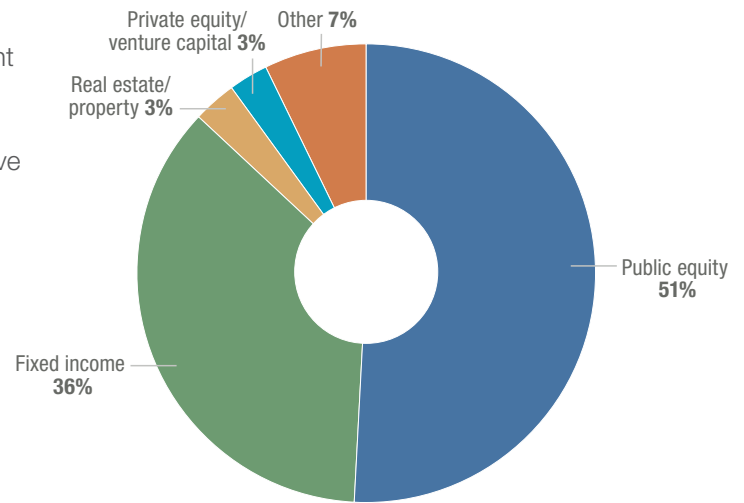
**Figure 1: Identifying the Approach that Matches Your Goals**



# Implementation in practice

As part of this analysis, prospective sustainable 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 sustainable investment could have strategies that fit your needs. Notably, sustainable investments can be employed across asset classes as shown in **Figure 2**, through active or passive investment styles, and with internal or external research.

**Figure 2: Integration of Global Sustainable Investments Across Asset Classes (as of 2018)<sup>2</sup>**



## Opportunities across asset classes

Each asset class has its own ESG considerations and can address distinct sustainable investment issues, as shown in **Figure 3**. Negative screening, positive ESG integration, and impact investing approaches are all available as equity, fixed income, or alternative investments.

For example, consider both positive ESG integration and negative screening. 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 either value a security or exclude it 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. Through 2018, \$580 billion in green bonds have been sold.<sup>3</sup>

ESG engagement is also steadily expanding beyond owners of public and private equities to include bondholders.<sup>4</sup> Overall, these nonfinancial factors are increasingly relevant inputs to nearly every kind of investment analysis.

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. Sources: Lyubov Pronina, "What Are Green Bonds and How 'Green' is Green?" and Bloomberg, 3/24/19.

4. Source: "Incorporating Environmental, Social, and Governance (ESG) Factors into Fixed Income Investment" by Georg Inderst and Fiona Stewart, 2018.

**Figure 3: Different Asset Classes Address Sustainable Investment Issues in Distinct Ways<sup>5</sup>**

Asset Class	Potential Practical Affect	Positive ESG Integration	Negative Screening	Impact Investing
Equity	Incremental large-scale change across ESG issues.	Incorporates ESG risks and opportunities into equity analysis.	Excludes stocks with negative ESG factors from the investment opportunity set.	Invests in public companies directly addressing ESG issues.
Fixed income	Incremental large-scale change across ESG issues and/or debt investment in environmental and social public goods.	ESG integration in bond analysis is increasingly helping to evaluate metrics, such as a company or country's creditworthiness.	Removes bonds with problematic ESG factors from universe. Passive exclusionary options are less common in fixed income, but increasing in prevalence.	Invests in debt instruments like green bonds to directly allocate assets to specific issues.
Alternatives	Fast, disruptive, and revolutionary change across ESG issues. Sustainability in the built environment.	Integrates ESG research into the analysis of private companies, real estate, infrastructure, etc.	Screening of ESG risk factors in private and real estate investment universes.	Direct investment in private companies seeking to affect positive change. Direct investment in sustainable real estate and infrastructure.

*In our view, approaches like positive ESG integration and impact investing are better suited to active management, whereas other forms, like negative screened or ESG-tilted strategies, are well-suited to passive sustainable investing.*

## **A role for both active and passive**

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

Index providers are creating increasingly sophisticated ESG indexes across asset classes. These already offer ‘best in class,’ values-based, or theme-based approaches to sustainable 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>6</sup>

Engagement is an important part of this discussion as it is often thought to be active specific. But a recent World Bank report on ESG investing notes “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>4</sup>

In our view, certain approaches – like positive ESG integration and impact investing – are currently better suited to active management. As previously noted, this enhances the manager’s ability to both engage with their investments and invest in companies or sectors with improving ESG factors. Other forms – like negative screened or ESG-tilted strategies – are well-suited to passive sustainable investing as they provide clients with simple and low-cost options.

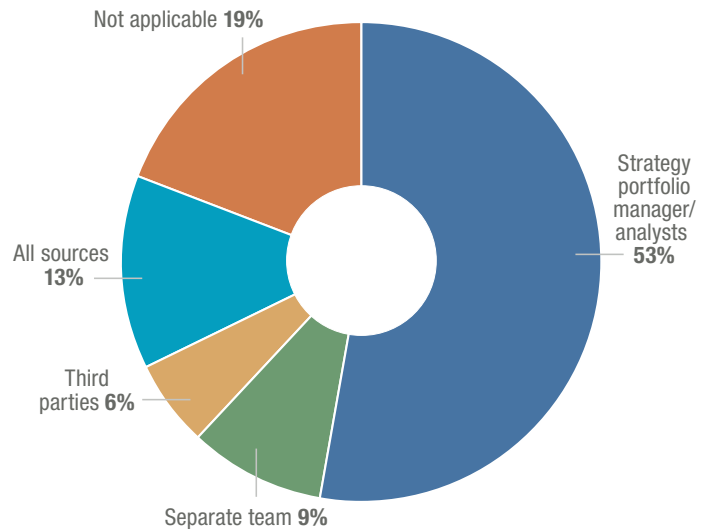
5. Sources: New York Life Investments, 2019; “Fundamentals of Sustainable Investment: A Guide for Financial Advisors” by Money Management Institute and The Investment Integration Project, 2019; and ‘Incorporating Environmental, Social, and Governance (ESG) Factors into Fixed Income Investment’ by Georg Inderst and Fiona Stewart, 2018.  
6. Source: “Fundamentals of Sustainable Investment: A Guide for Financial Advisors” by Money Management Institute, The Investment Integration Project, 2019.

## Integrating ESG research

Investment managers incorporate ESG research through a variety of different sources. Understanding how a specific manager generates their ESG research is critical to the evaluation of the potential allocation. Their investment process may integrate ESG factors through internal analyst and portfolio manager analysis, via a distinct ESG team within the overall investment manager, 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>7</sup>**



## Ensuring managers ‘walk the walk’

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

This practice – termed ‘greenwashing’ – has become more common as investors aim to capitalize on the growing ESG trend. In order to avoid allocating to a greenwashed strategy, investors should evaluate the sustainable investment pedigree of their prospective manager.

Greenwich Associates notes clients should seek managers that are able to “clearly articulate their firm’s overarching philosophy on ESG, as well as the specifics of its ESG investment process.”<sup>8</sup> In addition, a recent paper from the Money Management Institute and The Investment Integration Project offers

guidance on further best practices to help identify managers that are ‘walking the walk’ on sustainable investing. 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>9</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.

7. Source: InterSec Research, “ESG Investing by Global Managers,” 2015.

8. Source: “ESG Investing: The Global Phenomenon,” Greenwich Associate, 2018.

9. Source: “Fundamentals of Sustainable Investment: A Guide for Financial Advisors” by Money Management Institute, The Investment Integration Project, 2019.

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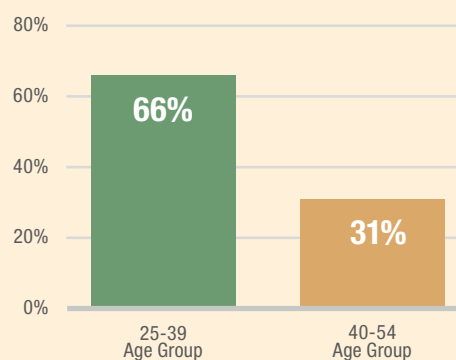
# The evolution of investment management

*In a 2019 New York Life Investments study, 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>10</sup>*

At present, sustainable 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 sustainable investing strategies, we think these factors ought to be incorporated into the analysis of new and ongoing investments. After all, managers that choose not to integrate nonfinancial 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 on how these factors impact their strategy, be transparent on how ESG research is incorporated into their process and be able to clearly articulate their firm's commitment to sustainable investing. We hope this guide will help you navigate this exciting investment opportunity set.

**Percentage of respondents who expressed an extremely high interest in discussing sustainable investment strategies with their advisor<sup>10</sup>**



<sup>10</sup>. 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+.



## 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.



## INVESTMENTS

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