Sustainability as a Megatrend: Investment Implications

Jon Hale, Global Head, Sustainable Investing Research
December 5, 2018
Outline

- Sustainable Investing: What is it? What do we call it? Why is it a thing?
- Manager evaluation considerations
- Morningstar data and analytics: Sustainability Rating, Carbon-Risk, Screening, Intentionality attributes
Megatrends

Megatrends:

- major shifts likely to have broad, deep and long-lasting impacts on our lives and institutions, and those of future generations
Sustainability as a Megatrend

**Sustainability:**

- Maintaining any successful system at its current rate
- Making decisions that meet current needs without diminishing ability of future decision-makers to make decisions that meet their needs
- Long-term orientation
- Includes multiple stakeholders
- Interconnection between financial, human, and natural capital
Sustainability Challenges

Factors causing businesses to pivot towards sustainability:

- Climate change
- Natural resource scarcity
- Radical transparency enabled by technology
- Burgeoning global middle class / wealth inequality
Sustainability Challenges

Sustainable Citizenship:

- Not only as Voters
- But also as:
  - Consumers
  - Business partners
  - Employees
  - Investors
Asset Managers incorporating sustainability considerations into their investments because:

- Sustainability has become a key factor in corporate financial performance

Sustainable Investing: Key Drivers

Asset Managers incorporating sustainability considerations into their investments because of:

▶ Investor demand

Interest in Sustainable Investing

Sustainable Investing Defined

- Sustainable investing is long-term oriented, includes the consideration of multiple stakeholders and broader systems-level impacts – social, environmental, and economic.

- It integrates the consideration of Environmental, Social, and Corporate Governance issues within the investment process.

- It is aware of the impact investments have -- beyond shareholders -- on other stakeholders and on systems; it seeks to mitigate negative impacts and to create positive impacts.

- Sustainable investors are responsible owners, meaning they actively engage with companies as shareholders and with fixed-income issuers about sustainability issues.
Sustainable Investing – Key Terms

Sustainable, ESG and Impact are in, SRI is out

Terms used in funds launched or renamed, 2015-2018:

<table>
<thead>
<tr>
<th>Term</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustainable</td>
<td>29</td>
</tr>
<tr>
<td>ESG</td>
<td>28</td>
</tr>
<tr>
<td>Impact</td>
<td>28</td>
</tr>
<tr>
<td>SRI</td>
<td>10</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
</tr>
<tr>
<td>None</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct. Data as of May 2018.

- $12 Trillion in U.S.
- 26% of all U.S. assets under professional management
- 38% growth since 2016
- 18X growth since 1995

SOURCE: US SIF Foundation.
Sustainable Investing Growth: Signatories to Principles for Responsible Investment

- $82 Trillion globally
- 1,588 Asset Managers
- 373 Asset Owners
Sustainable Investing Growth: Recent Intentional Fund Launches

- 108 ESG funds < 3 yrs old (as of 11/18)

ESG fund launches 2013-2018(Q3)
Sustainable Investing Growth: Repurposed Funds

44 funds added ESG to name and/or prospectus, 2017-2018(Q3)

Data as of 9/19. Source: Morningstar Direct
Sustainable Investing Growth: ESG Fund Flows

U.S. Sustainable Funds Monthly Flows, 2015-Aug 2018

Data as of 9/19. Source: Morningstar Direct.
Due diligence challenges: Understanding ESG data

▶ Materiality
SASB standards address the sustainability topics that are reasonably likely to be material and to have material impacts on the financial condition or operating performance of companies in an industry.

▶ Sustainalytics Examples:

<table>
<thead>
<tr>
<th>Integrated Oil &amp; Gas</th>
<th>Diversified Banks</th>
<th>Pharmaceuticals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carbon Emissions</td>
<td>Corporate Governance 19%</td>
<td>Product Governance 20%</td>
</tr>
<tr>
<td>Pollution/Waste</td>
<td>Business Ethics 19%</td>
<td>Corporate Governance 18%</td>
</tr>
<tr>
<td>Corporate Governance</td>
<td>Human Capital 13%</td>
<td>Business Ethics 16%</td>
</tr>
<tr>
<td>Occupational Health &amp; Safety</td>
<td>Data Privacy &amp; Security 13%</td>
<td>Human Capital 12%</td>
</tr>
<tr>
<td>Community Relations</td>
<td>ESG Integration 13%</td>
<td>Bribery &amp; Corruption 12%</td>
</tr>
</tbody>
</table>

Data as of 11/18 from Sustainalytics.
Due diligence considerations: Understanding ESG data

- Company ESG Reports

**SUSTAINALYTICS ESG RISK RATING SUMMARY REPORT**

**Facebook Inc**

Internet Software and Services | United States | NAS:FB

31.1 /100 High

Rating Overview: The company is at high risk of experiencing material financial impacts from ESG factors, due to its medium exposure and average management of material ESG issues. The company is noted for its poor corporate governance performance, which is increasing its overall risk. Despite its management policies and programmes, the company has experienced a high level of controversies.

ESG Risk Rating Distribution

Relative Performance

Data from Sustainalytics, as of 11/2018.
Due diligence considerations: Understanding ESG data

Facebook Inc (cont’d)

Data from Sustainalytics, as of 11/2018.
Due diligence considerations: Short track records/Small asset bases

- Half of intentional ESG funds < 3 years old
- Virtually all of repurposed ESG funds within past 3 years
- Passive ESG funds based on new indexes

Due diligence considerations: Degrees of intentionality

- Has Asset Manager signed PRI?

- Has Asset Manager articulated its approach to sustainable investing?
  - Is it limited or comprehensive?
  - Does it include intentional fund/strategy offerings?

- Has Asset Manager hired personnel dedicated to sustainable investing?

- How does Asset Manager approach stewardship?
  - Does it have a written policy on ESG-related engagements and proxy voting?
Due diligence considerations: Degrees of intentionality

- **None**: No evidence of ESG consideration
- **ESG Aware**: Some ESG consideration at Asset Manager or strategy level
- **ESG Incorporation**: ESG incorporation described in Prospectus or investment objective
- **ESG Portfolio**: Portfolio intentionally tilted towards ESG, using full integration, best-in-class, and/or exclusions
- **Impact Portfolio**: Portfolio tilted towards ESG & aims to deliver impact alongside financial returns
Due Diligence Considerations: Fixed Income

- ESG issues present material credit risk for both corporates and sovereigns

PIMCO’s integration of ESG credit analysis across the entire investment universe reflects the understanding that investors, like any lender, cannot ignore sustainability and governance issues that may affect a borrower’s ability to repay its debt.

- Companies with strong sustainability profiles realize a range of competitive benefits

[C]ompanies that effectively manage and integrate sustainability issues realize a range of competitive benefits – including resource and cost efficiencies, productivity gains, new revenue and product opportunities, and reputation benefits.
Due Diligence Considerations: Fixed Income & Impact

- Fixed Income can achieve impact through a focus on use of proceeds
  - Munis
  - Green Bonds
    - $155B issuance in 2017
    - ~$135B through 2018 Q3
  - SDG Bonds

Growth of Labelled Green Bond Market

Source: Climate Bonds Initiative
Due Diligence Considerations: Passive ESG Funds

- Simple, low-cost solutions

- About 70 in U.S. – open-end funds and ETFs

- What conventional benchmark is used?

- How long of a track record does ESG index have?

- What approach, if any, does Asset Manager take for stewardship?

Typical investment approach:

- **Exclusions** – How many? Which ones?
- **ESG Ratings** – Provider? Threshold for inclusion?
- **Portfolio Construction** – Overweight companies with highest ESG ratings/remove companies with lowest ESG ratings? Optimization to minimize tracking error?
Due Diligence Considerations: Impact & the Sustainable Development Goals

- Framework for evaluating impact
- Early stages
- Funds beginning to produce impact reports

<table>
<thead>
<tr>
<th>Sustainable Development Goals</th>
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<tbody>
<tr>
<td>1. No Poverty</td>
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<tr>
<td>2. Zero Hunger</td>
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<tr>
<td>3. Good Health and Well-Being</td>
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<tr>
<td>4. Quality Education</td>
</tr>
<tr>
<td>5. Gender Equality</td>
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<tr>
<td>6. Clean Water and Sanitation</td>
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<tr>
<td>7. Affordable and Clean Energy</td>
</tr>
<tr>
<td>8. Decent Work and Economic Growth</td>
</tr>
<tr>
<td>9. Industry, Innovation and Infrastructure</td>
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<tr>
<td>10. Reduced Inequalities</td>
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<tr>
<td>11. Sustainable Cities and Communities</td>
</tr>
<tr>
<td>12. Responsible Consumption and Production</td>
</tr>
<tr>
<td>13. Climate Action</td>
</tr>
<tr>
<td>14. Life Below Water</td>
</tr>
<tr>
<td>15. Life on Land</td>
</tr>
<tr>
<td>16. Peace, Justice and Strong Institutions</td>
</tr>
<tr>
<td>17. Partnerships for the Goals</td>
</tr>
</tbody>
</table>

Source: United Nations
Due Diligence Considerations: ESG Models

- ESG funds span a range of Morningstar categories

- Consider Global Developed Equity

- Consider Green Bond/Environmental “Sector” funds

- Don’t worry about TIPS (put them in if you need to)

- Fill in with ESG Aware/use Morningstar Sustainability Rating

<table>
<thead>
<tr>
<th>ESG Funds by Morningstar Category</th>
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</thead>
<tbody>
<tr>
<td><strong>International Equity</strong></td>
</tr>
<tr>
<td>Emerging Markets</td>
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<tr>
<td>Non-US Developed Markets</td>
</tr>
<tr>
<td>Global Developed</td>
</tr>
<tr>
<td>Global Real Estate</td>
</tr>
<tr>
<td><strong>U.S. Equity</strong></td>
</tr>
<tr>
<td>Large Blend</td>
</tr>
<tr>
<td>Large Growth</td>
</tr>
<tr>
<td>Large Value</td>
</tr>
<tr>
<td>Mid Cap</td>
</tr>
<tr>
<td>Small Cap</td>
</tr>
<tr>
<td><strong>Fixed Income</strong></td>
</tr>
<tr>
<td>Intermediate Bond</td>
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<tr>
<td>High Yield Bond</td>
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<tr>
<td>Emerging Markets Debt</td>
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<tr>
<td>Other Taxable Bond</td>
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<tr>
<td>Muni Bond</td>
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<tr>
<td><strong>Allocation</strong></td>
</tr>
<tr>
<td>Sector</td>
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<tr>
<td>Alternatives</td>
</tr>
</tbody>
</table>

Data as of 9/18. Source: Morningstar Direct
Company ESG Research

- Company ESG Scores (0–100)
- Controversy Scores (0–5)
  - Controversies are incidents that impact the environment or society and pose risks to companies

Historical Sustainability Score

- Asset-weighted roll-up of the 12-month weighted average of Sustainability Scores
- Company ESG scores with deductions for controversies
- Company analysis is based on stock and corporate bond holdings
- 67% of portfolio assets must have company ESG scores

Sustainability Rating

- Historical Sustainability Score relative to Morningstar Global Category
- At least 30 funds in Global Category need a Historical Sustainability Score
Morningstar Sustainability Rating

Intermediary Use Cases

- Sits alongside other due diligence metrics for all funds

- Used to evaluate current fund portfolios/lineups for clients who want to incorporate sustainability

- Used to find funds that could fit into ESG models where there may not be appropriate intentional ESG fund options

- Used as proof-of-concept for intentional funds – are they doing what they say they’re doing?
Morningstar Carbon Risk Score

- Carbon Risk Score: an absolute measure of carbon risk
- An advance over portfolio carbon footprinting, which relies solely on carbon intensity
- Considers how effectively a portfolio is managing its greenhouse-gas emissions to better align with the low-carbon transition
- Based on innovative Sustainalytics company-level carbon risk ratings
Additional Tools: Product Involvement, Intentionality Tags, Fund Proxy Voting, Reports

- Find any fund’s exposure to fossil fuels, weapons, alcohol, tobacco, gambling, etc.
- Find out more about Intentional ESG Funds – ESG, screening, impact, stewardship
- Find out how asset managers/funds voted their proxies
- Fund Sustainability/Carbon Risk Reports
Sustainable investing at Morningstar: giving investors the tools and research they need to make better decisions.