REFOCUSING THE SRI/ESG CONVERSATION: DISRUPTIVE CHANGE AND INVESTMENT OPPORTUNITY

THE GROWING FOCUS ON ESG

In recent years, Socially Responsible Investing ("SRI") or investing on the basis of Environmental, Social and Governance ("ESG") factors have become some of the hottest topics in the investment world. The United Nations lists 17 Sustainable Development Goals ("SDGs")[1] as part of its 2030 Agenda for Sustainable Development, which "provides a shared blueprint for peace and prosperity for people and the planet, now and into the future." Increasingly, stakeholders are demanding investments that strive to further these goals and/or divestitures from those antithetical to them. At the same time, institutional investors and investment managers generally have a fiduciary obligation to strive to maximize returns while taking an appropriate level of risk on behalf of those stakeholders. In recent policy discussions (and lawsuits), these potentially competing ideas have come to the fore, with questions about whether return maximization should be framed in financial or social terms. ESG investment approaches are seen by some as adverse to the goal of maximizing returns, while proponents argue that an investment approach considering ESG factors will, in fact, maximize returns in the long run.

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We believe that these two competing notions can, and should, be reconciled, and the current preoccupation with what this transformation means for investment management, as distinct from what it means for economies and specific companies, is not particularly helpful to that reconciliation process. The industry currently seems focused on developing ESG-labeled products and strategies, which has spawned a new group of businesses aimed at providing company-level ESG ratings, not unlike the role credit rating agencies play for debt issuers. With all this attention on ratings and labels, we believe there is a risk of underappreciating the economic megatrend that the ESG revolution represents and ways to approach it that focus appropriately on both financial returns and social considerations.

ESG'S CONUNDRUMS TODAY

A few large investment firms have led in the "ESG/SRI" arena, positioning themselves as sustainability champions. Many of these players manage large, index-like funds and receive nearly continuous inflows from 401(k) plans and other investors putting excess cash to work. Even incrementally reorienting flows that would have gone to traditional indices (such as the S&P 500 Index) toward newly crafted, ESG-aware versions of these indices could have profound effects. But, of course, the devil is in the details. How "ESG-aware" is defined, who determines these definitions, and whether they adopt an exclusionary approach (avoid the "bad" companies) or an inclusionary approach (overweight the "good" companies) will ultimately determine whether these are merely "feel good" changes or truly impactful ones. These are often complex exercises, wrought with data challenges and requiring subjective interpretation, but, conceptually at least, new index definitions could help drive positive impact without bearing the cost of lower long-term returns.

Many other investment firms have raced to market with new or repackaged products, or to tell investors why their approach is inherently ESG-aware or has always been ESG-aware. The momentum and dynamics of this dialogue have been a bit overwhelming for investors as they seek to adopt a thoughtful approach or policy of their own. A look at the ESG portfolios of many investment managers

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[1] https://sdgs.un.org/goals

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shows some glaring problems, as managers, often based upon the factors utilized by ESG rating agencies, can include the "cleanest shirts in the dirty laundry." For instance, many ESG portfolios hold positions in companies with sizeable global carbon footprints, but because much of their most carbon-intensive impacts are outsourced, or because they do "box-ticking" projects, they still receive good scores from an ESG rating agency. In addition, a company may score well on one factor (for instance, transparency and disclosure) and poorly on another (for instance, environmental impact) and still be included in an ESG portfolio. Furthermore, much of the scoring and metrics in the ESG space are based on industry models and not on company-specific analysis, both of which are difficult to standardize for all companies, particularly those further down the capitalization spectrum. Thus, we are not yet convinced that the ESG rating methodologies currently in place are effective. They may in fact be leading to adverse outcomes as companies manage themselves in part to "greenwash" and to score well from an ESG-rating perspective. Despite these conundrums, the ESG investing conversation remains important, and over time, we expect investors will demand ongoing improvements that better align intentions with outcomes.

THE OPPORTUNITY

Putting an ESG label on an index or applying subjective, and sometimes confounding, metrics to measure a portfolio's overall impact may be missing the forest for the trees. ESG is a growing, global megatrend that we expect to shape the destinies of economies and companies for decades to come. Many investment managers are positioning themselves to generate asset flows from investors who care about ESG and SRI-related issues in an effort to grow their businesses. However, in our view, the real skill that active investment managers can bring to bear is identifying the companies that will win or lose based upon their consideration (or lack thereof) of ESG issues and their ability to create value-added solutions that positively impact society and the planet.

If we soon inhabit a world in which every company must attempt to disclose its overall "impact" or, through carbon taxes or otherwise, bear *all* the social and environmental costs of production (in which the "negative externalities" become internalized), then measurement and mitigation take on great urgency. This will drive change and innovation, historically important precursors to value creation for companies within diverse supply chains. Moreover, the bigger the problem, the more valuable the solution, with implications for pricing power, growth, and future value creation. The current preoccupation with crafting indices and portfolios with favorable, if currently often dubious, ESG scores overlooks this dynamic entirely. Much like the globalization trend that began in the 1980s, company fortunes will be won and lost as these trends take further hold across the globe. Investments in areas undergoing secular change and disruptive innovation have always been fertile ground for outsized profits and alpha generation. In our view, this is a massive opportunity for investors who focus their efforts correctly and avoid the pitfalls of current market conventions. Rather than forcing strict definitions upon them, we think if our managers can identify and buy those companies that are bringing high-value solutions and solving ESG problems, and sell short those that do the opposite, they can both create lasting positive change *and* maximize returns.

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DISCLOSURES

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