

Keeping You Informed Values-Based Investing

For some investors, maximizing their financial returns or beating a benchmark is not the only thing that matters. These investors aspire to create portfolios that also reflect their core values and beliefs. Not only is the growth potential of a company or a fund considered in the stock selection and portfolio creation process, but corporate practices, policies, and business activities are also examined to ensure they are in harmony with and support an investor's principles.

This values-based approach to investing goes by many names and covers different practices, including:

- Socially responsible investing (SRI)
- Environmental, social, and governance (ESG) factor and sustainable investing
- Impact investing

The focus and objectives vary, but the common element in these disciplines is that they all consider factors beyond traditional fundamental and valuation metrics.

The interest in this area of investing has been growing rapidly as evidenced by the now 1,400 global institutional investor's signatories to the United Nations Principles for Responsible Investing initiative and the more than \$6 trillion invested in mutual funds, separate accounts, and institutions with an ESG mandate. With its evolution and increased scope, values-based investing is becoming mainstream, providing greater opportunities for investors motivated to align their investments with their personal values.

History and evolution

While the media coverage and popularity of values-based investing have expanded, the approach is certainly not new. This type of investing has been around for centuries with religious organizations being the earliest adopters. John Wesley, a founder of the Methodist Church, used the pulpit in the 18th century to outline tenets for ethical investing, including avoiding industries which harm workers' health.

The modern usage and understanding of SRI became popular in the 1960s and the first SRI mutual fund, the PAX World Fund, was introduced in 1971 during the height of the Vietnam era. It offered an investment alternative to those opposed to nuclear arms production. In the early 2000s, there was an additional emphasis on good corporate governance and ESG factor investing emerged.¹ More recently, in 2007, the term "impact investing" was coined by the Rockefeller Foundation as a novel way to think about investing for both financial and social return.

The evolution of values-based investing can be broken down into three approaches which all build off of each other. The spectrum of these strategies ranges from a focus on values alignment to a focus on social and environmental impact as described below.

Socially responsible investing (SRI)

This strategy **aligns** investments with beliefs by screening out companies or industries based on specific criteria. Faith-based institutions and progressive investors developed the strategy to filter out "sin stocks" and avoid businesses they considered morally questionable. Today, SRI screening is also used by all types of investors to filter out objectionable activity based on their own value choices. Common criteria used for screening include:

- Abortion
- Adult entertainment
- Alcohol
- Animal welfare
- Carbon emissions
- Child labor
- Firearms
- Gambling
- Military weapons
- Nuclear power
- Stem cell research
- Tobacco

For example, an individual investor with a desire to promote animal welfare can screen a potential investment portfolio and eliminate any companies involved with animal testing. A fund manager can filter out companies involved with alcohol or gambling or other factors that may violate specific moral principles.

Overall, the SRI objective is to exclude companies with business activities that run counter to an investor’s ethics. The screening methodology can be adjusted to match an investor’s preferences from zero tolerance to a particular activity to a defined minimum revenue percentage derived from the activity.

ESG factor investing

The emphasis in this approach is to search out and include companies based on desired environmental, social, and governance characteristics rather than solely exclude companies with undesirable business activities. ESG factors are **integrated** into the whole investment process to select companies and create portfolios using both positive and negative screens.

ESG issues are often interlinked, but tend to be classified into environmental, social, and governance categories. There are hundreds of ESG issues that can be considered, but some of the most common factors are listed in the table at the bottom of this page.

With this process, investors and managers proactively search out companies that support their goals and principles. An investor concerned about climate change, rising sea levels and weather disturbances can actively

search for companies that score high on climate change policy and environmental management factors. An investor with the goal of promoting gender equality and empowering women can actively search out companies with a higher percentage of women on the board.

Considering ESG issues is not new, as nonfinancial factors such as reputational risk and regulatory developments have historically been part of traditional fundamental analysis and risk assessment. The current ESG factor approach, however, refers to a more systematic, less cursory consideration of specified ESG issues throughout the entire investment process.

Some ESG-focused managers go beyond integrating defined factors into their portfolio creation process and actively support their principles through **shareholder engagement**. Such managers have direct communication with companies and exercise their shareholder rights, including voting proxies, filing shareholder resolutions, and engaging with management to improve ESG practices. Bringing ESG issues to the attention of public companies has driven positive change for many corporate policies and practices over the years.²

While many investors and managers use ESG factors for values alignment, others include ESG factors in their investment process for risk management and as a source of potential outperformance. Proponents of such ESG investing argue that considering ESG factors, such as good corporate governance, environmentally responsible behavior and other sustainability practices, provides more robust investment analysis and leads to improved decision making.³

| Most Common ESG Factors | | |
|--|--|--|
| <p>Environmental</p> <ul style="list-style-type: none"> • Climate change and carbon emissions • Toxic emissions and waste • Water stress • Clean tech opportunities | <p>Social</p> <ul style="list-style-type: none"> • Health and safety of employees • Data protection and privacy • Product integrity • Community relations | <p>Governance</p> <ul style="list-style-type: none"> • Board and executive diversity • Executive compensation • Corporate structure • Business ethics |

Impact investing

This relatively new area refers to investing for both a financial and social benefit. The objective is to create a positive and measurable **impact** on major environmental or social issues, such as climate change, clean water, or education, in addition to achieving a financial return.

The term impact investing is used loosely and has different meanings for different investors. Typically impact investors expect to receive a risk-adjusted market rate return, but others are willing to compromise on financial return to boost the social or environmental outcomes. The investor's desired impact can also range from high to do no harm.

Impact investors are often institutions or high-net-worth individuals with a passion for addressing specific environmental or social challenges. For example, a foundation with an environmental conservation focus may invest in a firm offering an energy saving solution for utility

companies. An investor with an anti-poverty mission may invest in a microfinance fund that provides affordable housing and economic development loans to low-income communities. Common impact investing themes are listed in the table below.

Impact investments are often concentrated in the private markets where there is a greater opportunity to deliver specific outcomes. Such private equity or debt investments can be direct, supporting an explicit impact goal, or indirect through intermediary managers who often create portfolios across a range of environmental and social themes.

Impact opportunities are also available in public equity, microfinance, green bonds, community development organizations, and alternative funds. Such options vary in their level of potential impact, return expectations, liquidity and associated risk.

| Common Impact Investing Themes | | | | |
|---|--|--|--------------------------------------|-------------------------------------|
| Resource efficiency | Sustainable products | Clear infrastructure | Healthcare | Education |
| Water and agricultural efficiency, energy storage | Green building materials and consumer products | Renewable energy, wastewater treatment | Health services, healthcare delivery | K-12 education, vocational training |

Increasing interest and growing popularity

Numerous statistics are illustrating that interest in SRI, ESG factor, and impact investing is growing rapidly, including:

- \$6.57 trillion of U.S. assets under management incorporated ESG criteria in 2014, up from \$3.47 trillion in 2012.⁴
- 6% of all dollars awarded to U.S. active equities by institutional investors in 2015 were in ESG/impact funds, up from negligible levels in prior years and a bit less than a third of the overall allocation made to large-cap equities.⁵
- The number of institutions (sovereign wealth funds, asset managers, pensions, university endowments) that have signed the United Nations Principle for Responsible Investments (UNPRI) pledge to integrate ESG into their investment process has been increasing at double-digit rates globally, and total assets controlled by those signatories is up to \$60 trillion.⁶

Much of the interest comes from institutional investors (foundations, endowments, and pension funds), family offices and high-net-worth individuals, particularly millennials and women.

- **Institutional investors** – While foundations are investing for impact as a way to increase assets to support their philanthropic mission and goals, pension funds, endowments and other institutional investors are also driving demand for SRI/ESG and impact investing. With this approach, pension funds benefit by aligning investments with the values of their beneficiaries and communities. For example, a large state pension fund recently invested billions in a fund that prioritizes companies with smaller carbon footprints, aligning with the state's green energy focus. An endowment can use such strategies to respond to pressure from students and alumni to address disparities between the university's mission and investment holdings.

- **Millennials** – Millennials tend to be values-focused and more socially and environmentally aware, so it is not surprising that they have shown an interest in values-based investing. In a recent survey by U.S. Trust Bank of America Private Wealth Management, 85% of millennial respondents agreed that social or environmental impact is important to their investment decisions, compared with 70% of Generation X and 49% of baby boomers.⁷

Increasing ESG/impact data and investment options

Driven by an increase in investor demand, the information, resources, and diagnostic tools for evaluating companies and fund managers on ESG factors and impact has also increased.

- More than 75% of S&P 500 companies now publish a Corporate Responsibility Report.⁸
- ESG and impact data and searching tools are now provided by both mainstream and specialized providers.
 - Both Morningstar and MSCI Research launched ESG metrics and scores for 20,000 mutual funds and ETFs in March 2016.^{9,10}
 - MSCI recently launched a tool to identify public companies that address a social or environmental challenge as defined by the UN Sustainable Development Goals.¹¹
 - Impactbase, a searchable online directory, offers a global database of private impact investment opportunities.
 - Cambridge Associates launched an index that tracks the performance of impact private equity funds that also seek a market rate of return.
- The CFA and other professional organizations have become more active in ESG education.
- The number of SRI/ESG indices used for benchmark and passive investment vehicles has greatly expanded.

There are also several international coalitions and global organizations dedicated to increasing the effectiveness and scale of SRI/ESG and impact investing, including the Global Impact Investing Network (GIIN) and the Forum for Sustainable and Responsible Investment (USSIF).

Financial performance

This is one area that has received substantial attention and where a growing body of research suggests that ESG factor investing provides comparable or even better financial returns than conventional investments. In 2015, Deutsche Asset and Wealth Management and Hamburg University conducted a meta-analysis of over 2,000 empirical studies, the most comprehensive review of academic research on the topic. They found that the majority of studies showed a positive correlation between ESG standards and financial performance.¹² At a minimum, the empirical evidence does not support the notion that SRI/ESG considerations adversely affect performance and should dispel critics' views that the investment process involves additional constraints and accepting a lower rate of return.

The body of research covering the financial performance of impact investing is significantly smaller as this is a newer approach with limited published results and a wide spectrum of return expectations. For example, some impact investors will accept below-market returns, and therefore, comparison against a conventional benchmark is unsuitable. A 2016 GIIN survey of global impact investors did find that the vast majority of their investments met or exceeded both impact and financial performance expectations.¹³ A 2015 GIIN and Cambridge Associates report of private equity impact investors seeking risk-adjusted market rate returns also found that such market rate returns were achievable and that manager selection was critical, just as in traditional private equity investing.¹⁴

Challenges

While there has been great progress and growth in SRI/ESG and impact investing, there continues to be a lack of consistency and understanding along with other challenges.

- **Questionable marketing claims** – Details on how ESG factors are being implemented in the investment process can be cloudy and susceptible to questionable marketing claims. ESG in the fund title does not mean their process is robust. Impact managers may have heartwarming stories, but not necessarily a solid track record.
- **Measurement of “impact”** – There is no general consensus or industry standard on what constitutes “impact” or standards and metrics to use for the ongoing measurement of such impact.
- **Private impact opportunities with a track record** – Even with overall growth, finding high-quality private equity or debt impact opportunities is a challenge and, as with all private investing, fundraising windows can be narrow.

Looking forward

Values-based investing has experienced exponential growth with demand coming from both institutional and high-net-worth investors looking to align their investments and values. There is expanding academic research, growing industry advocacy groups, increasing data, tools, and investment choices. All of these factors make it easier for the values-focused investor to achieve their goals. As the concepts and strategies become more understood and accepted, as challenges are addressed, and as wealth transitions to more values-focused investors, these investment approaches are poised to continue to grow and develop.

Key Private Bank helps individuals, families, and institutions create actionable, integrated investment strategies that align with their interests and expectations. We have delivered values-based investment solutions for many years, including a private collective religious-based SRI fund, multiple third party SRI/ESG mutual funds and private equity offerings. Please contact your Key Private Bank Relationship Manager to discuss your interest in values-based investments and potential solutions that may be a good fit for your financial and personal goals.

Contact your Key Private Bank Portfolio Manager to learn more about values-based investing.

Key Private Bank



¹ "Sustainable Investing: Establishing Long-Term Value and Performance," DB Climate Change Advisors, Deutsche Bank Group, June 2012

² The Impact of Sustainable and Responsible Investments (USSIF, US SIF, The Forum for Sustainable and Responsible Investment, June 2016

³ The Business Case for Sustainable Investing, Morgan Stanley, 2015

⁴ Report of Us Sustainable, Responsible and Impact Investing Trends, US SIF, The Forum for Sustainable and Responsible Investment, 2014

⁵ Empirical Research Partners, ESG Strategy: Lights, Camera, Action: April 2016

⁶ United Nations Principles for Responsible Investing, www.unpri.org

⁷ Annual Survey of High-Net Worth and Ultra-High Net Worth Americans, U.S. Trust, 2016

⁸ Governance Accountability Institute

⁹ Morningstar press release, March 1, 2016

¹⁰ MSCI press release, March 8, 2016

¹¹ MSCI ESG Sustainable Impact Metrics Methodology and Definitions, April 2016

¹² Gunnar Friede, Timo Busch and Alexander Bassen, ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investments, 2015

¹³ Annual Impact Investor Survey, Global Impact Investing Network (GIIN), 2016

¹⁴ Introducing the Impact Investing Benchmark, Global Impact Investing Network (GIIN) and Cambridge Associates, June 2015.

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