Why Move to a Sustainable Investment Portfolio Now

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If there was still doubt that sustainable investing has hit the mainstream, the globally connected events of 2020 eliminate it. Climate change, the urgent call for racial equality and the impacts of COVID-19 are requiring more of companies than ever before. These events also underscore why organizations that consider sustainability are positioned to succeed – and why those that don't are likely to flounder.

Any effort to gauge the value of an organization must include a careful analysis of environmental, social, and governance (ESG) factors. The evidence is clear on the investing side: vehicles that consider ESG factors are outperforming benchmarks, sustainable investments are consistently attracting greater inflows, and the global disruption is putting a laser focus on corporate behavior.

Blackrock, Bank of America, and Morningstar have been vocal on these themes and have published the following key research findings:

- According to **Morningstar research**, year-to-date 70% of actively managed ESG mutual funds outperformed their peer groups, with 44% placing in the top quartile while 92% percent of sustainable index funds outperformed their benchmarks (through 3/31/20).
- **B of A research** found that over the past 5 years, companies with high (top quintile) ESG ranks have outperformed their counterparts with lower (bottom quintile) ESG ranks by at least 3% (B of A).
- According to **B of A**, ESG is the best measure they have found for signaling future earnings risk, superior to leverage or other risk factors.
- Companies with high ESG scores enjoy a lower cost of capital. According to **MSCI**, the average cost of capital of the highest-ESG-scored quintile in the MSCI World Index was 6.16%, compared to 6.55% for the lowest-ESG-scored quintile.
- Research by **BlackRock** has established a correlation between sustainability and traditional factors such as quality and low volatility, which themselves indicate resilience. Further, Blackrock "would expect sustainable companies to be more resilient during downturns."

Indeed, the conclusion by BlackRock (and many others) comes as part of a massive and ongoing transformation of the sustainable investing space, with its roots firmly planted in data and financial materiality. 86 percent of S&P 500 companies are disclosing key sustainability metrics, and the Sustainability Accounting Standards Board (SASB) has been instrumental in helping industries and investors coalesce around sector-specific, material sustainability standards. Why? Simple. Companies that report on ESG factors understand that integrating sustainability is in their own economic self-interest. Investors are demanding it, and investment managers can make – and articulate – better decisions when they have a full accounting of a company's exposure to risk and competitive positioning.

The situation is accelerating and clarifying what has historically been a fitful learning curve around adoption of ESG. Investors, advisors, and institutions have all struggled to articulate the value of ESG issues in a way that connects directly to portfolio strategy and performance. In the context of COVID-19, racial equality, and climate change, that barrier is coming down in an "a-ha" moment that transcends the previous struggles.

The convergence of issues serves to magnify pressures regarding corporate sustainability that have been building for some time. The media, climate activists, pensions and a growing community of investors are intensifying demands on corporate behavior. If there is any doubt about evolving investor preferences, just follow the money: according to Morningstar, globally in the first quarter of 2020 sustainable funds saw net inflows of over $45 billion while the broader fund industry experienced net outflows of $385 billion.

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These corporate pressures have also resulted in a significant institutional shift in redefining the role and purpose of a corporation. The August 2019 Business Roundtable statement was a concrete step by companies to move toward a more inclusive form of capitalism that benefits all stakeholders including workers, customers, suppliers and local communities. COVID-19 and the protests against racial injustice will likely accelerate this shift and may further amplify the financial materiality of ESG factors.

So what exactly are the mechanisms that connect ESG with financial performance?

Material factors within the E, S, and G arenas have clear impact on risk management, present opportunities to create shareholder value, raise crucial reputational and brand issues, and contribute to overall corporate health:

ENVIRONMENTAL

The necessity of climate change adaptation and the related transition to a low carbon economy create a clear link to corporate financial performance. Companies can increase profitability through effective resource management, waste reduction, adoption of sustainable processes, or by offering products or services that address sustainability issues. These elements not only play into forward-looking business models, they present opportunities for authentic, market-facing messages that reinforce brand reputation.

Poor environmental performance, on the other hand, can increase cost of capital, operating costs, create potential liabilities including fines and lawsuits, and invite reputational risks. PG&E became the poster child for environmental risk: its infrastructure failures led to catastrophic fires, 100 deaths, and the company's bankruptcy.

SOCIAL

Evaluating the corporate impact on all stakeholders – employees, suppliers, customers and local communities – used to elicit eyerolls among mainstream investors. That sentiment was changing over time, and COVID-19 has now obliterated it by showing that "S" factors are increasingly material and more relevant than ever.

Consider a **recent study by State Street** of corporate responses to COVID-19 that address social concerns. Results based on aggregations of online reactions and news coverage showed that "firms experiencing more positive sentiment on their human capital, supply chain, and operational response to COVID-19 experienced higher institutional money flows and less negative returns."

The corporate response to COVID-19 and racial injustice will be closely monitored by the investment community with brand reputation likely being a key driver of firm value going forward.

GOVERNANCE

Furthering the State Street findings, sound governance practices create a culture of transparency and accountability. Never have those two elements been so important to corporate brand, as the consumer and activist universe has easy access to nearly everything a company does.

Poor governance naturally risks the opposite. It can result in fines, legal costs, disruptions to materials, labor and productivity, negatively impact revenues, increase cost of capital and...

severely damage brand value. Companies that continue to be managed under the antiquated notion that their sole purpose is to maximize profits for shareholders put their reputations at risk. These are the companies focused solely on cost cutting and shareholder buybacks, and they are missing crucial signals from society and investors.

The ground-shaking events, dramatic market volatility, and global focus on corporate behavior bring us to an ESG crossroads for investment management. Down one road is an antiquated investment strategy that fails to consider all the material data. Down the other? Added material ESG factors to paint a more comprehensive picture of a company's value. The more effective direction seems clear. ESG analysis should be an integrated part of any sound investment process.