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Why ESG Investing Makes Sense

Environmental, social and governance strategies allow investors to incorporate their principles into portfolios without sacrificing investment performance.

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Once considered a niche market for institutional clients with specialized investment needs, ESG investing has gone mainstream. It now spans multiple asset classes and is used by a diverse group of investors. The Forum for Sustainable and ESG Investment formally defines sustainable, ESG and impact investing (SRI) as an investment discipline that considers environmental, social and corporate governance, or ESG, criteria to generate long-term competitive financial returns and positive societal impact.

Many different terms are used to describe this approach: ESG, responsible, socially responsible, sustainable, ethical and impact. For our purposes, we will refer to it as ESG investing. Though all of these terms have slightly different definitions, the main focus is investing in companies that are deemed acceptable according to ESG standards and also have the ability to deliver strong financial performance.

ESG factors can be incorporated into investment strategies in different ways. Generally speaking, ESG investing refers to complementing traditional techniques of analyzing financial risk and return with qualitative and quantitative analyses of ESG policies, performance, practices and impacts. Every investment manager has their own definitions of environmental, social, and governance factors. Some managers look at different factors dependent upon the industry or region in which a company operates.

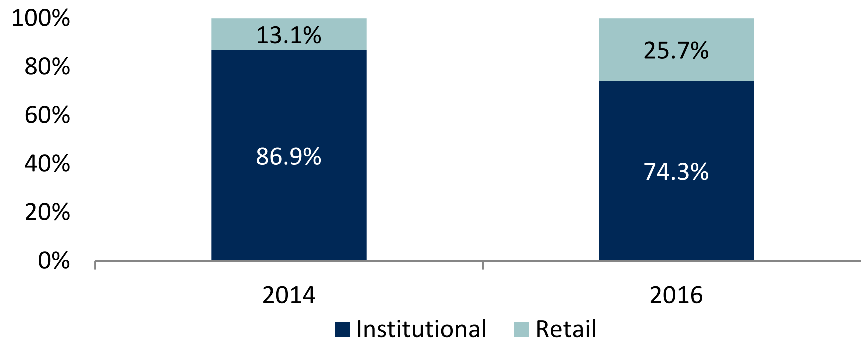
Some examples of environmental factors that managers may focus on include climate change, greenhouse gas emissions, resource depletion, waste and pollution. Social factors may refer to work environments, community impact, diversity, or health and safety concerns. Governance factors typically include board structure, executive pay and legal issues. ESG investing may also include more specialized strategies that focus on a single issue, such as fossil-fuel-free mandates.

Heating Up

ESG investing has become increasingly popular over the past several years. According to the Global Sustainable Investment Alliance there was approximately $22.89 trillion in global assets invested in ESG investment strategies at the end of 2016. This represents more than a 25% increase from the end of 2014. ESG investing has continued to be most popular in Europe. However, ESG investing has seen significant growth in the United States as well. As of the beginning of 2016, U.S. sustainable assets totaled approximately $8.72 trillion, a 32.7% increase from 2014. Assets in ESG investment strategies now represent 21.6% of the total managed assets in the United States.

Going Mainstream

Socially ESG investing has doubled among retail investors.



Source: 2016 Global Sustainable Investment Review

Historically, ESG investing has been thought of as more of an issue for institutional investors rather than retail clients. Religious organizations, foundations and endowments often have special requirements for their investments that limit the investable universe based on environmental, social or governance issues. Indeed, ESG assets continue to be made up of primarily institutional assets. However, retail assets have become a growing piece of the pie as individual investors have started to buy into the potential financial and risk benefits of ESG investing. In fact, as of 2016, retail assets made up 25.7% of total sustainable assets, a significant increase since 2014 when retail made up only 13.1% of that asset base.

The penetration of ESG investing into the retail market illustrates the growing interest and confidence by individual investors. A recent Legg Mason study showed that 82% of high-net-worth investors found ESG investing appealing, and 47% would like to invest more in ESG investments. The trend is even more appealing to younger millennial investors. Of this group, the study cited that 88% found ESG investing appealing and 60% would like to invest more in ESG investments. The growth in assets and the increasing number of strategies available in the market signal that ESG investing is more than just a short-term trend. Rather, these signs point to these strategies being important investments in the future.

Global Impact

Significant asset growth in socially ESG investments spans the globe.

Growth of SRI Assets by Region 2014–2016

Region	2014	2016	Growth over period	Compound Annual Growth Rate
Europe	$10,775	$12,040	11.7%	5.7%
United States	$6,572	$ 8,723	32.7%	15.2%
Canada	729	1,086	49.0%	22.0%
Australia/New Zealand	148	516	247.5%	86.4%
Asia ex Japan	45	52	15.7%	7.6%
Japan	7	474	6689.6%	724.0%
Total	**18,276**	**22,890**	**25.2%**	**11.9%**

Note: Asset values are expressed in billions. Asia ex Japan 2014 assets are represented in U.S. dollars based on the exchange rates at year-end 2013. All other 2014 assets, as well as all 2016 assets, are converted to U.S. dollars based on exchange rates at year-end 2015. Source: 2016 Global Sustainable Investment Review.

Approaches to ESG Investing

There are numerous approaches to ESG investing. Different sources have aimed to classify ESG investment strategies in various ways both according to the approach as well as the targeted characteristics. The GSIA has defined seven classifications of ESG investment strategies, depicted in the graphic below along with their global assets. ESG research firm Sustainalytics developed its own typology for ESG managers based on three dimensions: management, research and application.

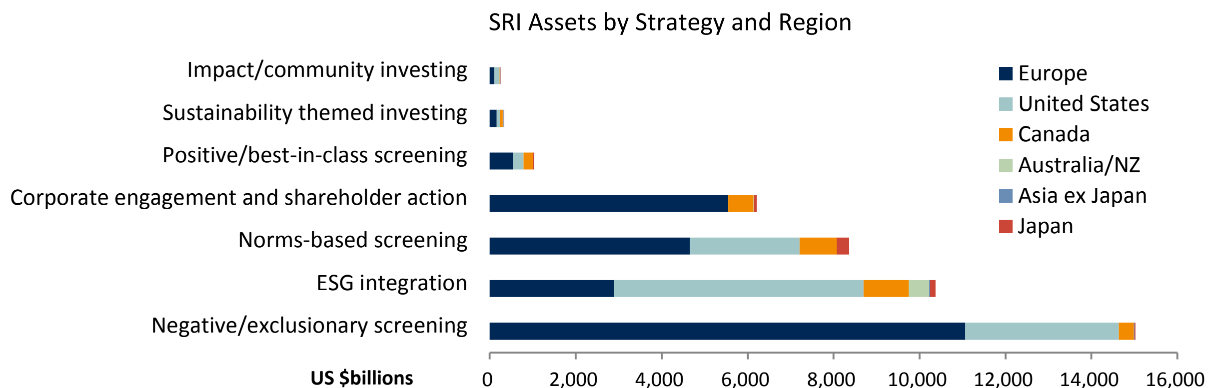
We prefer to think of the ESG manager universe more broadly, instead classifying strategies into one of three buckets. The first and most basic form of ESG investing is the use of ESG screens. Managers that use ESG screens are altering the investable universe by screening for certain ESG characteristics. There are positive screens, such as targeting firms with good corporate governance and ethical employment practices.

Negative screens that filter out individual companies or entire industries are more common. For example, these strategies may exclude companies operating in industries such as oil and gas, firearms, alcohol, tobacco or gambling. These managers are not altering their investment process to incorporate ESG research. These firms leverage outside research, external scoring or sustainable indexes in order to create their universe. In our view, these strategies are not adding any value through ESG investing, but rather simply narrowing the investable universe to meet the needs of certain clients.

On the opposite side of the spectrum, there are dedicated ESG investment firms that have a focus on impact or engagement investing. These firms often have significant team depth and experience with regards to ESG research. All of the firms’ strategies are managed in a sustainable fashion, and often these strategies take an active approach to ESG investing through engagement with company management and proxy voting. However, while these investment firms may be well known within the ESG universe, they may not be widely followed by due diligence teams.

A Diverse Set of Strategies

Integrating ESG factors into the investment process across firms is on the rise.



Source: 2016 Global Sustainable Investment Review

For us, we prefer the middle ground: Firms that have successfully integrated ESG research into their fundamental research process. These teams don’t just screen for certain characteristics, but rather include ESG as one of several aspects of their bottom-up company analysis. We feel that this approach has the potential to add

value by limiting potential ESG risks while still benefitting from the expertise of these investment teams.

Is There a Performance Penalty?

Many investors may be hesitant to utilize ESG investment strategies for fear that they will be giving up financial performance in order to invest in a sustainable fashion. In fact, in the early days of ESG investing the common belief in the market was that investors had to be willing to pay a performance penalty. However, numerous studies over the past several years have sought to disprove that theory.

So far, the results have been encouraging. A 2014 report by Envestnet evaluated performance of U.S. equity mutual funds and found that there was no meaningful difference between the performance of SRI and non-SRI mutual funds. Other studies have gone as far as suggesting that ESG research could be beneficial to performance. A 2015 paper by Deutsche Asset & Wealth Management aggregated data from more than 2,000 studies to conclude that a majority of these studies found a positive relationship between ESG and the financial performance of individual companies. Another 2015 report by Morgan Stanley concluded that sustainable investing has usually met—and often exceeded—the performance of traditional investments.

There is less data available on the fixed-income side of the ESG investing universe. However, this is increasing in popularity as well, and initial research is encouraging. Barclays conducted research in 2016 to study the performance effects of ESG incorporation and corporate bond performance. The study found a small but steady performance advantage from the ESG tilt and no evidence of negative performance effects.

Selecting the Right Strategies

As the market for ESG investing has grown, so has the number of strategies offered by investment firms. With so many options available and so many different techniques utilized, it can be overwhelming for investors to choose the right managers for their ESG investments. Oppenheimer Asset Management uses its thorough due diligence process to evaluate managers of ESG investment strategies in order to ensure that the management team has the ability to add value on the investment side while also possessing the skills and knowledge necessary to identify potential ESG risks.

If you are interested in ESG investment strategies or building an ESG portfolio, then work with your Oppenheimer & Co. Inc. Financial Advisor to determine the appropriate strategies and allocation given your investment objectives and risk tolerance.

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