ESG INVESTMENTS: YOUR MONEY YOUR VALUES

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You may find yourself among a growing number of investors who are becoming very conscious and increasingly concerned about certain non-financial risks to their portfolios – climate change, for example.

As concerns over non-financial risks have risen to the forefront of the minds of many over the past few years, so too has the integration of innovative ESG factors into investment strategies. If you are among these increasingly concerned investors and you wish to manage and measure these risks to your portfolio, ESG investing may be of interest to you.

Although the industry doesn't have agreed-upon definitions, these investing approaches generally share a dual mandate: achieving competitive investment returns *while* expressing an investor's values. In fact, the lack of standard industry definitions may reflect the broad array of possible approaches that can be used to align your portfolio with your beliefs.

WHAT IS ESG INVESTING?

At its core, ESG is an approach that incorporates Environmental, Social, and Governance factors into an investment strategy. You may recognize other terms associated with ESG investing: values-based investing, sustainable investing, impact investing, responsible investing, socially responsible investing, socially conscious investing, "green" investing, and ethical investing. Each of these terms has its own nuanced meaning that can vary according to individual perspectives.

ESG FACTORS AND APPROACHES

If you choose to make ESG part of your investment strategy, generally there are three factors and subsequent approaches you can consider for your portfolio:

Environmental: carbon emissions, pollution and other waste, natural resource usage, energy efficiency, sustainability initiatives

Social: human rights, workforce safety and health, workforce diversity, equal opportunity, privacy and data security, community initiatives

Governance: board independence, board diversity, shareholder rights, reasonable executive compensation, ethics policies and history

When considering ESG investing for your portfolio, typically stock strategies come to mind. However, corporate and municipal bonds, as well as other asset classes, can also be managed through an ESG approach.

WHAT THE FACTORS REPRESENT

The three ESG factors classified above – Environmental, Social, and Governance – represent non-financial indicators of a corporation's commitment to sustainable practices and good corporate citizenship. In other words, ESG investing seeks to satisfy the desire of many investors to invest in good corporate citizens. This desire is also based on the idea that environmental, social, and governance factors may also be important to a company's financial success.

One way for financial advisors to incorporate these factors into an investment strategy is to evaluate a company's history, current commitments, and stated promises to some or all of these factors, then weigh that evidence along with traditional investment metrics when making decisions for a portfolio.

For example, let's say your advisor is evaluating two stocks for your portfolio, each with a similarly favorable profile from a financial standpoint. The stock of Company A – whose board is well diversified, has an exemplary record in its employment practices, is committed to sustainable environmental practices, and avoids ESG controversies – may be preferred over the stock of Company B if that company has a poor record in those areas.

Various levels of emphasis can be placed on ESG factors in an investment strategy, which creates a spectrum. At one end of the spectrum, you have a traditional strategy that doesn't incorporate ESG factors at all. On the other end, you have impact investments that only incorporate ESG factors. Ultimately, how an investor decides to weigh their personal beliefs and values is up to the investor. After all, it is your money and it should represent your values.

HOW ESG INVESTING EMERGED

While ESG investing has experienced a meteoric increase in attention during recent years, its roots go back decades. Beginning as early as the 1970s, socially conscious investors developed an approach you may recognize known as "Socially Responsible Investing (SRI)." This approach:

- Involves the screening of stocks to exclude companies operating in "sin" industries (e.g., gambling, alcohol, tobacco, nuclear weapons, etc.) from a portfolio.
- Can also include screening based on Catholic values, Sharia law, and other institutional frameworks.
- Allows individual investors to customize their SRI portfolios based on the specific industries they wish to avoid supporting.

Traditional SRI has become more sophisticated over the years. However, with its ability to avoid owners, subsidiaries and distributors of offending companies, many believe SRI represented a first-generation solution that has now been eclipsed by ESG investing.

ESG investing, as opposed to simply excluding companies, aims to include companies that are strong corporate citizens while also incorporating traditional factors such as growth, valuations, and cyclicality.

THE GROWTH OF ESG INVESTING

ESG investing has experienced exponential growth during the past few years. At the start of 2020, global assets managed using an ESG investing approach were $38 trillion, an increase of 66% in three years.[1] This figure represented a sizable share of all professionally managed assets across Europe and in countries such as Japan, Australia, and New Zealand. U.S. assets accounted for $17 trillion, representing approximately 33% of U.S. managed assets and an increase of 42% from $12 trillion in 2018.[2]

ESG INVESTING IS NOT A FAD

Because of the growing popularity of ESG investing, the number of investment vehicles now available to investors also has grown. By the end of 2020, the number of mutual funds and ETFs that screen or incorporate ESG/SRI factors into their investments grew to 392, up 30% from 2019.[3]

Another indication that ESG investing has entered the mainstream is reflected in the number of global participants adhering to the United Nations Principles of Responsible Investment (PRI), a set of six principles that was developed to provide a global standard for responsible investing.

Participants adopting this standard must publicly commit to implement the principles where they are consistent with their fiduciary responsibilities and report on their ESG investing activities. In 2020, more than 3,000 PRI participants represented assets under management of more than $100 trillion.[4]

Lastly, while the market has seen strong uptake in ESG investing by institutional investors (as seen by the growth in UN PRI participants), individual investors have also shown strong interest. In a survey of U.S. individual investors, 85% said they would be interested in sustainable investing.[5]

ARE ESG INVESTMENTS FOR YOUR PORTFOLIO?

To learn more about incorporating ESG investing into your portfolio, contact Commerce Trust Company today. We will answer all your questions and guide you in selecting investments aimed not only to achieve your financial goals but also to reflect your beliefs and values.

[1] Azoth Analytics, "Global Environmental, Social & Governance (ESG) Market Analysis by Investor (Retail, Institutional), Fund, Sector, Region and Country (2020 Edition): Market Insights, COVID-19 Impact, Competition and Forecast to 2025," published December 2020, https://www.marketresearch.com/Azoth-Analytics-v4068/Global-Environmental-Social-Governance-ESG-13918813/

[2] General source for information and works cited: Commerce Trust Company Research Group, "ESG (Environmental, Social & Governance) Investing," Commerce Trust Company, 2020

[3] Morningstar, "Sustainable Funds U.S. Landscape Report," published February 10, 2021

[4] United Nations, "PRI Annual Report 2020," referenced March 31, 2020 https://www.unpri.org/annual-report-2020/how-we-work/building-our-effectiveness/enhance-our-global-footprint#:~:text=The%20collective%20AUM%20represented%20by,investors%20and%20337%20service%20providers

[5] Morgan Stanley/ISI, "Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice," published September 2019 https://www.morganstanley.com/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf

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