

Portfolio Perspectives

# Sustainable, Responsible & Impact Investing

## Advice & Research

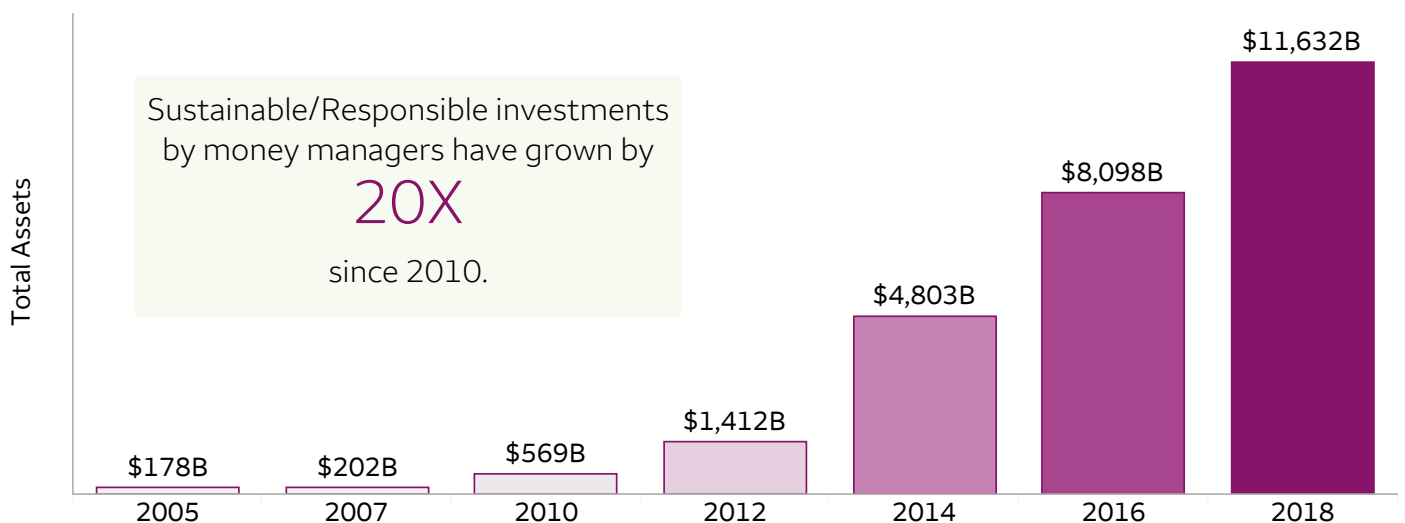
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Once a niche corner of the financial services industry, the practice of aligning investment portfolios with investor principles is going mainstream. The rise of sustainable, responsible, and impact investing underscores the belief that investment portfolios can be used as more than just a means to achieve financial security. A growing number of clients are asking for investments that also mirror their personal convictions, or achieve a broader impact on their community, while simultaneously meeting financial objectives. In response, the financial services industry has mobilized. A broad array of options now exist for clients to **invest in companies they believe in, avoid companies they don't, and participate in strategies that aim to mitigate environmental, social, and governance risks.**

While the acronyms that describe these strategies can sometimes be confusing, the growth of responsible investing\* has been more straightforward: Roughly 25% of all U.S. assets under management now incorporate responsible investing concepts.

### Growth of Sustainable/Responsible Investing 2005-2018



Source: USISIF - The Forum for Sustainable and Responsible Investment. Sustainable and Impact Investing - Money Managers 2018 Report. Growth of ESG Incorporation by Money Managers 2005-2018 graphic. For illustrative purposes only. Past performance is no guarantee of future results.

\*For the purposes of brevity, this report will use the broader “responsible investing” term to encapsulate sustainable, responsible, and impact investing.

Investment and Insurance Products:

▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

Determining which of these strategies may be right for you can sometimes be overwhelming. In the past, investors had a limited number of options by which to incorporate their values into the investment process, most of which focused on excluding objectionable companies and industries such as “sin stocks.” Today, a growing number of diverse and customizable products are embedded within the broader responsible investing umbrella. For the most part, however, responsible investing strategies can be divided into three categories:



## Exclusionary or Restrictive Strategies

**Strategies that seek to avoid industries and companies that don’t match a client’s values.** The primary outlet for values-based investing was traditionally called Socially Responsible Investing (SRI), which gained prominence as investors screened portfolios based on everything from religious beliefs to avoiding South African assets during apartheid.



I have a moral problem with certain industries and companies and therefore would like to exclude them from my portfolio.



## Impact, Thematic, and Sustainable Strategies

Strategies that utilize both positive and negative screens **intended to generate identifiable and measurable impact**, in addition to financial return. The financial services industry has created products including mutual funds, ETFs, and separately managed accounts (SMAs) based on ideas ranging from gender and racial equality, to clean energy and animal rights, in order to satisfy investor demand.



I believe certain companies and industries will have a positive impact on society at large and want to reflect that in my portfolio.



## Integration and Risk Lens: ESG

Strategies which seek to manage risk by assessing **environmental, social, and governance (ESG) factors that influence both financial performance and society at large.**



In recent years the environmental, social, and regulatory landscape has changed, and it will likely change more in the next few years. How is this company going to be affected by these changes?



### Environmental

- Biodiversity & land usage
- Climate change
- Green building
- Renewable energy
- Water stress/pollution



### Social

- Consumer protection
- Diversity & inclusion
- Human capital
- Labor standards
- Privacy & data security



### Governance

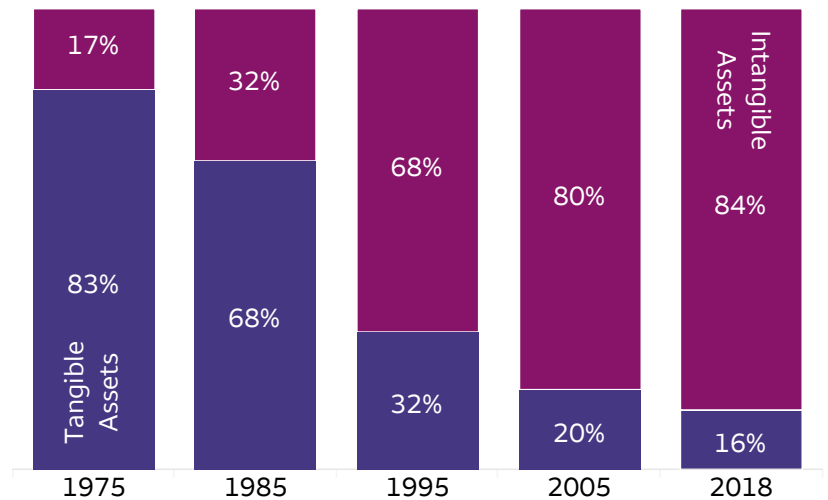
- Accounting
- Board structure
- Business ethics & fraud
- Corruption
- Executive compensation

Many responsible investing products integrate all three of these strategies, while others view exclusionary, impact, and ESG factor investing as distinct options. The definitions and parameters of responsible investing vary from manager to manager, and from client to client.

## Growth

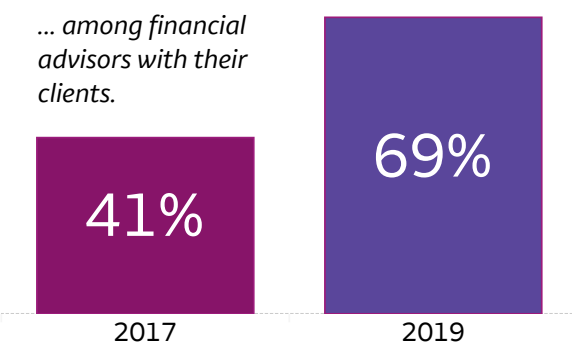
One reason responsible investing concepts have become so prominent, particularly ESG analysis of companies, is the changing nature in the way financial value is calculated. In 1975, tangible assets (such as land and equipment), represented the majority of the value of the S&P 500, while intangible assets (such as reputation and intellectual property), accounted for just 17% of the index's value. The importance of tangible assets has become less pronounced over time, and by 2018, intangible assets represented 84% of the S&P 500's value. Given this change in dynamic, greater emphasis is being placed on the risks companies face in an economy (and society) that is evolving faster than ever. At its core, ESG analysis aims to understand and quantify these risks.

## Tangible vs. Intangible Assets of S&P 500



Source: Aon Corporation. 2019 Intangible Assets Financial Statement Impact Comparison Report.

## Growth in ESG Discussions

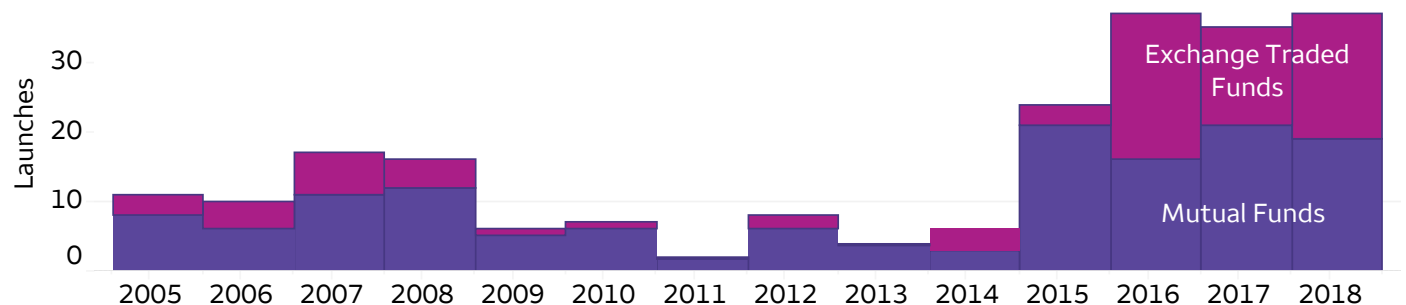


Source: Ignites, 2019. Report on Percentage of Financial Advisors that Use ESG.

In the past, institutional investors, such as pension funds and endowments, were responsible for the bulk of the growth in responsible investing. Recent data, however, shows that individual retail investors are beginning to catch up. According to data from Ignites, only 41% of top U.S. financial advisors reported discussing ESG with their clients in 2017. In 2019, that number has ballooned to nearly 70%. While Millennials are often cited as the primary driver of the growth in responsible investing, **a host of evidence suggests broad interest that spans generational divides.** In fact, a Morningstar study found that 72% of all U.S. investors are at least moderately interested in sustainable investing, with Millennials showing only a slightly higher propensity than their Generation X counterparts.

It is no surprise, given the jump in interest, that financial institutions have rushed in with products from mutual funds and exchange traded funds (ETFs) to “green” bonds. The number of sustainable or responsible ETFs and mutual funds has more than quadrupled in the last three years, with offerings ranging from broad index-tracking products to funds that single out specific issues, such as clean energy and gender equality.

## ESG Fund Launches by Year



Source: Morningstar Direct. Data as of 12/31/2018.

## Performance

The oldest and perhaps most prominent barrier to responsible investing adoption has been the notion that investors have to sacrifice performance in order to align their portfolios with their principles. A growing body of evidence from both academics and financial institutions, however, shows that ESG indices have experienced commensurate performance with the underlying non-ESG benchmarks they track. In fact, More than 90% of the 2,200 individual studies reviewed by the Journal of Sustainable Finance & Investment have shown a non-negative relationship between ESG and corporate financial performance, with a “majority” of findings showing positive results. <sup>1</sup>

### MSCI All Country World Index (ACWI) vs MSCI ACWI ESG Leaders Index



Source: Bloomberg. Index return information provided for illustrative purposes only. Past performance does not guarantee future results.

Data and research provider Morningstar has identified 10 global indices as its Sustainability Leaders Indexes. Through the end of 2018, here is how these 10 benchmarks stacked up against their non-ESG counterparts on a number of key indicators.

#### **Performance:**

80% of the Sustainability Leaders Indexes have outperformed their non-ESG equivalent since the end of 2012 from a price return standpoint.



#### **Volatility:**

80% of Sustainability Leaders Indexes had higher Volatility scores, implying a lower range of possible long-term returns, than their non-ESG equivalents.



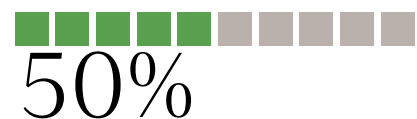
#### **Financial Health:**

90% of Sustainability Leaders Indexes had a higher Financial Health score. This factor assesses the strength of a firm’s financial position and ranks companies on the likelihood that they will enter financial distress.



#### **Economic Moat:**

50% of Sustainability Leaders Indexes had a higher exposure to the Economic Moat factor than their non-ESG equivalents. Companies with a higher Economic Moat Factor tend to be more favorably positioned, with their profits more insulated from competition.



Source: Morningstar. For more information see Morningstar’s ESG Indexes Exhibit Attractive Investment Attributes, February 2019 by Dan Lefkowitz. Data as of Dec. 31, 2018. The Morningstar Sustainability Leaders Indexes are derived from the large-cap segment of the equivalent Morningstar region/country index. More information on index constituents and methodology can be found at <https://indexes.morningstar.com>

1. ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies. Journal of Sustainable Finance & Investment, 2015.

## Issues

Responsible Investing still faces a number challenges and barriers to widespread adoption. While Morningstar’s study of performance in its Sustainable Index Family showed positive return characteristics, the report was quick to point out that “relative returns are highly changeable.” The study also acknowledged that a rally in commodities such as oil could negatively affect returns, as many responsible investing products have lower exposure to energy and materials stocks. Other headwinds facing the responsible investing world include, but are not limited to:

### **Lack of Standardization in Terminology**



Definitions of what constitutes sustainable, responsible, or impact investing can vary widely from firm to firm. For instance, the acronym “SRI” can mean Socially Responsible Investing, or it could mean Sustainable, Responsible, and Impact investing.

### **Lack of Standardization in Data**



According to The Wall Street Journal, “there is often little overlap” in how ESG ratings agencies rate a particular company. There is more uniformity, however, when ratings agencies such as Moody’s and S&P grade the same companies for their creditworthiness.<sup>1</sup> A joint survey by the United Nations (UN) and CFA Institute showed that 43% of U.S. investors cited a lack of historical performance data and 41% cited limited understanding of ESG issues as the top barriers to adoption.<sup>2</sup>

### **Lack of Oversight and Accountability**



Due to both the relatively new advent of most responsible investing strategies, government or financial regulatory oversight is lacking. The UN has developed 17 Sustainable Development goals, but adoption is voluntary in most countries. The UN also supports Principles for Responsible Investment (PRI), but the six main tenants outlined by PRI are self-described as “voluntary and aspirational.” Further, a 2018 study by Bain & Co. found that just 2% of companies beat or even achieved their self-stated sustainability goals.<sup>3</sup>

### **“Greenwashing”**



Given the lack of oversight, many within the responsible investing community have raised concerns about “greenwashing.” A host of products have been re-branded in recent years to include descriptions like “ESG,” “sustainable” or “impact.” Unfortunately, the underlying makeup of the products hasn’t always changed with the name. According to the CFA Institute, “Investors need to do research when investing in anything called “ESG” or “sustainable,” to ensure they agree with the methodology behind those designations.”

## Conclusion

The exponential rise in interest and adoption suggests that the concept of aligning investor principles with investment portfolios will only become more prominent in the years to come. At the same time, the responsible investing landscape will need to continue to evolve to meet a dynamic investing environment. Ultimately, individuals should consider their own preferences and objectives, and review potential strategies with their financial advisor to decide the best course of action.

1. *Why It's So Hard to Be an 'Ethical' Investor*. The Wall Street Journal, 9/1/2018.

2. *ESG Integration in the Americas: Markets, Practices, and Data*. The CFA Institute and Principles of Responsible Investment (PRI), 2018.

3. *Sustainability and Change Survey*. Bain & Co., 2018.

## INDEX DEFINITIONS

**Index return information is provided for illustrative purposes only.** Index returns do not represent investment returns or the results of actual trading nor are they forecasts of expected gains or losses a fund might experience. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.**

**S&P 500:** The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

**MSCI All Country World (ACWI) ex USA:** The MSCI All Country World ex USA Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the USA. The Index consists of 45 country indices comprising 22 developed and 23 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

**MSCI All Country World (ACWI) ESG Leaders Index:** The MSCI ACWI ESG Leaders Index is a capitalization weighted index that provides exposure to companies with high Environmental, Social, and Governance performance relative to their sector peers. The MSCI ACWI Leaders Index consists of large and mid cap companies across 23 developed markets and 26 emerging market countries. The MSCI ESG Leaders Index targets companies that have the highest environmental, social, and governance (ESG) rating in each sector of the parent index. The MSCI ESG rating is a rating system designed to identify ESG risks or opportunities that may not be captured through conventional analyses.

## DISCLOSURES

All investing involves risk, including loss of principal.

Sustainable investing focuses on companies that demonstrate adherence to environmental, social and governance principles, among other values. There is no assurance that social impact can be an effective strategy under all market conditions. Different investment styles tend to shift in and out of favor. In addition, a fund's social policy could cause it to forgo opportunities to gain exposure to certain industries, companies, sectors or regions of the economy which could cause it to underperform similar portfolios that do not have a social policy. In addition, there can be no guarantee that the companies invested in by a fund will exhibit positive or favorable ESG characteristics.

The investment(s) discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Additional information is available upon request.

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