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Strategy Insight

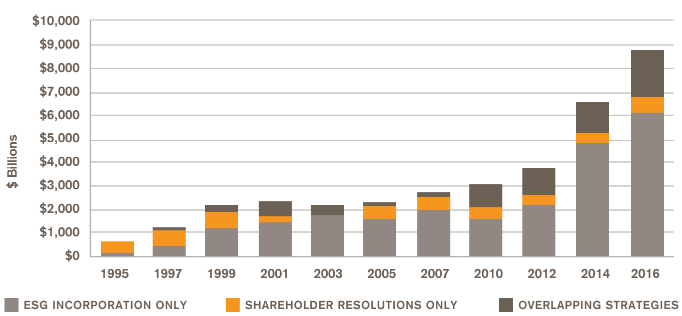
ESG: An Investment Approach

3Q2017

Introduction to ESG Investing

As defined by the US Forum for Sustainable and Responsible Investment, ESG investing reflects the incorporation of environmental, social, and corporate governance criteria into investment analysis and portfolio construction across a spectrum of asset classes.[1] ESG investing represents a large and growing component of the overall investable universe; approximately $8.72 trillion of professionally managed assets factor in ESG components in some aspect of their investment process, representing approximately one-fifth of all assets under professional management and a 33% increase since 2014.[2]

SUSTAINABLE, RESPONSIBLE AND IMPACT INVESTING
IN THE UNITED STATES 1995-2016



Source: US SIF Foundation

ESG investing increasingly has become a significant component of mainstream investing discussions across many different stakeholders. Large banks, money managers, and their affiliated research arms have published in-depth reports on this movement, academia has devoted increasing time to addressing this ideological shift and integrating it into relevant curriculum, and the topic hits headlines of major financial publications with increasing frequency and focus. The number of corporations that proactively disclose their performance with respect to social, environmental, and governance criteria has increased four-fold since 2011. In 2016, 82% of companies included within the S&P® 500 produce some form of sustainability reporting, compared to 20% that reported in 2011.[3]

This growth of, and focus on sustainable investing is profound, and it is important to consider the factors driving this shift. Much of the transition towards ESG investing is driven by client demand, whether it be institutions who aim to invest alongside their values or the rise of millennial investors who have grown alongside this new investment approach. While this values-based, demand-side shift may have helped to catalyze the broader conversation, ESG has captured multi-stakeholder attention for a multitude of reasons. Many asset managers may recognize the opportunity in adapting to client demand, but there is another compelling argument in favor of ESG investing for both investors and investment professionals: risk mitigation.

Risk Mitigation

Critics of ESG investing often point to the subjectivity of the criteria used to assess a company's performance within ESG, and some investors may prioritize financial metrics over the (often) non-financial metrics that are addressed within company sustainability reports. However, recent studies have shown that strong operational and financial performance and attentiveness to ESG factors go hand-in-hand. At the heart of ESG analysis is the exercise of quantifying the impact of a company's operations on the environment and society, and its internal governance. Setting aside any values associated with operational prudence within these spaces, there are large, systemic risks for any company within each of the ESG verticals. Companies that are cognizant of and actively manage their footprint across all ESG factors are more likely to have thorough and proactive risk management strategies that correspond. Additionally, analysts and portfolio managers who integrate ESG analysis into their investment approach are identifying and quantifying potential concerns and benefits related to risk that can impact future performance.[4]

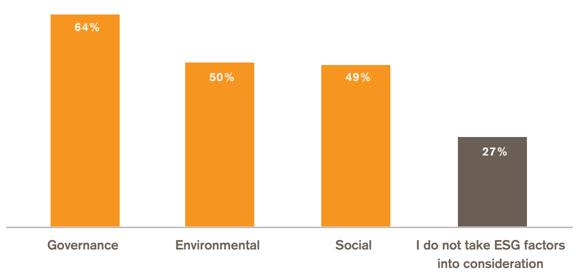
Data from a recent CFA Institute study[5] exemplifies the risk-related factors that drive consideration of ESG issues. Of the total respondents, who are comprised of portfolio managers and research analysts, 63% indicated that they consider ESG issues in order to help manage investment risk, while 38% view ESG performance as a proxy for management quality.

WHY CONSIDER ESG ISSUES?

The CFA Institute study also found that despite the challenges surrounding the use and implementation of incorporating ESG issues, 73% of respondents consider some form of ESG in the investment process.

ESG ISSUES CONSIDERED

WHICH, IF ANY, OF THE FOLLOWING ESG ISSUES DO YOU TAKE INTO ACCOUNT IN YOUR INVESTMENT ANALYSIS OR DECISIONS?



Types of ESG Investing

While ESG is defined as an overall approach, there are a number of strategies within the approach that allow for different avenues of ESG consideration. US SIF defines the various sub-approaches as follows[6]:

- **Positive/best-in-class:** Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers. This also includes avoiding companies that do not meet certain ESG performance thresholds.
- **Negative/exclusionary screening:** The exclusion from a fund or plan of certain sectors or companies involved in activities deemed unacceptable or controversial.
- **ESG integration:** The systematic and explicit inclusion by investment managers of ESG factors into traditional financial analysis.
- **Impact investing:** Targeted investments, typically made in private markets, aimed at solving social or environmental problems.
- **Sustainability themed investing:** The selection of assets specifically related to sustainability in single- or multi-themed funds.

Collaboration Capital's Approach

Focusing on those strategy verticals which address the public markets, Collaboration Capital is distinctly positioned in its approach to ESG consideration in that it leverages a multi-faceted approach. Through a collaborative model, our ESG strategies allow for flexibility in that each portfolio contributor can adopt the approach that functions best for its respective theme or sector-focus. Some strategies may optimize around exclusionary screening of bad actors while others optimize security selection around a certain theme pertaining to sustainability. Collaboration Capital supplements this model with proprietary assessment and screening of the ESG inputs provided to us by our collaboration practitioners to ensure fidelity to the firm's mission and purpose.

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1 http://www.ussif.org/esg
2 http://www.ussif.org/files/SIF_Trends_16_Executive_Summary(1).pdf
3 http://sfmagazine.com/post-entry/october-2017-sustainability-reporting-increases/
4 https://www.ft.com/content/35798046-a33c-11e5-8d70-42b68cfae6e4
5 Environmental, Social, and Governance Issues in Investing, CFA Institute, October 2015
6 http://www.ussif.org/esg