Sustainable Investing: Rewards *Beyond* Returns

For the benefit of principal and principles.

What began decades ago as a fringe notion of investing to make the world a better place has soared in popularity in recent years. To understand what's meant by sustainable investing and the efforts to align one's values with financial goals, we turned to Steve Norcini, head of sustainable investing for Wilmington Trust Investment.

Steve Norcini
Head of Sustainable Investing and Senior Equity Portfolio Manager, Wilmington Trust

Q Let's start out by defining terms. We hear about ESG, SRI, SI … can you provide an overview of what they all mean and how they're related?

A. We use sustainable investing (SI) as our umbrella term for all forms of investing that focus on long-term sustainability and ethical behavior of companies. Socially responsible investing (SRI) avoids investing in companies and industries that run contrary to an investor's set of values. A quick history lesson first, to give some context to the acronyms. Back in the mid-1900s, SRI, came into play with the notion of eliminating "sin stocks"—those related to alcohol, tobacco, or gambling—from investment consideration, as some viewed them as morally objectionable. You can still exclude or screen out certain industries that don't align with your values, but the field has expanded to a broader focus on the more *inclusionary* ESG investing which considers environmental, societal, and governance criteria to help achieve financial objectives.

The E, or *environmental pillar*, refers to actions that reflect positive stewardship of our planet and covers how resources are allocated, looking at a wide range of factors, such as the extent of their (and their suppliers') carbon footprints, how they approach recycling, water usage, pollution, etc. The S or *social pillar* focuses on the management of *all* stakeholders—including employees, clients, shareholders, suppliers, and the communities they serve. For example, it encourages behavior such as a focus on employee health and safety as well as diversity in

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hiring. The G, or *corporate governance pillar*, relates to whether a company ensures incentives of all stakeholders are aligned to help maximize the long-term value. ESG criteria provide a non-financial lens to assess the long-term risks and opportunities of a firm. It can also offer greater diversification with the potential to cover a wider range of concerns than traditional SRI strategies. You'll hear many other acronyms and terms as well, such as "socially conscious," "green," or "values-based," "thematic," or "impact investing," but they can all generally be thought of under the blanket term *sustainable investing*.

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So clearly, sustainable investors want to drive positive change in the world—but they're still seeking an attractive, competitive return on their investment. For a long time, many argued that you couldn't do good *and* do well at the same time. Has that changed or do you have to sacrifice returns to make a positive impact?

Register now for our important webinar, April 21 at 1:00 PM ET, "ESG Strategy Returns: Why We Believe They May Be Sustainable," where Steve and Tony delve more deeply into ESG investing strategies.

A. Sustainable investors are definitely, and appropriately, out to maximize risk-adjusted returns, through the implementation of ESG criteria. And the numbers have shown the ability to do just that.

Last year was a big year for ESG investing, not only because of the flows into ESG-focused strategies but also because the market environment was volatile and ESG issues were at the forefront. What we saw is that ESG exposures added significantly to performance. A study by MSCI based on their own series of ESG indices found that the greater the focus on ESG characteristics, the greater the outperformance for the year. In 2020, the most concentrated high ESG index, the MSCI SRI Index, outperformed other ESG indexes and its parent MSCI ACWI benchmark by 4%.*

In 2019, Morningstar studied the performance of 56 unique indexes in which ESG criteria are the primary driver of security selection and found that 41 of the 56 indices outperformed their non-ESG equivalents since inception. The picture in the U.S. market was not as strong as the results in Europe and Asia, but in our view the landscape in the U.S. is changing quickly and the results from Europe may in fact be a bellwether of what we can expect domestically over the next several years.

We have found that names that scored high on a composite of ESG criteria have attractive characteristics. By decomposing the stocks within the Russell 1000 Index into high- and low-scoring groups, we see that high-scoring stocks on ESG criteria have significantly better profitability and lower volatility than low-scoring stocks. For those who want to delve a bit deeper on this front, I recommend they read the ESG page in our 2021 Capital Markets Forecast.

The future is uncertain, but we think ESG investments may offer an attractive set of characteristics that have the potential to provide competitive returns over the longer term.

* Each of the MSCI SRI ACWI Indexes, the ESG AWI Indexes, and the MSCI ACWI Index differ in several ways, including the number in stocks in the indices and the requirements for inclusion or exclusion from the indices.

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The $1 million question is, how have sustainable funds been able to compete with broader stock market indices?

Companies that are serious about ESG have shown themselves to be better positioned for certain unexpected risks.

A. Keeping in mind, of course, that past performance is not indicative of future returns, sustainable indices overall have done well, as discussed in the prior question. We believe it's because sustainable investing is about focusing the investment process on the long-term risks and opportunities in the marketplace.

The integration of ESG principles into investment processes have tended to focus the analysis on these long-term risks and opportunities. Historically, "long term" has been consistent with one complete market cycle. However, the marketplace is much more dynamic than that, which requires management teams to think far out into the future. In our view, companies that are serious about ESG are better positioned for certain unexpected risks, such as increased government regulations, evolving consumer preferences, and yes, even pandemics, that will play out in repeated ways in the future and which will impact risk and return. Most recently, with the pandemic and social issues around inequality at the forefront, considerations in the social pillar of ESG have been key. However, as action on climate change speeds up, potentially the E pillar will start to dominate. The key point from our perspective is that we think ESG investments offer an attractive set of characteristics that are likely to support competitive risk-adjusted returns over the longer term.

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So, in 2020, a year which will be remembered as the toughest in decades, sustainable investing grew mightily. Why? How do the events of 2020 relate to sustainable investing?

At the start of 2020, one out of three dollars under professional management in the U.S.—approximately $17.1 trillion—employed a sustainable investing strategy, a 42% increase since 2018.

(Source: US Social Investment Forum's 2020 Report on US Sustainable and Impact Investing Trends)

A. In 2020, investors got a first-class education on tail risks, which refers to the risk of assets deviating more than a certain degree from their current price. Tail risk events—such as the pandemic and civil unrest we witnessed last year—are very uncommon, but when they occur, they are very impactful to portfolios. They seem to occur once every several decades and are very difficult to predict in terms of timing and severity. There is good evidence that highly rated ESG companies are generally less susceptible to risks. For example, research from MSCI has found that the frequency of tail-risk events was around three times higher for companies that score poorly on ESG metrics compared to their higher-ranking counterparts. Investors seemed to have learned this lesson. One study showed 78% of U.S. investors said they would increase ESG investment as a response to COVID-19.

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Steve, as the manager of Wilmington Trust's ESG equity strategy, when you're looking for sustainable companies with solid growth prospects, what do you look for? And how do you know if they're who they make themselves out to be—or if they're just greenwashing, where they only have the appearance of being ESG friendly?

A. Our experienced team has a robust process to identify companies that display superior ESG qualities. We start with a quantitative screen that looks at over 130 different ESG criteria across the market to isolate companies with the qualities that are consistent with our ESG mandate. Drilling down deeper, we perform robust fundamental due diligence on those

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companies to see if they are just screening well, or if they *really* meet our ESG standards. We then construct a diversified portfolio of companies that passes this process in an effort to maximize risk-adjusted returns. Finally, we utilize our comprehensive risk management process to help ensure that the expected return on an investment won't be negatively impacted by unanticipated factors.

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For those who want to learn more and find out how sustainable investing can be reflected in their portfolio, what's the next step?

A. Like other areas of investing, investors should consult with their advisors, who are familiar with their goals, needs, risk tolerance, and unique circumstances. Taking all those factors into consideration, they can then explore how ESG criteria may be integrated into their portfolios and overall wealth management plan.

Definitions:

Russell 1000 index measures the performance of the largest 1,000 securities by market capitalization listed on U.S. exchanges. The Growth and Value indices divide the main (core) index by market cap, with Growth characterized by higher expected growth rates, higher price to earnings, and lower dividends while Value is characterized by lower expected growth, lower price to earnings, and higher dividends.

MSCI ACWI Index represents performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 27 emerging markets, covering more than 3,000 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market as of November 2020.

MSCI Socially Responsible Investing (SRI) Indexes represent the performance of companies with high environmental, social and governance (ESG) ratings. The indexes employ a 'best-in-class' selection approach to target the top 25% companies in each sector and can be used by institutional investors seeking to align ethical values and manage potential financial risks. Short term performance may not be indicative of long term results.