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What's the story with **ESG Investing?**

ESG investing incorporates non-traditional considerations related to environmental, social or governance issues into investment analysis. These issues vary by company and industry. In this issue we explore the benefits of ESG investing, how managers incorporate it in their investment process, and what type of investors may (or should) make ESG issues an important element in their investment decision-making process. We then take a deeper dive into a few of the specific issues under the umbrella of ESG - energy and corporate governance.

1 What are the benefits of including ESG-sensitive considerations in the investment process?

Regina Pitaro, GAMCO

A fundamental tenet of active investing is looking at downside risk carefully. Consequently, anything that identifies and mitigates downside risk is worth evaluating. In public equity, one way to understand and manage idiosyncratic stock level risk is through careful research, including understanding the drivers of management decisions, the externalities of its operating environment, regulatory framework and associated risks. So what are the benefits to incorporating Environmental, Social & Governance (ESG) considerations in investing?

ENVIRONMENTAL	SOCIAL	GOVERNANCE
• Air & Water Pollution • Biodiversity • Carbon Footprint • Waste Management • Water Scarcity • Land Use	• Product Safety • Employee Safety • Labor Standards • Supply Chain • Diversity	• Board Independence • Board Diversity • Corruption • Transparency • Ethics

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First, awareness of ESG issues can enhance and broaden understanding of externalities around the world's diminishing resources, as the population reaches 10 billion people by 2050. We see companies adapting operations to a world increasingly concerned with sustainability in the broadest sense. ESG-integration enables consideration of non-financial issues and external risks in a way that negative screening simply does not. The importance of being able to connect a particular ESG issue into investment-related analysis requires experienced judgment and perspective. Some examples are shown below.

ESG Factors	Investment Impact
• Water Quality • Water Scarcity • Water Management	• Production input cost • Manufacturing disruption • Impact on agriculture • Commodity price volatility
• GHG emissions • Energy efficiency & management • Waste Management	• Production input cost • Increasing regulation • Increasing cost • Slower growth
• Food supply chain quality • Water availability • Farming Security	• Commodity price volatility • Global instability as population grows • Changing consumer choices
• Income inequality • Labor Practices & Development • Employee Health & Safety • Consumer Safety	• Slower growth • Consumer behavior • Increasing regulation • Political instability

Second, including ESG factors in the process can lead us to sustainability-related themes that we believe highlight good long-term investing opportunities. Some examples would include investments related to: water scarcity, energy efficiency, sustainable transportation, health & wellness, power infrastructure and sustainable agriculture. Uncovering the companies whose products and services will advance solutions to some of the world's biggest challenges can make good long-term investments. For example, the 2011 water crisis in Flint, Michigan reminded us all of the investments in water infrastructure that are needed throughout the U.S. And increased sales of electric vehicles are certain to contribute to mitigating climate change.

Third, among ESG issues, we would highlight that corporate governance is perhaps the most developed historically. Corporate governance has long been considered by the financial markets to be an important factor in understanding company management, controls, oversight behavior and decision making. There are established "best practices" in governance. Several scandals have highlighted the importance of board of directors' governance, including incidents within companies such as **Wells Fargo** and **Volkswagen.** The need for transparency around ESG issues cannot be underscored enough, as it may, in fact, reveal types of risk not captured in traditional valuation modeling.

***Gabelli's* Magna Carta of Shareholder Rights** *written in 1988 declared our stance on specific governance issues which we felt impacted shareholder value. Understanding a management's track record of shareholder friendly capital allocation decisions has remained important to our research and analysis. Certain environmental and social issues of companies are additional risks that can provide insight into a management's focus on resource efficiency, waste or even customer relationship management practices.*

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As companies face complex, interconnected challenges that require an evolving approach to sustainability–some regulated, others from shifting consumer patterns—ESG issues play a meaningful role in creating long-term value for stakeholders. Those who tap into this deep, under researched, non-financial information with the ability to connect it to the financial implications—*rather than simply ignore it*—can benefit. Understanding ESG factors and risks alongside traditional company analysis enhances understanding and should lead to better informed, more holistic investment decisions, which ultimately may generate better long- term, risk-adjusted performance.

2 How can investors incorporate ESG factors into their investment process?

to Matt Christensen, Head of Responsible Investing, AXA Investment Managers

After starting out with the basic idea of investing in "good" companies and avoiding "bad" ones, responsible investing has since come a long way. And the rising enthusiasm for investment products deemed more responsible and less harmful is understandable, as investors increasingly want to know how companies are creating value and how their activities are impacting the wider world.

But alongside creating a positive impact on society, responsible investing can potentially deliver sustainable, long-term value for investors by using insights from three primary factors, namely environmental, social and governance (ESG) data. Within each of these, there are key themes, including natural resources and climate change (in environment), human capital and business behavior (in social) as well as board oversight and management quality (in governance). But within these lie an abundance of sub-themes, such as working conditions, business ethics and human rights.

From an investor's perspective, the range of responsible investment approaches can be broadly categorized into three buckets; ESG-embedded, ESG-integrated—and the latest addition to the set—impact. Together they cover the full investment spectrum, and reflect the increasingly refined approach evident in the evolution of responsible investing.

Managing risk and leveraging opportunities

The ESG-embedded approach is the first step in the world of responsible investing, in which various forms of scoring create a starting point for embedding ESG factors in the investment process. Initially designed to avoid ESG risks by excluding companies that conflict with an investors' values, such as weapons manufacturers, screening now goes much further than simple 'exclusionary' filters. A focus on ESG scoring means an investment portfolio can be evaluated in terms of its exposure to both ESG risks and opportunities. Every holding, every bond and stock, can receive an ESG score that is aggregated to form an overall scorecard.

Integration in action

ESG-integrated investments go a step further. This approach uses ESG analysis, including the ESG score outlined above, and incorporates this information into investment decisions. However, while any company can be analyzed on an ESG basis, there are no perfect firms, so it is not a simple exclusionary exercise. Companies are instead assessed on how they are positioned to handle both short- and long-term ESG risks—as well as opportunities. The expectation is that management teams taking decisions to address ESG issues are likely to be more competitive relative to their peers in the long term. This approach's primary goal is to create a portfolio of strong ESG holdings, more likely to outperform their peers with lower ESG scores.

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Positively impacting returns

The most recent phase in responsible investing's evolution is impact investing. This approach specifically targets positive change, while simultaneously delivering competitive financial returns. Vitally, these positive impacts must be quantifiable. Impact investing seeks to harness the power of finance, in a bid to solve complex social and environmental problems, such as improving access to education and healthcare, or reducing the effects of climate change. To deliver on both criteria —positive societal outcomes and consistent financial returns—target outcomes need to be clearly identified from the outset, and of course, be measurable.

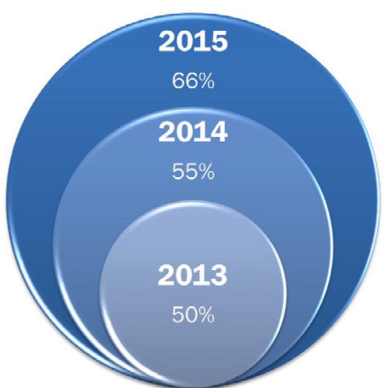
Right now responsible investing momentum is building and we believe, in time, it will become the mainstream. From here, we see only one direction of travel.

3 Are ESG-sensitive strategies just about attracting millennial investors?

John Goldstein and Meg Starr, ESG and Impact Investing, GSAM

While there is a proliferation of research and discussion around millennial interest in ESG and impact investments and the impending wealth transfer to the next generation, we believe the picture is actually broader than just attracting investment dollars. Millennials are intersecting with ESG investing in a few different ways, which may be altering business models, broader investment trends, and market opportunities:

- **Consumer demand trends:** The purchasing behaviors and consumer preferences of millennials are opening up new markets and spurring different demand drivers, which may benefit investment themes such as sustainable agriculture, consumer packaged goods, resource efficiency, and healthcare IT. Companies engaged in certain practices may potentially benefit due to factors such as increased consumer demand for ESG-related products and services, higher quality foods and services, and more productive employees. In recent years, the percent of consumers willing to pay extra for products and services that come from companies committed to generating positive social and environmental impact has increased steadily[1]. For example, our Quantitative Investment Strategies team has recently been using natural language processing to identify alpha signals from companies that garner more media and press mentions of sustainable business practices and products, which our research has found are benefiting from increased consumer demand for these traits.



Sixty-six percent of global respondents are willing to pay more for sustainable goods, up from 55% in 2014 and 50% in 2013)

Source: Nielsen Global Sustainability Report 2015

- **Human capital:** As companies think towards recruiting and retaining the next generation of talent, which is particularly critical in early and growth-stage private companies, mission-aligned companies have increasingly shown that they have an edge. Nearly 3 in 4 millennials prefer to work for socially responsible companies, a human capital shift which can give these corporations a distinct edge over competitors, which may translate to financial outperformance over time[2].

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1 Nielsen Global Sustainability Report 2015

2 Cone Communications Millennial Employee Engagement Study, 2016

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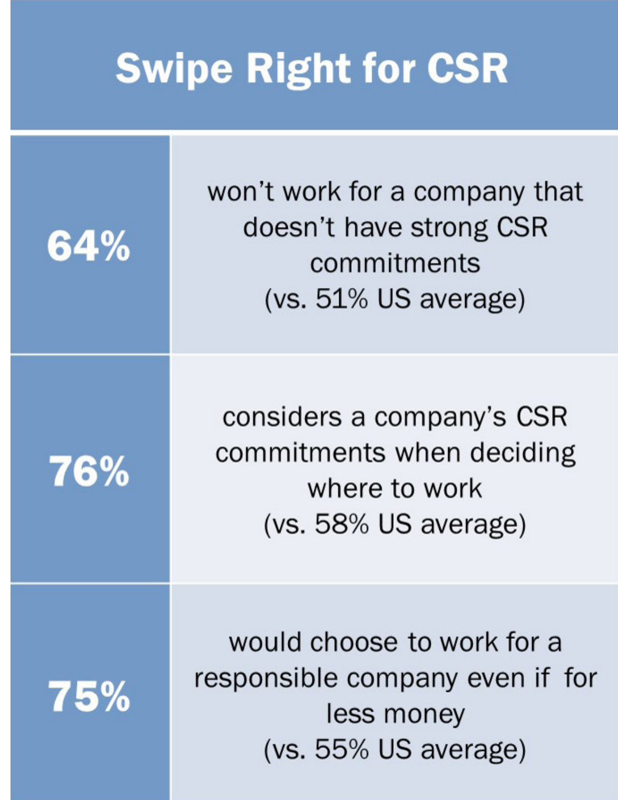
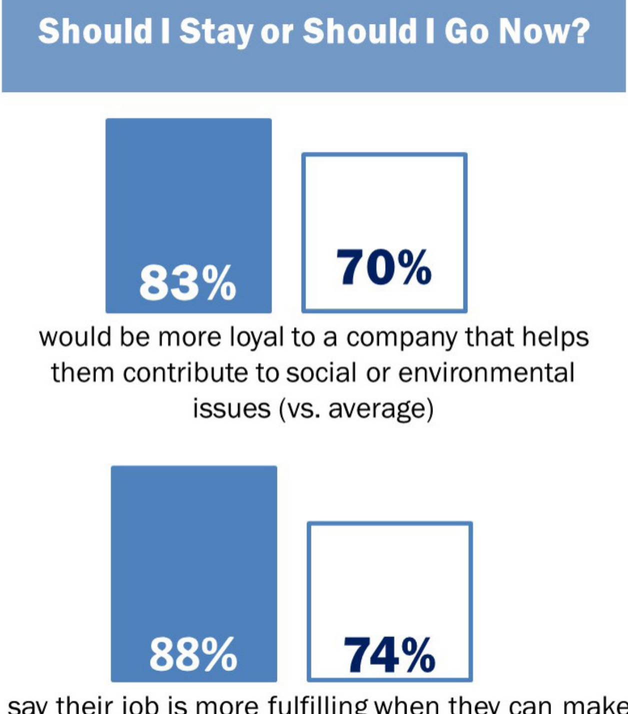




Corporate Social Responsibility ("CSR")
Source: Cone Communications Millennial Employee Engagement Study, 2016

- **Investment dollars:** As millennials start to inherit wealth and invest their own dollars, we may see a clear preference for ESG and impact investment strategies, not just for savings and retirement accounts, but through additional avenues as well. For example, we have seen university endowments receive large donations earmarked for ESG and impact investments. Next-gen donors want their dollars to be invested for impact as they generate returns for operating capital. We also see ESG and impact investments as an important tool for engaging the next generation in family financial decisions – whereas philanthropy used to play this role, ESG and impact investing is now increasingly serving as the "financial literacy class" for the next generation

While millennials are a significant part of the ESG investing surge, their contributions aren't as simplistic as pure investment dollars. Millennials' focus on environmental and social issues impacts how they spend, donate, work, and invest; this, in turn, is reshaping the investment landscape dramatically.

4 Where can investors find attractive opportunities in sustainable energy production?

BLACKROCK®

Titania Hanrahan, Product Strategist, BlackRock Active Equity

Investing in sustainable energy is no longer just about regulation, and reliance on such support has fallen significantly as technology has improved and meaningful cost reductions have been achieved. The New Energy sector has been outperforming broader equity markets[3], in spite of the negative sentiment surrounding U.S. policy changes; this reflects the fact that we are reaching a tipping point where New Energy solutions are becoming the more economically attractive option versus the existing solution, in many instances.

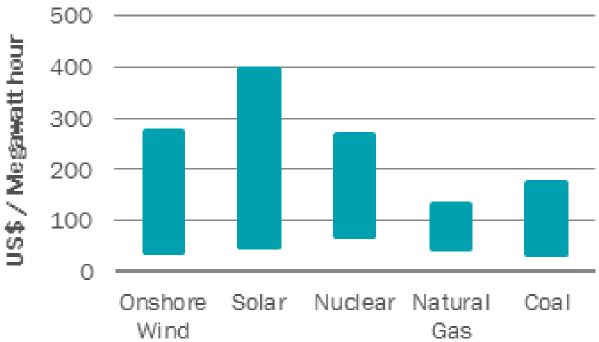
The global population is expected to reach 8.8 billion people by the year 2035, from 7.3 billion in 2015[1]. During this period, global GDP is expected to double, as more than 2 billion people are lifted from low incomes[4]. This population and GDP growth will likely lead to increasing demands on the world's resources and forces us to face the three quintessential questions of the current era:

- How do we enable growth without destroying global and local ecosystems?
- How do we embrace new technologies that limit carbon emissions?
- How do we do more with less?

It is these three questions that the sustainable energy sector is attempting to answer, and while this sector has historically focused on power generation, it is today more wide reaching than the pure-play renewable energy sector. This transition to a lower-carbon economy presents significant investment opportunities 1) through a decarbonization of energy production and 2), through more efficient utilization methods of this energy. We believe the transition is already underway and is driven by three key pillars:

1) The economics make sense:
Onshore wind power is now comparable, or in some locations, more economic than fossil fuels. Meanwhile, the cost of solar power generation has fallen ~80% since the global financial crisis, and continues to do so[5].

Leveled Cost of Energy



Source: Vestas Investor Presentation 31st January 2017.

3 As displayed by the Wilderhill Global Clean Energy Index performance relative to the MSCI World Index performance from 31-Dec-2016 to 26-Feb-2018
4 The World Bank, as at 30th June 2017
5 BlackRock Investment Institute and International Energy Agency, 30th September 2015

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2) Consumer trends:

Much of the transition to a lower carbon economy is today driven by consumer trends rather than legislation, for example: consumers choose to better insulate their homes to cut energy costs and corporations choose to utilize smart building technology in order to drive efficiencies in their business. From a macro perspective, urbanization is also a key driver of these trends, for example, the average age of commercial buildings in the US is 49 years old[6] and as these buildings are renovated and rejuvenated they are becoming more energy efficient. The sustainable energy sector encompasses companies that are supplying insulation and construction materials that increase the energy efficiency of both new and existing buildings.

3) Technological development:

Technology for lower-carbon solutions can deliver better results than the higher-carbon alternatives today, for example: The Tesla Model S can deliver 0 to 60 miles / hr in 2.3 seconds, while the BMW 7 Series takes 6.0 seconds to reach this same speed[7]. But development is not simply focused on pure-play electric vehicles today. The development in hybrid technology has increased the adoption in this segment, and it is now expected that ~70% of global auto sales in the year 2030 will be a form of electrified vehicle.[8]

Electric Vehicles as a % of Global Auto Sales

% of global auto sales
70%
60%
50%
40%
30%
20%
10%
0%
2015
2020e
2025e
2030e
Mild hybrid (incl. 48v)
Full hybrid
Plug In Hybrid EV
Battery EV

Source: IHS 31st December 2016.

Elsewhere, the adoption of assisted driving and autonomous driving increases the energy efficiency of both electric vehicles and internal combustion engine vehicles. It is already commonplace in 2018 to have stop-start technology and assisted parking technology in new vehicle models, and suppliers of this technology form a part of the New Energy sector today.

In short, sustainable energy is no longer just about regulation and reliance on such support has fallen significantly as technology has improved and meaningful cost reductions have been achieved.

The combination of population growth and economic growth demands a new approach to energy consumption and supply. This path to a lower carbon global economy will continue to disrupt many industries and business models but it also creates opportunities. The IEA estimates that $22 trillion will be invested in the sector through 2040, an average of nearly $1 trillion per year[9] and we believe that the scale of the growth opportunity for the sector as a whole has been under-appreciated by investors.

6 4 SMR Research, January 2018
7 Company websites
8 Global Trends in Renewable Energy Investment 2017
9 International Energy Agency, World Energy Outlook 2017

5 Since the upheavals of the financial crisis, how can stronger corporate governance contribute to investment returns?

By Jordan Jackson, J.P. Morgan Asset Management

Since the global financial crisis, there has been increased demand for more robust corporate governance policies in order to promote transparency and trust between public shareholders and corporate management. Broad issues include moves that promote board member independence, anti-corruption policy, robust accounting standards and diversity. For investors, identifying material factors that may impact a company's future financial performance (e.g. cost of poor strategy and execution, fines and potential litigation) is critical in determining the health of a business. Therefore, we believe that ESG considerations, particularly those related to governance, can play a critical role in finding opportunities and avoiding potential losses, which should yield a better risk/return profile in a long-term investment strategy. In turn, as active owners, taking an integrated approach that incorporates corporate governance considerations and traditional fundamental analysis can be a key part of risk management.

When considering governance, we focus on two areas: first, whether a company shows a proper regard for the interests of all shareholders; and second, whether it can demonstrate proper stewardship of a company's assets and value over time. In practical terms, this means assessing the motives and competence of the decision-makers[10]. In focusing on these two areas, we can unearth how conflicts of interest are addressed and consider the skill with which shareholder value is developed over time; primarily, the returns made on incremental capital retained within the business and how management balances considerations of risk and reward. These considerations pay off, as suggested by the data.

The MSCI World Governance-Quality Index ("MSCI WGQ"), a subset of the MSCI World Index, includes large- and mid-cap stocks across 23 developed market countries and aims to capture both the financial and corporate aspects of quality investing[11]. The standard of governance is measured through a ranking methodology on independence, diversity, ownership and control structure of company, accounting practices and auditor opinions. Since November 2009, the MSCI WGQ Index has outperformed the MSCI World Index by 29% cumulatively, and done so with a better Sharpe ratio of 0.74 compared to the MSCI World Index at 0.57[12]. Given that asset class returns are projected to be lower going forward, investors should look for companies with governance policies in place that minimize downside risk and maximize upside potential. We believe, over the long-term, companies with better governance should yield better risk-adjusted returns for investors.

MSCI World and MSCI World Governance Quality Index

Nov 2009 = 100 U.S. dollar price return

Source: MSCI, J.P. Morgan Asset Management. Data are as of February 19, 2018.

10 *Investing sustainably: Environmental, Social and Governance (ESG) in Emerging Markets* - J.P. Morgan Asset Management

11 MSCI Governance–Quality Indexes Methodology – June 2015

12 Based on US Treasury 3M Bellwether. Data as of February 19, 2018

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The **MSCI World Index** is designed to represent the performance of large and mid-cap stocks across 24 developed markets.

The M**SCI World Governance-Quality Index** is based on MSCI World index, its parent index. The index aims to reflect the performance of a strategy that is seeking to capture both the financial and corporate governance aspects of Quality investing. You cannot invest directly in an index.

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