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GLOBAL ASSET MANAGEMENT

ENVIRONMENTAL • SOCIAL • GOVERNANCE

Introducing ESG into your practice

ESG is a general term for investing that considers environmental, social, and governance factors in the fundamental analysis of a company. ESG criteria can be used to assess corporate responsibility, and may allow investors to identify investment risks and opportunities, as well as to align financial assets with personal values. There is no standardized list, but Figure 1 highlights some of the factors used most frequently.

ESG analysis is not exclusive to funds labeled "SRI," "ESG," or "sustainable." These criteria may be a part of any asset manager's investment approach, as a way to better determine a company's fair value and manage portfolio risks.

FIGURE 1: SAMPLE ESG FACTORS

Environmental issues	Social issues	Governance issues
Carbon emissions	Labor practices	Management structure
Water management	Human rights	Board structure
Waste management	Community involvement	Compensation policies
Deforestation	Diversity	Political contributions
Air and water pollution	Data protection and privacy	Risk oversight
Energy efficiency	Customer satisfaction	Shareholder engagement
Energy mix	Animal welfare	

Strategies that use ESG analysis have had many names over the years, from socially responsible investing (SRI) to responsible, sustainable, and impact investing. We believe these terms describe different ways of implementing environmental, social, and/or governance considerations in an investment process. All use ESG criteria at some stage, but implementation can vary considerably. Interest in the style has been growing in response to a stricter regulatory environment, leading many to believe that companies with strong environmental, social, and governance records may be more sustainable long-term investments.

Implementation methods

There are three common ways to implement ESG considerations in an investment strategy: negative screening, best-in-class, and ESG integration. Each can be used on its own or in conjunction with the others, depending on the desired result. For example, a manager could use negative screening to exclude "worst offenders", such as businesses with human rights violations, but then use ESG integration to find opportunities for the portfolio.

Negative screening

The earliest SRI strategies relied primarily on negative screening to exclude controversial industries, products, or countries based on moral or faith-related values. This could mean excluding companies involved with tobacco or stem cell research, or businesses that violate widely accepted corporate behavior norms, such as human rights or anti-corruption. While negative screening can help avoid specific ESG risks, it often leads to underperformance relative to traditional investment strategies as it may exclude large sections of the investable universe. Even so, SRI strategies based on exclusion are still commonly used.

Best-in-class

Best-in-class ESG analysis came later, as the focus shifted from simply minimizing ESG risks to actively looking for ESG-related opportunities. Best-in-class refers to investing in companies with better or improving ESG scores relative to their industry peers. The belief is that this methodology can lead to a portfolio with an improved ESG profile as well as better financial performance and risk characteristics. This relative approach encourages progress in each sector, but without excluding any of them.

ESG integration

ESG integration puts the emphasis on absolute ESG factors to evaluate companies and their associated investment risks and opportunities. This style of implementation seeks to identify businesses that may be more resilient over the long term because their environmental, social and governance policies may contribute to better financial performance. ESG integration differs from best-in-class in that decisions are not relative to industry peers. It analyzes all sectors to more fully understand companies' exposures to ESG risks and opportunities, and ESG considerations are part of the investment process at the sector and company levels.

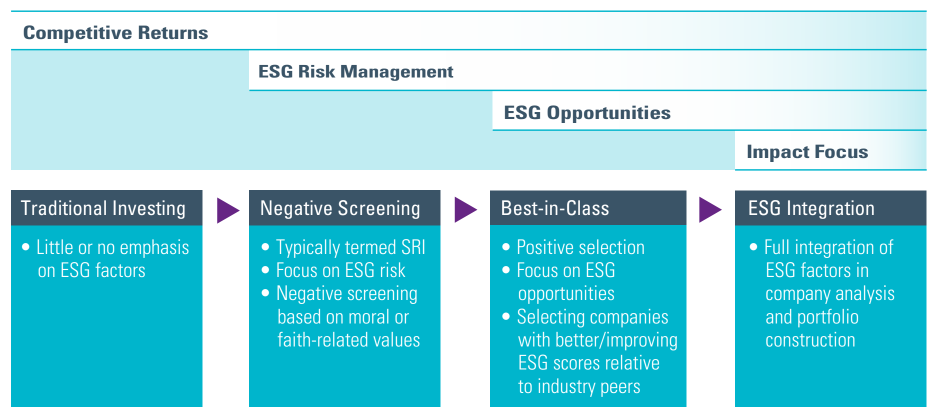
Entering the mainstream

In recent years, ESG analysis has played a bigger role across investment styles, moving from strictly exclusionary practices to a greater emphasis on positive company selection. Changes related to corporate transparency and reporting, along with growing awareness of the business risks associated with governance, environmental, and social issues, have also highlighted some of the potential benefits of considering ESG criteria in an investment approach.

Increased transparency and reporting

Given the demand for ESG reporting transparency, many corporations and other organizations have responded. In 2010, the Sustainability Accounting Standards Board (SASB) was established to set industry-specific standards for corporations to ensure that sustainability disclosure is material, comparable, and useful for investors.

FIGURE 2: ESG IMPLEMENTATION IN PUBLIC MARKETS



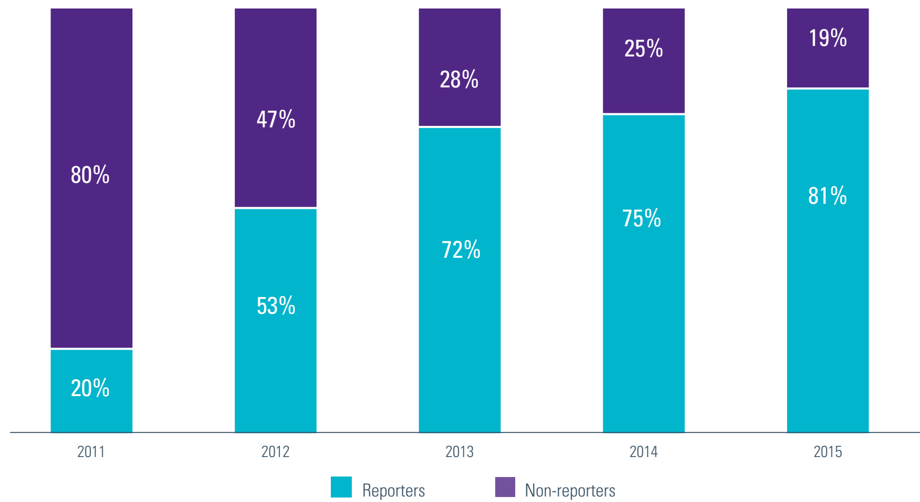
According to analysis by the Governance & Accountability Institute, 81% of S&P 500® companies published a sustainability or corporate responsibility report in 2015, up from just 20% in 2011 **(Figure 3)**. The Institute's Executive Vice President, Louis D. Coppola, notes, "Measuring, managing, and reporting on Environmental, Social, and Corporate Governance issues has been established as a mainstream practice in both the corporate and investment communities. Leaders increasingly understand the critical importance of adopting and implementing strategies, products, services, programs and initiatives that reflect the 21st century business environment, and the interests of investors and important stakeholders."

Greater awareness of the value of ESG analysis has also led to the creation of several indexes that incorporate ESG criteria from providers such as FTSE, MSCI, and S&P Dow Jones.

Morningstar and others have begun rating mutual funds and other investment products based on sustainability and ESG criteria, regardless of ESG labeling. This gives investors the ability to compare ESG-labeled and traditional mutual funds on the same metrics.

These are just a few examples of the movement toward better and more transparent reporting and measurement. Going forward, there may well be additional indicators that specifically show how companies' ESG records affect performance over the long term.

FIGURE 3: S&P 500® COMPANIES PUBLISHING SUSTAINABILITY REPORTS ON THE RISE



Source: Governance & Accountability Institute Flash Report, 2016.

What about performance?

Objections to ESG-related investing often focus on concerns about a performance tradeoff. Until recently, however, academic and industry studies on the comparative performance of ESG factors have been largely inconclusive. Unlike financial reporting, there has been little regulatory guidance for ESG disclosures, making it difficult to measure and compare performance data. While the earliest SRI/exclusionary styles did tend to lag more traditional strategies, it was largely because they avoided a significant portion of the investable universe. Today, however, ESG and profitability don't have to be mutually exclusive. Many portfolios that incorporate ESG analysis include large, well-respected companies that are household names.

Newer research has demonstrated that ESG performance is correlated with corporate financial performance.

In 2015, Deutsche Asset Management and the University of Hamburg combined research from 2,200 individual studies on the topic. The results supported the business case for incorporating ESG considerations, with roughly 90% reporting a non-negative relationship between ESG and corporate financial performance. More importantly, the large majority of studies showed positive findings.[1] Additionally, a 2015 study by Nielsen found that, in the prior year alone, sales of consumer goods from brands with a demonstrated commitment to sustainability grew more than 4% globally, while those without grew less than 1%.[2]

MSCI analysis also indicates that including ESG criteria in an investment process doesn't necessarily lead to weaker investment performance.

1 Journal of Sustainable Finance & Investment, Vol. 5, Issue 4, 2015

2 http://www.nielsen.com/us/en/insights/reports/2015/the-sustainability-imperative.html

MSCI created the MSCI All Country World Index (ACWI) ESG Universal Index in November 2009. Since its creation, the ESG-focused version has kept pace with the traditional MSCI ACWI -- and slightly outperformed as of April 30, 2017 **(Figure 4)**.[3] Of course, given changing market conditions, there will likely be times when the traditional index has the better record. Even so, it's clear that a focus on companies with strong ESG profiles doesn't necessarily lead to poor returns, and may in fact improve returns over time.

Recent findings from MSCI's 2017 ESG Trends to Watch[4] show that selective application of ESG criteria in an investment process can have a positive impact on performance. This may be more effective than a blanket approach, and may also offer support for using actively managed ESG allocations.

FIGURE 4: ESG-BASED STRATEGIES HAVE KEPT PACE OVER TIME (11/1/09–4/30/17)[3]

ESG factors and risk

In addition to being a potential performance driver, ESG analysis may also help identify unforeseen investment risks. Incorporating ESG may help avoid drawdowns related to bankruptcies, corporate scandals and other headline and reputational risks as well as risks related to long-term sustainability. A recent example is Volkswagen, which appeared to have a positive environmental record, but had governance issues that led to cheating on emissions tests. In the week following the issuance of the EPA's notice of violation to Volkswagen, investors punished the company and the stock lost 33%. Deep ESG research might have revealed some of these governance issues.

Growing interest

Investment performance and risk management are important benefits of adding ESG criteria to the investment process. But a growing number of investors are also starting to appreciate the positive environmental and social impact they can make with their wealth, whether directly or indirectly. Investing in companies with responsible environmental and social practices can be a way to put those beliefs into practice. The ability to combine financial returns with social and environmental gains is increasingly in demand.

Aligning investments and values

While we believe there is likely a disconnect between what U.S. investors say they want and where they put their money, the growing demand for non-financial products that are sustainable may be a good indication of what's to come for sustainable investment strategies. Environmentally and socially conscious consumers may become more discerning investors.

Research shows that many high-net-worth (HNW) investors are patterning their investments after their consumption habits. The number of HNW investors who agree that the "social or environmental impact of the companies they invest in is important to their investment decisions" is up significantly year-over-year, according to a recent U.S. Trust survey. The number of HNW respondents who have reviewed their portfolios for impact has also increased, and there is evidence of a generational shift: Millennials are more

3 MSCI: Can ESG Add Alpha?, June 2015 paper https://www.msci.com/documents/10199/4a05d4d3-b424-40e5-ab01-adf68e99a169;
4 MSCI 2017 ESG Trends to Watch https://www.msci.com/documents/10199/cbc27309-8157-4589-9cc0-00734bca6a6b)

likely to have conducted a portfolio review, and are also more likely to factor ESG considerations into their search for a financial advisor.[5]

Not only are people saying they want these types of strategies, there's money in motion. There has been a spike in the growth of U.S.-based funds and assets that incorporate ESG factors, a clear indication of investor demand. Both the number of investment funds and their total assets have grown explosively in recent years. According to the Forum for Sustainable and Responsible Investment (US SIF), total U.S.-domiciled assets under management applying various ESG criteria in the investment analysis grew to almost $9 trillion at the start of 2016.[6] **That's over 30% growth from the start of 2014.** This includes institutional investors, money managers and community investment institutions.

In 2016, there were more than 1,000 funds **(Figure 5)** with over $2.5 trillion assets under management incorporating ESG.

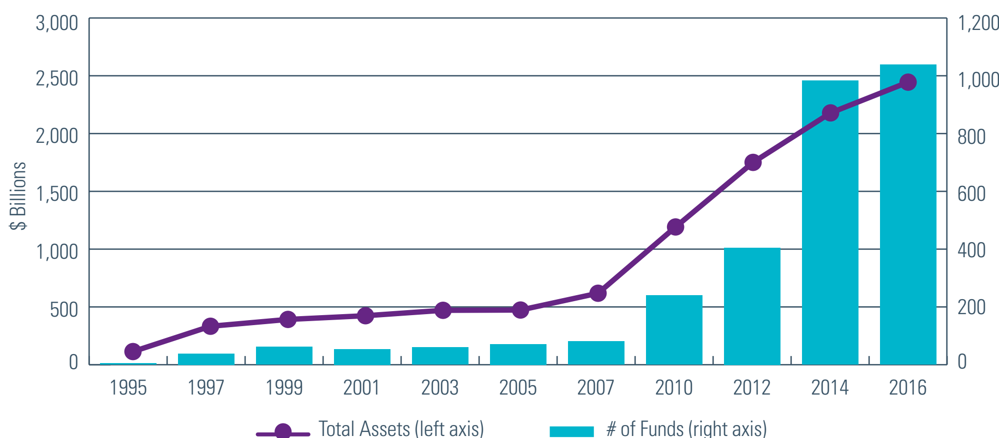
This significant growth reflects several factors, including:

- Growing market penetration
- Development of new products that incorporate ESG criteria
- Growing use of ESG criteria by many large asset managers across wider portions of their holdings

This trend has also been supported by new disclosure provided by institutional investors and asset managers that indicates how they are implementing the Principles for Responsible Investment (PRI). PRI is a global framework for taking ESG considerations into account in investment analysis, decision making, and active ownership strategies.

The number of U.S. funds incorporating ESG factors in their strategy topped 1,000 in 2016.

FIGURE 5: GROWTH OF FUNDS INCORPORATING ESG FACTORS, 1995–2016



Source: US SIF Foundation; includes mutual funds, variable annuity funds, closed-end, ETFs, alt investment funds (excludes SEP accounts, other/not listed, and community investing funds).

5 2016 U.S. Trust Insights on Wealth and Worth® Survey

6 Forum for Sustainable and Responsible Investment (US SIF) 2016 Report on US Sustainable, Responsible and Impact Investing Trends.

Who's talking about ESG?

Both professional buyers and individual investors believe ESG is an important consideration when it comes to their investments. In fact, 91% of institutional managers say their organizations incorporate ESG criteria in their analysis and decision-making process.[7]

Many of these specialists are looking at ESG through a new lens, investing in key trends such as green energy, in which businesses will benefit from increased societal focus on sustainability. This kind of impact investing may be the opening for more managers to incorporate ESG considerations into institutional strategies.

Similarly, individual investors surveyed by the Natixis Durable Portfolio Construction Research Center also indicated strong demand for ESG-driven strategies. More than three-quarters (78%) of individuals across demographic groups say it's important to invest in companies that are ethically run.[8] Three-quarters also say it's important to invest in companies that reflect their personal values. More specifically, seven in ten respondents want to invest in companies with sound environmental records and almost the same number want to invest in companies that have a positive social impact **(Figure 6)**.

Survey data also supports the view that interest in sustainable investing will continue to grow based on demand for sustainable consumer goods. Two-thirds of consumers say they are willing to pay more for sustainable brands – up from 55% in 2014 and 50% in 2013. Among the 66% of global respondents willing to pay more, over half are influenced by key sustainability factors, such as a product being made from fresh, natural and/or organic ingredients (69%), a company being environmentally friendly (58%), or a business known for its commitment to social values (56%).[9] For this group, personal values are more important than personal benefits, such as cost or convenience.

FIGURE 6: INDIVIDUAL DEMAND IS STRONG FOR INVESTING THAT REFLECTS PERSONAL VALUES[7,8]

7 Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research in October and November of 2016. Survey included 500 institutional decision makers and 200 wholesale portfolio managers in 31 countries.

8 Natixis Global Asset Management, Global Survey of Individual Investors compiled by CoreData Research, February 2016. Survey included 7,100 investors in 21 countries of which 750 were in the U.S.

9 http://www.nielsen.com/us/en/insights/reports/2015/the-sustainability-imperative.html

Implementation in client portfolios

However, despite growing evidence of investor interest, only 51% of survey respondents say their financial advisor has discussed ESG with them. This may create an opening for advisors to attract and retain clients across a range of demographics. Consumers have already shown that they'll support businesses they believe are environmentally and socially conscious by buying their products. Many may also prefer to do the same with their investment dollars – but they need to be given an opportunity. Financial advisors can help their clients connect the dots.

Incorporating ESG considerations can be a way to attract new clients as well as retain clients and their adult children, who may have their own investment ideas. In some cases, assets dedicated to these strategies may be stickier, as there is an emotional component to the investment. And it doesn't have to be all or nothing: ESG strategies can be introduced gradually.

Integrating ESG into your portfolio construction process can help differentiate your practice – and may eventually become the standard. Getting started now may put you ahead of the curve.

ESG conversation starters

Some investors may need more education than others, but many clients may be surprisingly receptive. Here are a few ideas.

- When considering ESG options, talk to your clients about any current holdings that may have questionable ESG credentials based on their known beliefs – and gauge their reactions. Making the connection between values and investments can start a useful discussion. With ESG strategies, clients have an opportunity to use their values as the basis for investment decisions.
- Be knowledgeable on the voting and engagement policies of the investment managers you use. Discussing voting and engagement can bring this style of investing to life. Clients can see that asset managers may be fighting on their behalf for issues they care about, rather than just sitting idly by.
- For more financially sophisticated clients, framing ESG as part of fundamental analysis or as a way to manage risk may make more sense. Bringing in specific stock examples, such as Volkswagen, can be a good way to illustrate this concept.
- For clients who have already shown an interest in incorporating ESG considerations into their investments, focusing on companies or funds known for sustainable, ethical business practices may provide new sources of investment ideas.

NATIXIS GLOBAL ASSET MANAGEMENT

Natixis Global Asset Management ($895.6 billion AUM[1]) is a multi-affiliate organization that offers a single point of access to more than 20 specialized investment firms in the Americas, Europe and Asia. The firm ranks among the world's largest asset managers.[2] Through its Durable Portfolio Construction® philosophy, the company is dedicated to providing innovative ideas on asset allocation and risk management that can help institutions, advisors and individuals address a range of modern market challenges.

1 Net asset value as of March 31, 2017. Assets Under Management (AUM) may include assets for which non-regulatory AUM services are provided. Non-regulatory AUM includes assets which do not fall within the U.S. Securities and Exchange Commission's definition of "regulatory AUM" in Form ADV, Part 1.

2 Cerulli Quantitative Update: Global Markets 2016 ranked Natixis Global Asset Management, S.A. as the 16th largest asset manager in the world based on assets under management ($870.3 billion) as of December 31, 2015.

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