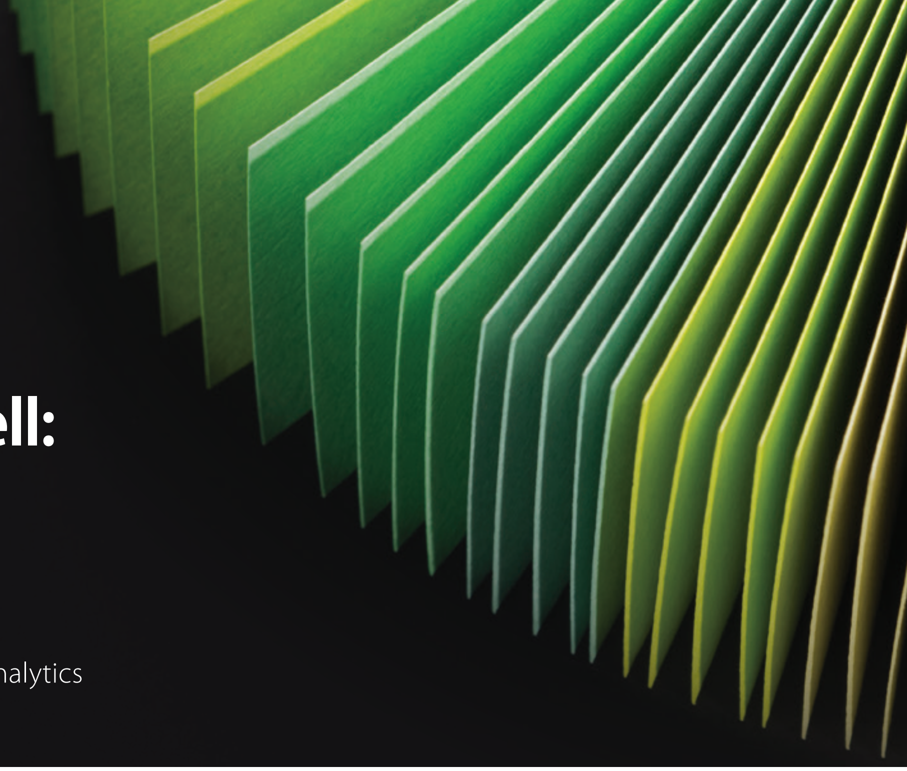
Westwood®



Do Good and Do Well: Understanding ESG

Kellie R. Stark, CFA®, FRM
Executive Vice President, Risk & Performance Analytics

ESG is gaining popularity as an investment factor and having a large impact on the financial services industry. There are a number of different investing philosophies within the responsible investing realm, but **"ESG investing"** and **"ESG integration"** have been gaining a considerable amount of attention lately. Not only because of the "feel-good" factor, but also because it affords investors the opportunity to outperform using a factor that can provide alpha through higher returns and by spotting potential risk and avoiding losses. Threats posed by ESG issues have the potential to be a serious detriment to a company's future financial prospects and avoiding these can be important to an investor and their portfolio.

The letters "ESG" stand for **environmental, social** and **governance** and refer to the three main categories considered with regard to a firm's ethical impact in the world and their sustainable practices. While corporations traditionally have felt they have a responsibility to shareholders, there are many other stakeholders to whom a company is also accountable. Millennials are generally seen as leading the charge toward ESG, but the recent rise is a reflection of society as a whole embracing the notion that companies should be held accountable for their actions toward shareholders, employees, vendors and the community at large. ESG investing works to find those companies that are building relationships with all stakeholders.

As wealth is transferred from the baby boomer generation to the millennial generation, the estimated inflow of investments into ESG-type strategies over the next few decades could be roughly equivalent to the current size of the S&P 500[1].

Companies are under pressure to demonstrate they can deliver value in ways that work for their stakeholders and the community, and to do so in a way that aligns with their values about fairness, the environment and human rights.

This new rising emphasis on ESG means companies can express their corporate values and investors can invest in good companies whose practices align with their values — all without sacrificing returns.

In essence, you can **Do Good** and **Do Well**.

The precursor to ESG investing was **socially responsible investing (SRI)**. In the past, SRI investing according to your beliefs required one to outright exclude areas that did not align with your values. Commonly excluded investments included those in tobacco, alcohol, weapons, gambling or other "sin" stocks. Now, ESG

[1] Top 10 reasons you should care about ESG, Bank of America Merrill Lynch 09/23/2019.

investing or ESG integration offers more flexibility and depth of research into the nuts, bolts and fine details that make up a comprehensive corporate initiative and define management's patterns. ESG investing allows investors to incorporate ESG metrics that they deem material into risk and reward analysis and include these metrics in their investing practices. It also allows investors to purchase shares of companies that they feel may be improving or where they may be able to influence company management.

ESG integration does not require that all factors be included in an analysis but would include issues that could have an impact on a company's future prospects, both negatively and positively. Beyond traditional environmental factors, ESG includes other areas that truly place a company at risk or present opportunities. Firms should consider these when examining risks and investors should consider them when making an investment.

Highlights of what investors may be looking at include:

Environment. The environmental factor looks at the impact a company may have on the earth. It includes better known metrics such as recycling, energy conservation, new categories like climate change and greenhouse gases, as well as lesser-known categories like water and resource usage, and scarcity and conservation. Failure to manage these areas could result in lost sales, fines and increased costs through higher regulation and limited availability of resources.

Social. The social factor looks at the people-related elements and issues that impact people from within a company as well as within society. Issues could range from how a company treats its employees in pay, benefits, engagement and development to lobbying efforts. It also includes the diversity practices, supply chain sourcing, consumer friendliness and protection of data, or cybersecurity.

Governance. The governance factor looks at a company's management, oversight, attitude toward shareholders and how incentives align management interests with the business' success. Executive compensation metrics, the roles of board members, transparency and relationships with key regulatory bodies such as the U.S. Securities and Exchange Commission (SEC) are key elements in the area of governance.

It is important to consider ESG metrics in your investment analysis. Businesses that choose to maximize profits at the expense of stakeholders may be ignoring real financial risk. ESG impacts and examples of companies failing to consider ESG risks in their strategy can be found all around.

Environmental impacts, normally at the forefront of an investor's mind, can have large consequences and go further than regulatory or reputational risk. Global warming or climate change cause a variety of risks ranging from scarcity of precious resources such as food, water, trees or minerals to a higher rate and magnitude of natural disasters including fires and hurricanes, global unrest, instability and potentially war.

The impact to a company based on their social commitment to workers and society can also have far-reaching effects. According to The Adecco Group, the cost of replacing an employee can reach as high as 30% of their annual salary[2]. When one includes intangible costs such as lost productivity as new employees are onboarded or falling morale, the costs go much higher.

A far more dramatic example is Fox News' sexual harassment scandal which cost the company $90 million in settlement claims alone and is a major failure in the company's culture. Likewise, the data breach of Equifax in 2017 shows just how large the impact an ESG failure can be. Roughly half of U.S. citizens had their data stolen, the breach cost Equifax over $400 million, according to Reuters, and there were many charges of insider trading.

[2] https://www.adeccousa.com/employers/resources/cost-of-turnover-calculator/ "The cost of turnover calculator" 03/04/2019.

Westwood®

Conversely, employees expect their companies to uphold their personal values and happy, satisfied workers provide companies with a motivated, innovative and productive workforce. Companies that cultivate a broad and diverse workforce generate returns above industry medians.

Risk reduction is a strong motivator for companies to improve ESG performance. It will always play an important role in an investment portfolio, but the positive benefits of companies with strong ESG characteristics are now also coming to light. Integrating ESG into business operations allows executives to better manage complexity of business and encourages long-term strategic planning by management.

There is also mounting evidence that companies with high non-financial quality indicators, or ESG factors, perform significantly better on market and accounting-based metrics. Data supports the notion that companies with strong ESG characteristics produce superior results to their lower-performing peers.

According to studies, social factors are generally the best signals of future ROE among financial companies. It is also noted that an investor who only bought stocks with above-average Thomson Reuters' Environmental and Social scores five years ahead of a company's bankruptcy would have avoided 90+% of the bankruptcies that occurred in the S&P 500 since 2005[3].

MSCI research shows that high ESG-rated companies show higher profitability and pay higher dividends. They also have a lower cost of capital, are less volatile and show lower systematic and idiosyncratic risk[4].

In a study published in early 2020, Institutional Shareholder Services stated that good ESG initiatives may be driving financial performance higher, which provides the financial resources for a company to invest further in projects which drive performance higher. Higher ESG performance is positively correlated with higher Economic Value Added (EVA) performance, profitability and lower volatility. Conversely, people may choose to not invest in low-scoring firms, thereby driving their cost of capital higher while also increasing potential distraction due to increased regulatory scrutiny and lower employee productivity[5].

Last, through November 2019, nearly 65% of U.S. open-end and exchange-traded sustainable funds ranked in the best half of their respective Morningstar Categories.[6] Overall asset management by professionals with an eye toward responsible investing was $12 trillion to begin 2019[7].

ESG investing has come a long way in recent years. Through November 2019[8], estimated flows into U.S. open-end and exchange-traded sustainable funds reached $17.7 billion, or more than three times 2018's record-setting year.

Companies recognize that having a good ESG rating is more important than ever, as it can have a significant impact on a firm's bottom line and shareholder returns.

Long-term value is created by taking into account the entire set of stakeholders. Shareholder returns will always be important, but the highest returns will come from well-run companies with good management. Market-led changes can act as a force for good worldwide and ESG isn't just an opportunity to "do good" — it's the backbone of a successful company and investing.

Indeed, in 2020, you can Do Good and Do Well.

[3] "Top 10 reasons you should care about ESG" 09/27/2019; Bank of America Merrill Lynch.
[4] Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance. MSCI Research; July 2019.
[5] https://www.issgovernance.com/file/publications/ISS_EVA_ESG_Matters.pdf "ESG Matters" ISS; Jan. 2020; Dr. G. Kevin Spellman, CFA and David O. Nicholas.
[6] https://www.morningstar.com/articles/959379/10-sustainable-investing-stories-of-2019 "10 Sustainable Investing Stories of 2019" Jon Hale, PhD, CFA; Dec. 12, 2019.
[7] US SIF: The Forum for Sustainable and Responsible Investment: 2018 Report on US Sustainable, Responsible and Impact Investing Trends.
[8] https://www.morningstar.com/articles/959379/10-sustainable-investing-stories-of-2019 "10 Sustainable Investing Stories of 2019" Jon Hale, PhD, CFA; Dec. 12, 2019.