ESG

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The New Math of **Socially Responsible Investing**

Investors are putting a lot more money into ESG funds. They also expect a lot more in return. BY CHERYL WINOKUR MUNK

ESG investing has come a long way in the past few years.

Once a niche investment sector, strategies that screen companies and other assets based on environmental, social and governance (ESG) criteria are attracting more money than ever.

There are various definitions of—and approaches to—so-called sustainable investing. Some strategies seek to avoid investments in industries deemed harmful to society such as tobacco, while others aim to further environmental or social causes like climate change or workplace diversity. Regardless of the approach, interest in the category as a whole is growing dramatically.

At the end of 2019, about $17.1 trillion—roughly one-third of all assets under professional management in the U.S.—was being managed using some type of sustainable-investment strategy or by institutions that filed shareholder resolutions on ESG issues, according to the most recent data from the US SIF Foundation, a sustainable-investing trade group. That was a 42% increase from two years earlier, the group said.

In the first quarter of this year, meanwhile, a net $21.5 billion flowed into mutual funds and exchange-traded funds that use ESG screens or some other type of sustainable-investing approach, a record amount and almost double the net inflows in the year-earlier quarter, according to a report from Morningstar Inc.

"Individual investors are connecting with the idea that they can address some of the challenges they are concerned about," says Michael Jantzi, chief executive officer of Sustainalytics, a Morningstar company that focuses on ESG and corporate-governance research.

As more people dip their toes into ESG waters, however, expectations are changing: In addition to feeling good about where they are putting their money, these investors also crave good returns. And while there are more ways to measure how seriously companies and asset managers take sustainability issues such as workplace diversity and carbon emissions, there still is a lack of clarity when it comes to ESG disclosures, an area where regulators have started weighing in.

Here is a closer look at those and other shifts taking place in ESG investing in 2021:

Mainstream success

For years, there has been a subset of investors focused on ESG, and companies that have quietly made such issues a priority, says John Streur, president and CEO of Calvert Research and Management, an investment-management firm that specializes in responsible and sustainable investing across global capital markets. Now, more investors and companies are getting on board, he says, as a growing body of research suggests that focusing on material ESG issues can drive better financial performance. Outside factors also have

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been at play, including a political focus on climate change and racial and social unrest following the May 2020 killing of George Floyd and a global pandemic that showed how quickly a multitude of lives can be upended.

"Five years ago, people could still say this is some far-off problem and it could impact my great-great-great-grandchildren, and I'm not going to worry about it in my investments today," Mr. Streur says. "That has been debunked and it's right here, right now."

Higher expectations

The socially conscious investors of yesterday tended to be more focused on causes than performance. These days, a lot more people are in it not just to advance causes they believe in, but in the hopes of achieving returns that are equal to or greater than those of traditional investments.

"The whole movement has shifted," says Craig Jonas, co-founder and CEO of **CoPeace**, an impact-investing holding company in Denver. "Investors like the idea of having measurable impact plus strong returns," he says.

A notable 47% of respondents in the Schroders 2020 Global Investor Study say they are attracted to sustainable investments because of their environmental impact, while another 42% base their attraction to sustainable funds on the likelihood they will provide higher returns.

Whether values-based investing actually pays off, however, is a matter of debate. Last year, U.S. sustainable equity funds outperformed their traditional peer funds by a median total return of 4.3 percentage points, while U.S. sustainable bond funds outperformed their traditional peer funds by a median total return of 0.9 percentage point, according to a report from the Morgan Stanley Institute for Sustainable Investing.

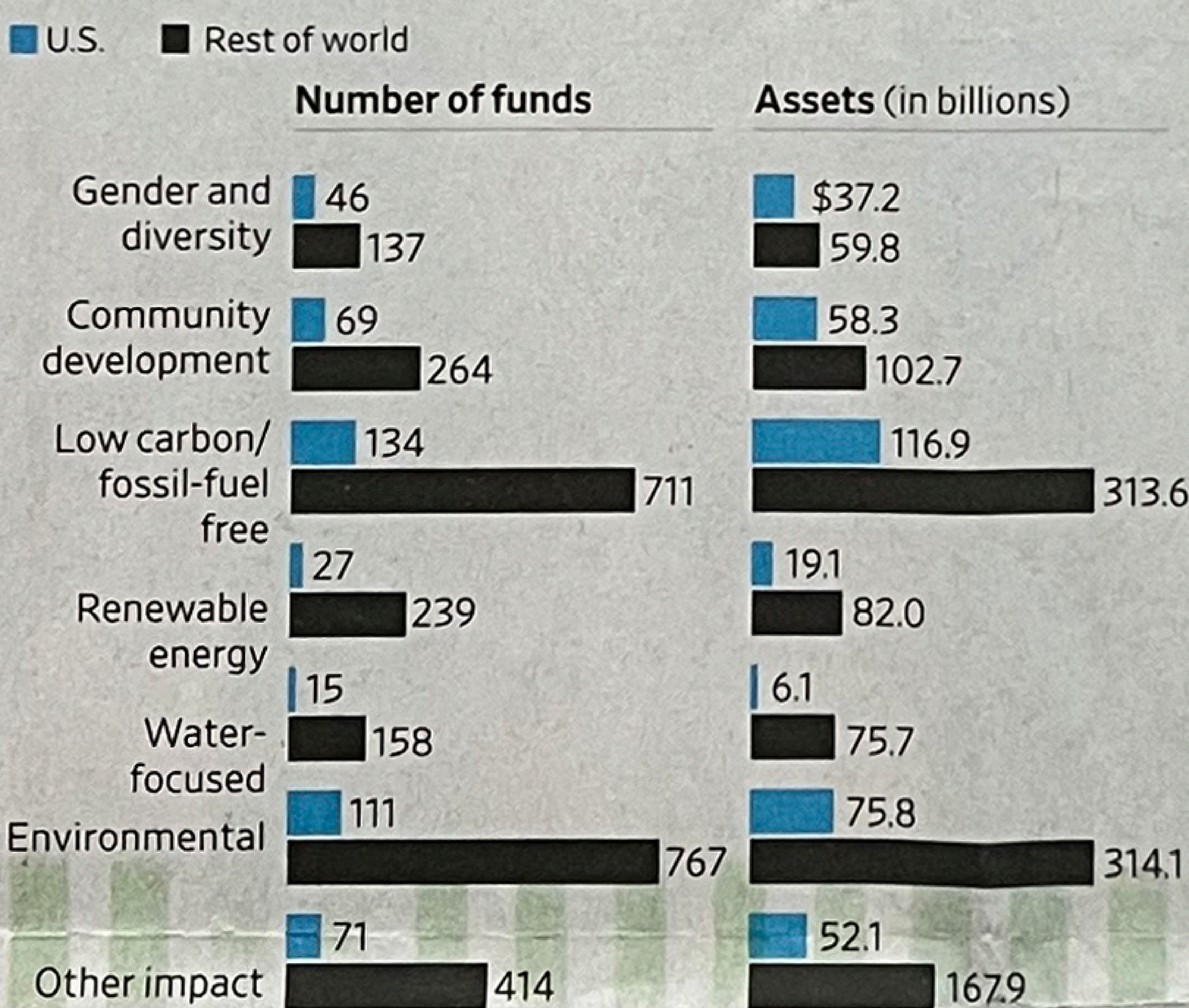
But Meir Statman, professor of finance at Santa Clara University in California, says socially responsible funds tend to have higher annual fees, so their returns are likely to lag behind over time.

"Short-run realized returns are noisy because of luck or other circumstances, sometimes favoring ESG investors and sometimes favoring non-ESG ones," Dr. Statman says. "Each tends to crow when returns favor them. The logic of fees, however, suggests that, in the long run, ESG investors are likely to earn lower after-fee returns than non-ESG investors."

Dr. Statman advises ESG investors to see how their particular ESG fund stacks up over time against a low-cost index fund of the same category. He offers the example of the Vanguard FTSE Social Index Fund, categorized by Vanguard as a large growth fund. It had an annualized return between May 31, 2000, and June 17, 2021, of 6.73%, compared with

Getting Focused

Where the money is going among sustainable-investment themes



Note: As of April 30, 2021; Some funds fall under more than one category based on the Morningstar Sustainable Investment Attributes.
Source: Morningstar Direct

7.67% for the Vanguard Growth Index Fund, also a large growth fund, over the same period.

A look at costs shows that the average annual expense ratio of sustainable ETFs that invest in U.S. stocks is 0.33% versus 0.09% for U.S. equity ETFs in the cheapest quintile by fee, according to Morningstar Direct, an investment-research platform.

Product proliferation

A few years ago, it was hard to build a well-rounded portfolio solely from ESG investments, says Heidi Vanni, chief client officer and managing director at Boston Trust Walden Co., a Massachusetts chartered bank and trust company. That is no longer the case, she says.

"Today, in both the public and private markets, there's no shortage of products—ESG opportunities abound," says Ms. Vanni.

Just how fast have ESG investments grown? The number of U.S. open-ended funds and ETFs with defined sustainability objectives at the end of 2020 grew around 30% from the year before, according to Morningstar. That's a nearly fourfold increase over the past decade, with significant growth beginning in 2015. As of the end of the first quarter of 2021, there were 409 of these funds, according to Morningstar.

More transparency

One thing that makes some investors wary of ESG is the lack of transparency around what ESG really means and how to measure it. Part of the problem is that there is no one global standard for ESG reporting.

In the U.S., the Securities and Exchange Commission generally requires public companies to disclose ESG information if they deem it "material" to their financial condition, operating performance or to risks investors may face. That leaves a lot of wiggle room.

Without a common standard for accountability, companies can cherry pick which metrics to make public in their annual sustainability reports and which to keep close to the vest. Some companies have even been accused of greenwashing—that is, conveying a false impression or providing misleading information about their products being environmentally friendly.

In a 2020 BlackRock investing survey, 53% of global respondents cited the "poor quality or availability of ESG data and analytics" as their biggest barrier to adopting sustainable investing, higher than any other barrier that was tested.

Efforts to improve transparency are under way. The European Union in March introduced rules requiring asset managers to start disclosing information on their funds' environmental and social claims and prepare to back up their claims with more detailed disclosures in January 2022. The EU also has proposed that starting in 2024, nearly 50,000 publicly traded and large private companies will have to report standardized data on various ESG metrics.

In the U.S., the SEC in March announced an enforcement task force to focus on areas including climate and ESG-disclosure at public companies. In April, regulators published examples of what they believe fund managers and investment advisers are doing wrong with respect to ESG disclosures and related areas. And in mid-June, the SEC announced its annual regulatory agenda, which includes disclosures related to climate change and corporate board diversity, among other things.

Data providers, meanwhile, are developing more tools to help investors evaluate how companies stack up. Global index provider **MSCI** just launched the MSCI Target Scorecard, which allows institutional investors to make direct comparisons between companies' climate commitments and assess which companies have realistic decarbonization targets.

Under the microscope

Investors also are watching closely to make sure executives live up to their ESG promises. This proxy season, in particular, institutional investors ratcheted up the pressure on company executives to take action in areas such as climate change, diversity, equity and inclusion and racial justice.

In particular, shareholders at American Express, Berkshire Hathaway, International Business Machines and Union Pacific showed strong support for resolutions requiring the companies to provide data to support their claims of diversity and inclusion, according to As You Sow, a nonprofit that promotes environmental and social corporate responsibility.

"Companies currently tell us stories about their commitments to diverse employees," says Meredith Benton, workplace-equity program manager at As You Sow. "We're asking companies to show investors if they can, or cannot, provide data that substantiates what they tell us."

With the Biden administration pledging to substantially slash U.S. emissions of greenhouse gases by 2030, U.S. companies in all industries are likely to be under scrutiny when it comes to their climate policies. It's an issue that investors and executives at every company will have to address in some way—big or small, given the underlying social demand, says Remy Briand, head of ESG at MSCI.

Asset-management firms, too, are being evaluated for their ability to offer ESG and impact investments. In January, more than a dozen institutional plan sponsors and investment consultants formed the Institutional Investing Diversity Cooperative to increase data and transparency within investment teams in the asset-management industry.

In addition to the sustainability ratings it provides for funds, Morningstar also offers a ratings system for asset managers to evaluate how well they incorporate ESG factors into their investment processes.

"It's a practice-what-you-preach moment for the industry," says Amy O'Brien, global head of responsible investing at Nuveen, a global investment manager.

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