CAMMACK RETIREMENT

Making Sense of ESG Investing

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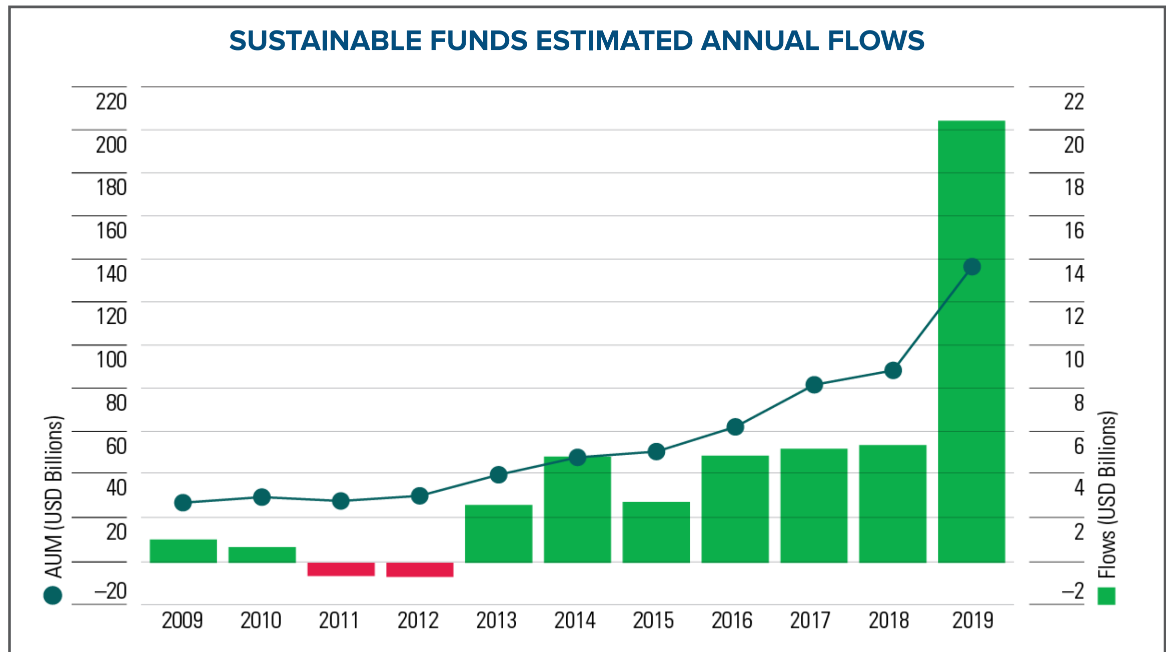
Environmental, Social and Governance (ESG) investing, often referred to as sustainable investing, has been around for decades but has gained significant prominence in recent years, with record-setting inflows into ESG funds for the fifth consecutive year. This momentum has accelerated since the beginning of 2020. According to Morningstar, sustainable funds in the United States gathered an estimated $10.4 billion in the second quarter of 2020 alone.[1] In addition, ESG funds performed well relative to conventional funds during the volatile first quarter and continued to perform well in the second quarter, contributing to their outperformance year-to-date. The recent outperformance of ESG strategies and current social and economic concerns have emphasized the need for investors to consider ESG-related risks in their portfolios and affirmed ESG as a mainstream investment strategy.



Source: Morningstar

THE BASICS OF ESG INVESTING

The term ESG investing was officially adopted by the United Nations in the early 2000s. In 2015, the UN introduced 17 Sustainable Development Goals, or SDGs, providing a useful framework to guide impact investing in public equities and fixed income. Investors are increasingly applying the non-financial factors of environmental, social and governance as part of their analysis process to identify material risks and growth opportunities. While

[1]Morningstar Sustainable Funds Continue to Rake in Assets During the Second Quarter

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ESG investing grew out of investment philosophies such as socially responsible investing (SRI), there are key differences. Earlier models typically used value judgments and negative screening to decide in which companies to invest, avoiding disagreeable businesses or "sin stocks" like alcohol, weapons, tobacco, gambling, nuclear power, fossil fuel, and adult entertainment. ESG investing and analysis, on the other hand, looks at finding value in companies, not simply at supporting a set of principles. While SRI uses exclusionary filters to keep companies out of portfolios that do not meet certain criteria, ESG opts-in companies that are making a positive impact in the three factor areas.[2]

ESG FACTORS

E - Environment	S - Social	G - Governance
Climate Change **Natural Resources** **Pollution & Waste** **Environmental Opportunities**	**Human Capital** **Health & Safety** **Supply Chain** **Social Opportunities**	**Risk Management** **Corporate Leadership** **International Controls** **Executive Remuneration** **Shareholder Rights**
Including Suppliers & Contractors: Energy-, (Toxic) Waste-, Water-, Green House Gas-Waste, Intensity & Footprint, Clean Tech, Buildings, etc.	Including Suppliers & Contractors: Labor Management, Health & Safety; Product Safety; Freedom of Association, etc.	Anti-Bribery & Corruption; Anti-Fraud; Board Diversity; Board Independence; Compensation, etc.

Source: DWS Investment Management

While trends have been more focused on the environmental aspect of the analysis, particularly when it comes to climate change, recent developments for social justice and a push for broader diversity have resulted in a greater emphasis on racial issues, particularly from institutional investors. Since ESG portfolios incorporate all of these issues and look to find companies that score well with each criteria, this sparked greater interest in ESG portfolios.

Managers use various approaches to build socially responsible/ESG portfolios, including exclusionary screening, best-in-class selection, active ownership, thematic investing, impact investing, and ESG integration (which is the most common approach). ESG issues, such as a company's environmental damage, abuse of human rights, or labor relations, often draw the attention of headlines and may cause a sharp drop in stock prices. Longer-term megatrends, such as the scarcity of a natural resource or changing demographics (e.g., the economic rise of pro-sustainability millennials), are also relevant to the investment risk and return across asset classes. Thus, ESG integration strategies look at ESG factors in the investment process to identify potential risks for investments that could materially affect financial performance. The number of conventional funds that now say they consider ESG factors has grown enormously, to 564 funds from 81 in 2018.[3] This explosive growth of funds considering ESG factors reflects the growing recognition among asset managers of the relevance and materiality of ESG factors in evaluating investments.

[2]CFA Institute
[3]Morningstar Sustainable Funds U.S. Landscape Report

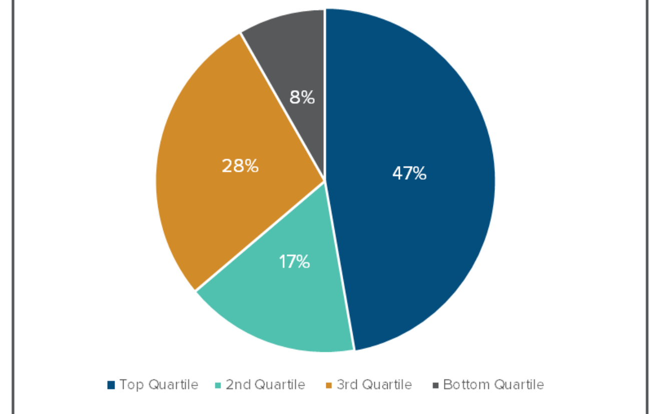
ESG INVESTING APPROACHES

Exclusionary / Negative Screening	ESG Integration	Positive / Best-In-Class ESG	Thematic Investing	Impact Investing
Exclusion of certain sectors or companies involved in activities deemed unsustainable or controversial.	Explicit inclusion of ESG risks and opportunities into financial analysis which can include adjusting estimated future cash flows or modeled discount rates based on ESG-risks and opportunities.	Investments in companies with high ESG scores and avoiding companies that do not meet certain ESG criteria.	Thematic investment selection and portfolio construction around ESG themes such as low carbon and gender-lens investing.	Invests in companies with explicit intention to generate positive social or environmental impact alongside the financial performance.

ESG PERFORMANCE

ESG funds outranked their conventional peers in the second quarter of 2020. After outperforming their peers on a relative basis in the first-quarter downturn, the opposite might have been expected in the second quarter, as stocks posted their best quarter since 1998. On a year-to-date basis, 47% of U.S. large blend funds with an ESG mandate scored in the top quartile of Morningstar's large blend category.

Looking at average sector exposures, ESG managers do tend to overweight the technology sector, which has been one of the best-performing sectors, while being underweight in the underperforming energy sector. Impact from the sector weights attributes close to an estimated 1.2% performance difference between non-ESG managers and ESG managers on a year-to-date basis. However, ESG fund managers' outperformance, relative to conventional managers, cannot only be attributable to having less weight in the energy sector. With the energy sector being the top performer in the second quarter, sustainable funds faced headwinds in their effort to outperform their peers. However, according to Morningstar analysis, ESG stock selection was key to strong performance.



Source: Morningstar

WEIGHT OF ENERGY SECTOR IN ESG MANAGERS COMPARED TO CONVENTIONAL MGRS.

	Weight in Energy Sector	Weight in Technology Sector
US large blend ESG equity funds	0.97%	24.61%
US large blend conventional equity funds	2.67%	20.80%
S&P 500	2.80%	27.50%
	Energy Sector	**Technology Sector**
Q1 2020 Performance	-50.50%	-11.90%
Q2 2020 Performance	30.50%	30.50%
Year-to-Date Performance	-35.30%	15.00%

Source: Morningstar

The better relative performance of sustainable funds so far this year derives mainly from their focus on companies that have stronger ESG profiles and face lower levels of ESG risk. It helps make the case that investing with an eye toward how a company addresses material ESG risks and, more broadly, how it manages all of its stakeholders, can produce better returns than those of conventional funds, especially during periods of market and economic turmoil. However, this does not mean that sustainable funds will consistently outperform or that all sustainable funds will outperform conventional funds. Analyzing and investing in an ESG manager involves the same due diligence process as investing in conventional funds.

Passive ESG options also outperformed the S&P 500 Index during the second quarter and on a year-to-date basis.

PASSIVE LARGE BLEND ESG INVESTMENT OPTIONS AND THE S&P 500

Name	Total Ret Q2 2020	Total Ret % Rank Cat Q2	Total Ret YTD	Total Ret % Rank	Total Ret 1-Yr	Total Ret % Rank Cat 1-Yr	Total Ret Annlzd 3-Yr	Total Ret % Rank Cat 3-Yr	Total Ret Annlzd 5-Yr	Total Ret % Rank Cat 5-Yr	Total Ret Annlzd 10-Yr	Total Ret % Rank Cat 10-Yr
Calvert US Large Cap Core Rspnb Idx R6	22.72	14	0.33	6	11.61	5	12.19	4	10.95	7	14.36	4
Vanguard FTSE Social Index I	23.37	10	-1.26	13	11.18	6	12.67	3	11.64	3	14.87	1
Fidelity® U.S. Sustainability Index	20.35	53	-1.88	17	9.32	13	11.50	9				
S&P 500 TR USD	20.54		-3.08		7.51		10.73		10.73		13.99	

Source: Morningstar

ESG managers lost less, on average, than conventional managers in the recent down market. Down-capture ratio is less than 100, indicating better relative performance in declining markets.

1-YEAR DOWN-CAPTURE RATIO

	ESG Managers	Conventional Managers
Average	104	109
Max	171	221
Min	78	39
Median	103	104

Source: Morningstar

An increasing number of studies from academia and the asset management industry have shown that ESG investing does not necessarily mean sacrificing returns. The link between ESG investing and performance has been either positive or neutral.[4] In regard to year-to-date performance, responsible investing factors have significantly outpaced non-ESG indices, while also reporting a lower amount of volatility.[5]

CHALLENGES IN ESG INVESTING

One of the challenges in ESG analysis is that ESG metrics are not commonly part of mandatory financial reporting, though companies are increasingly making disclosures in their annual report or in a standalone sustainability report. Numerous institutions are working to form standards and define materiality to facilitate incorporation of these factors into the investment process. While these examples can often be measured (e.g., what the employee turnover for a company is), it can be difficult to assign them a monetary value (e.g., what the cost of employee turnover for a company is).

Investment managers use either proprietary data, third-party data, or a combination of both, in the ESG investment selection criteria. Sometimes third-party data for ESG scores for a specific

[4]S&P Dow Jones Indices: DSWESG outperformance: Anomaly or Long-term Trend?
[5]ISS: The Screened and Prime Series: ESG Attributes and Market Returns During the Pandemic

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company can be different among the data providers, complicating the comparisons for ESG metrics across the investment funds.

Another important challenge for ESG investing is the recently proposed rule by the Department of Labor (DOL). In June of 2020, the DOL issued a proposed rule indicating the DOL's growing concern that market trends emphasizing the non-economic benefits of ESG investing may lead ERISA plan fiduciaries to make investment decisions for reasons other than maximizing returns for plan participants. The proposed rule appears to create stricter limits for ESG funds in retirement plans and confirms that an ERISA fiduciary's duties of prudence and loyalty are satisfied where the fiduciary has "selected investments and/or investment courses of action based solely on their pecuniary factors and not on the basis of any non-pecuniary factor." The proposed DOL rule makes it clear that the need to be able to explain and document how ESG considerations will contribute to investment goals is greater than ever. Comments on the proposed rule were being sought for 30 days following its issuance in June. During this period, the Department of Labor received more than 1,500 comment letters from the industry, with many taking issue with the proposal.

THE FUTURE OF ESG IN RETIREMENT PLANS

There will be more to come from the DOL on ESG investing in retirement plans. However, the increasing prominence of ESG in investment decisions has become significant across the industry. On the supply-side, an increasing number of portfolio managers are considering ESG factors in their portfolios. On the demand-side, 85% of individual investors expressed interest in sustainable investing in 2019, up 10 percentage points from 2017.[6] ESG interest is even greater for the Millennial Generation, and with the Greatest Generation wealth transfer, it could mean significantly more assets flowing through to ESG investments. Approximately $30 trillion of wealth will transfer from Baby Boomers to 75 million millennials over the next few decades.[7]

The sustainable funds universe grew to 303 open-end and exchange-traded funds in 2019.[8] The recent launch of passively-managed ESG target date funds by the world's largest and one of the most influential asset managers will continue the push to bring U.S. sustainable fund fees down. The recent outperformance of sustainable portfolios and increasing demand from investors contributed to strong momentum of flows into these strategies. Given all of the circumstances, the need for higher-quality, low-cost ESG funds has never been greater.

ABOUT CAMMACK RETIREMENT GROUP

Cammack Retirement Group has been helping retirement plan sponsors meet their goals for half a century. Solely focused on serving retirement plan sponsors, we provide a tailored approach to investment advisory and consulting services. We work with some of the nation's leading academic and research institutions, healthcare providers, corporations, non-profit organizations and public sector employers to help them manage fiduciary risk.

For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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[6] Morgan Stanley Institute for Sustainable Investing: Sustainable Signals -- The Individual Investor Perspective (2019)
[7] Accenture: The "Greater" Wealth Transfer – Capitalizing on the Intergenerational Shift in Wealth, 2012
[8] Morningstar