What Is ESG Investing?

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SUMMARY

Environmental, social and governance (ESG) investing incorporates the direct consideration of material ESG information into the investment decision-making process. This approach to investing has grown dramatically in the U.S. over the past five years due to a rising level of interest across investor segments as well as the increased ability of asset managers to integrate ESG data into their investment processes. For example, an ESG analysis might consider the financial risks associated with carbon emissions, labor or supply chain standards or firm governance practices.

This paper provides historical context on ESG investing, outlines the basics of ESG investing, discusses why investor demand is growing and describes several approaches available to traditional investors.

EVOLUTION OF ESG INVESTING

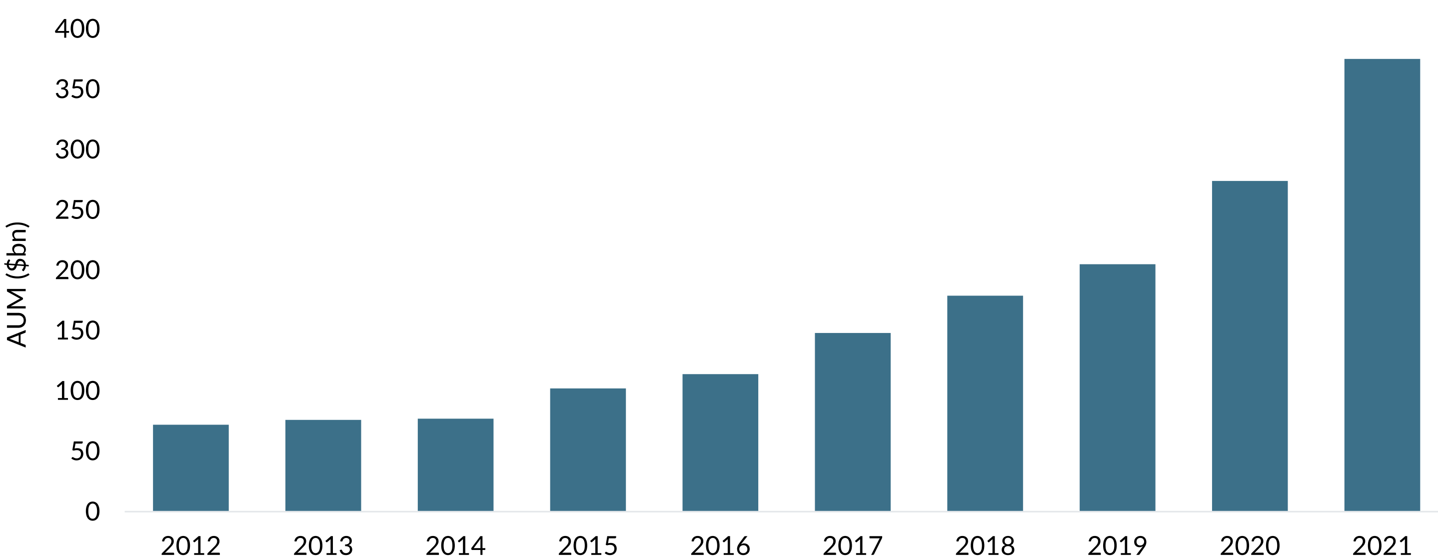
Throughout the 1970s, 1980s and 1990s, ESG was predominantly associated with the exclusion of companies in sectors that were viewed as negative from an overall environmental or social perspective. For the most part, the direct assessment of the ESG consequences of conducting business were an afterthought and considered to be at odds with investors' and asset managers' focus on maximizing risk-adjusted returns.

With the rise of the stakeholder value approach, in which businesses consider the effect of their operations on constituents including shareholders, clients, workers and the surrounding community, attention to ESG has begun to flourish. Assets under management (AUM) in active U.S. sustainable funds topped $357 billion as of December 31, 2021 (Exhibit 1).

The emergence of ESG, intrinsically linked to shifting shareholder demands and sentiment around how companies consider ESG-related information, has led to a rise in organizations promoting ESG transparency, disclosure and data availability for asset manager consideration. While some organizations (i.e., behemoths like MSCI or Sustainalytics) provide ESG data across a host of ESG criteria, others take a pillar-specific approach, perhaps highlighting only environmental ("E") data.

With increasing evidence that ESG investing is not detrimental to returns (see page 6), asset managers and asset owners have begun viewing ESG investing as another tool to potentially enhance risk-adjusted returns.

Exhibit 1: AUM in active U.S. sustainable public funds and ETFs



Source: Morningstar *As of 12/31/2021*

Milestones for ESG since 1970

- **1970:** Milton Friedman publishes his essay "A Friedman Doctrine: The Social Responsibility of Business Is to Increase its Profits" in *The New York Times Magazine*. This view, that a company's only responsibility is to its shareholders, is often cited in opposition to ESG investing and dominates for at least two decades.

- **1984:** R. Edward Freeman releases his book *Strategic Management: A Stakeholder Approach*, looking at business as a system to create value for stakeholders.

- **1985:** US SIF The Forum for Sustainable and Responsible Investment is founded; its mission is to "rapidly shift investment practices toward sustainability, focusing on long-term investment and the generation of positive social and environmental impacts."

- **1990:** MSCI introduces the first ESG index, the MSCI KLD 400 Social Index. The index is a cap-weighted index of 400 U.S. securities that provides exposure to companies with outstanding ESG ratings and excludes companies whose products have perceived negative social or environmental impacts.

- **1997:** The Global Reporting Initiative (GRI) is established to promote transparency and dialogue around sustainability disclosure standards. The international independent standards organization helps businesses, governments and other organizations understand and communicate their impacts on issues such as climate change, human rights and corruption.

- **2005:** The coining of the nomenclature "ESG" as a result of the "Who Cares Wins" conference, an event designed through a joint initiative of the UN Global Compact with the support of the International Finance Organization.

- **2006:** The United Nations launches the Principles for Responsible Investment (PRI), an international network created to understand sustainability implications for investors and foster a collaborative signatory network. As of December 31, 2021, there were more than 3,800 signatories.

- **2011:** The Sustainability Accounting Standards Board (SASB), a nonprofit devoted to developing sustainability accounting standards, is founded.

- **2015:** The United Nations adopts the Sustainable Development Goals (SDGs), a collection of 17 interlinked global goals designed to be a blueprint to achieve a better and more sustainable future for all, with targets and measurement indicators geared toward 2030.

- **2015:** The Financial Stability Board creates the Task Force on Climate-related Financial Disclosures to improve and increase consistent climate-related financial risk disclosures.

- **2015:** The Paris Agreement (also known as the Paris Accords or the Paris Climate Accords) is adopted. This international treaty on climate change covers climate change mitigation, adaptation and finance.

- **2021:** The U.S. Securities & Exchange Commission creates the Climate and ESG Task Force in the Division of Enforcement to develop initiatives to proactively identify ESG-related misconduct.

- **2021:** The SASB and the International Integrated Reporting Council (IIRC) merge to form the Value Reporting Foundation (VRF) and unite their ESG reporting frameworks.

- **2022:** Further consolidation: The VRF merges with the International Sustainability Standards Board (ISSB), part of the IFRS Foundation. This merge sets the stage for further standardization of material ESG disclosures and reporting.

- **2022:** SEC releases guidance relative to ESG disclosures based on the type of strategy and proposes amendments to the "Names Rule."

Glenmede Investment Management (GIM) believes interest in ESG is increasing for three primary reasons (Exhibit 2):

Exhibit 2: Reasons for increased ESG demand

Investor demand

High-net-worth individuals, institutional investors and consultants are driving the growth in ESG-related investments. According to a recent Deloitte report, it is estimated that dedicated sustainable investing will total $13 trillion in AUM worldwide by 2025. Investors are expected to drive $3.2 trillion in net new flow in sustainable strategies by 2025. Further, 39% of global assets are anticipated to fall under firms using investment approaches that are guided by sustainability commitments.[1]

More than 380 money managers and more than 1,200 community investing institutions incorporate ESG criteria into their investment analysis and decision-making processes. These groups represented $16.6 trillion in ESG integrated assets in 2020, a nearly 43% increase over 2018, according to the biennial US SIF: The Forum for Sustainable and Responsible Investment report released in December 2020.[2] Further, money managers and institutions incorporate ESG factors fairly evenly across ESG categories, although climate change remains the most important specific ESG issue in asset-weighted terms.[3]

Why are investors of all types motivated to apply ESG criteria to decision-making? The US SIF survey ranked these motivations in order of importance:[4]

- Minimizing risk
- Improving returns
- Fulfilling fiduciary duty
- Meeting regulatory or legislative compliance

Growing data availability

As investor interest in ESG grows, so, too, does the amount of ESG data and number of data providers trying to satiate the demand. Depending on the source, it is estimated there are between 125 and 600 different ESG data providers that provide research in a variety of forms. Some of the most well-known include MSCI ESG Research, S&P Global, Bloomberg and Sustainalytics. The management consulting firm Opimas estimates the ESG data market will have an expected annual growth rate of 20%.

The availability of data and its increasing sophistication serve to encourage more asset managers to use ESG data to help produce market rate or superior risk-adjusted returns. ESG data vendors, including those that use artificial intelligence (AI) and machine learning technologies, help managers understand and evaluate this new set of mass-data for what is most important to investors for both impact and financial materiality.

Most ESG ratings and data providers make available the overall scores assigned to companies they cover. However, the proliferation of data providers means there can be diverging opinions of ESG ratings providers for the same company, which is important to note since the ratings are used to select constituents of ESG indexes. Further analysis of ratings providers lends itself to proprietary materiality matrices which thoughtfully combine data providers and proprietary analysis.

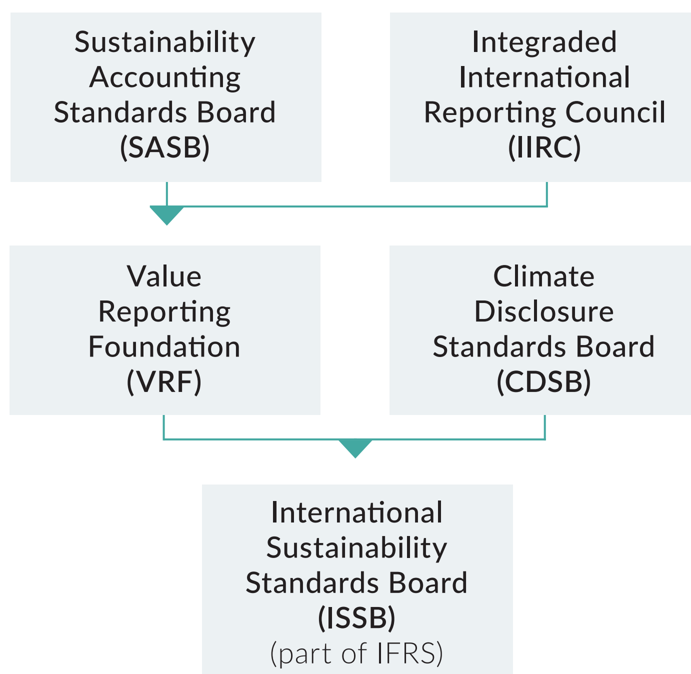
Another part of the rising availability of ESG data can be attributed to increasing regulatory acceptance that ESG criteria can be material to investment decision-making, and the subsequent pressure and focus on companies to standardize their ESG disclosures. For example, in March 2021 the SEC formed the Climate and ESG Task Force to develop initiatives to proactively identify ESG-related misconduct. The task force's intent was to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules as well as analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

In May 2022, the SEC released guidance relative to ESG disclosures based on the type of ESG investing employed in the strategy, with more focused ESG products requiring additional disclosure. The SEC also proposed amendments to the "Names Rule," which, among other actions, would improve and expand the requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus the fund's name suggests.

Data availability is also improving as more companies are publishing sustainability reports to satiate investor demand. In its December 2021 report, the Governance & Accountability Institute (G&A) reports that 92% of S&P 500 companies published sustainability reports in 2020. The G&A adds that the volume of reporting has steadily increased each year since 2011 alongside the actual content that's covered by each of these reports.

In addition, recent consolidation of SASB alongside other reporting entities as shown in Exhibit 3 is set to standardize the framework by which companies report out on sustainability disclosures. The consolidated organization will provide guidance, which regulatory entities may look to adopt as policy in time, as to how to report these metrics alongside traditional financial criteria.

Exhibit 3: SASB consolidation



Evidence of strong risk-adjusted performance

New research has also demonstrated a link between ESG and financial materiality over the past several years. For example:

- In a meta-analysis of more than 1,000 studies from 2015-2020, researchers examining the relationship between ESG and financial performance found that it was neutral or positive 92% of the time.[9]

- An NYU Stern School of Business study concluded that 1) improved financial performance due to ESG becomes more prominent over longer time horizons and that ESG investing appears to provide downside protection, especially during a social or economic crisis; 2) corporate sustainability initiatives appear to drive better financial performance due to mediating factors such as improved risk management and more innovation; and 3) managing for a low carbon future improves financial performance.[10]

- When financial materiality is applied, firms' ESG performance scores change significantly. Environmental pillar issues, particularly natural resource use, are predominantly responsible for the changes. Financial materiality may affect the informative value of ESG scores and rankings, allowing the identification of investment opportunities in firms with high [or improving] scores on business-critical ESG issues.[11]

THE ESG INVESTMENT SPECTRUM

Asset managers have responded to growing interest in ESG and performance evidence with a variety of product offerings, as indicated in the ESG investing spectrum shown in Exhibit 4.

- **Integration** is the explicit consideration of material ESG factors in the traditional investment decision-making process.[12] ESG integration incorporates and considers

Exhibit 4: ESG taxonomy

Integrated

Explicit **consideration of material ESG factors** in the traditional investment decision-making process

Mandated

Use ESG screens to **avoid companies** with poor ESG criteria **and/or tilt toward companies** with strong ESG characteristics

Thematic

Dual goal to achieve at least **market-rate returns** and measurable environmental or social outcomes

ESG criteria but continues to focus on maximizing risk-adjusted returns. It does not limit the investment universe, nor is it exclusionary in nature: Any name can still be implemented in a portfolio as long as the material ESG risks are identified and if the portfolio manager believes they are being compensated for this risk. ESG integration simply serves as an enhancement to existing investment processes by ensuring that material risks are considered alongside other fundamental factors.

ESG integration, which serves as an enhancement to existing investment processes, is the most common type of ESG investing as investors look to become more comfortable in this space.

- **Mandated** strategies consider ESG criteria, but there is a strong tilt toward companies with strong ESG characteristics or screening out companies with poor ESG qualities. For example, an ESG mandated strategy might avoid weapons, tobacco or energy or tilt toward companies that exhibit best-in-class ESG characteristics.

- **A Thematic Investing** ESG strategy has a dual goal of achieving at least market-rate returns and measurable environmental or social outcomes. It is a more targeted approach to investing which often centers on a specific area of interest like women in leadership or climate change. Thematic investing strategies may also pair shareholder engagement as a part of their approach to request additional environmental or social data disclosure that would, by extension, advance an investor's ability to evaluate a company's progress toward its environmental/social goals.

It is important to note that each type of ESG investing can be accomplished across a variety of asset classes and investment styles.

CONCLUSION

GIM believes that maximizing risk-adjusted returns is not mutually exclusive from, or inconsistent with, the integration of ESG into an investment process. We recognize that with the increased client demand and supply of products comes a higher requirement for ESG investing quality from asset managers. As ESG investing evolves, GIM is committed to refining our investing approach, including our ESG product offerings. We thoughtfully analyze available ESG data and keep up with industry trends as a way to continually focus on producing alpha.

To learn more about GIM's approach to ESG investing, please see our ESG policy document or visit our website at www.glenmedeim.com.

[1] *Buttermark, A., et al. "It's Not Easy Being Green: Managing Authentic Transformation Within Sustainable Investing." CaseyQuirk, a practice of Deloitte Consulting (2021). https://www2.deloitte.com/content/dam/Deloitte/us/Documents/process-and-operations/us-its-not-easy-being-green.pdf.*

[2] *"Report on US Sustainable and Impact Investing Trends 2020. Executive Summary." https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf.*

[3] *Ibid.*

[4] *Ibid.*

[5] *https://practicalesg.com/2021/08/reliance-on-esg-data-providers-better-as-opinions-than-ratings-part-1/*

[6] *Foubert, A.-L. "ESG Data Market: No Stopping Its Rise Now." Opimas, March 9, 2020.*

[7] *G&A Institute's publishes "2021 Sustainability Reporting in Focus" Trends Report. December 2021.*

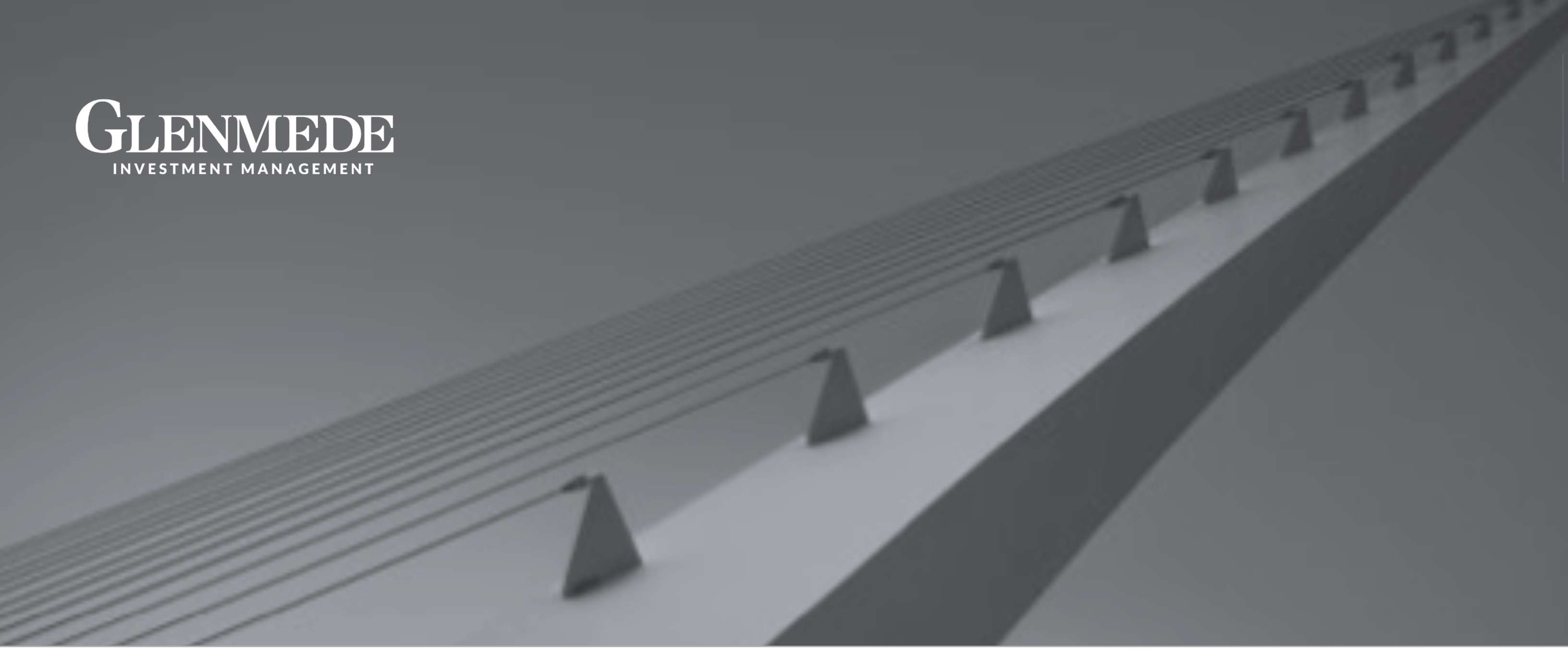
[8] *G&A Institute's publishes "2021 Sustainability Reporting in Focus" Trends Report. December 2021.*
https://www.sustainability-reports.com/ga-institutes-publishes-2021-sustainability-reporting-in-focus-trends-report/#:~:text=G%26A's%20research%20found%20that%2092,the%20largest%20U.S.%20public%20companies.

[9] *Whelan, T., et al. "ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015-2020." NYU/Stern. https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf (accessed May 18, 2020).*

[10] *Ibid.*

[11] *Madison, N., and Schiehll, E. "The Effect of Financial Materiality on ESG Performance Assessment." Sustainability, March 25, 2021.*

[12] *https://www.unpri.org/listed-equity/esg-integration-techniques-for-equity-investing/11.article#:~:text=The%20PRI%20defines%20ESG%20integration,alongside%20thematic%20investing%20and%20screening.*



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