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INVESTMENT MANAGEMENT

Five Burning Questions on the Future of Sustainable Investing

2023 represented a reckoning for the sustainable investing industry. Following several years of inflows, rising investor interest and competitive investment performance, regulators, politicians and investors began to scrutinize the industry with a more critical lens. Against the backdrop of this increased scrutiny and a challenging macroeconomic environment, the U.S. sustainable investing industry experienced net outflows for the first time since Morningstar began tracking the space in 2012.[1]

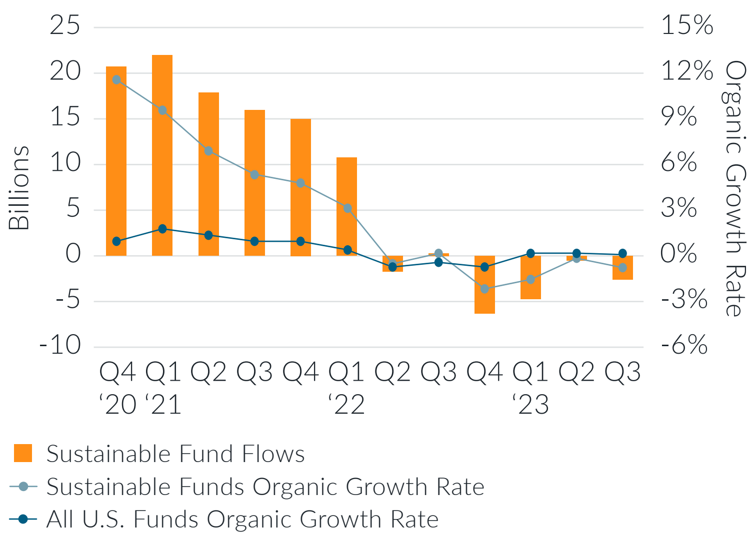
Today's Impact

What does the industry look like post-reckoning, and how can investors navigate the changed landscape? To answer the most pressing questions that we're hearing from clients, we sat down with Mark Hays, Director of Sustainable & Impact Investing at The Glenmede Trust Company, N.A. (GTC), and Amy Wilson, Director of ESG Investing at Glenmede Investment Management, LP (GIM).

How significant have outflows been from sustainability-focused funds, and why is it happening?

Amy: Outflows from sustainable investment funds resulted in a negative growth rate in 2023 and an unfavorable trend when compared to traditional funds. However, it's important to note that this comes after a period of significantly high growth and inflows to these strategies as investor focus shifted to the merits of sustainable investing during the pandemic. While on a dollar-by-dollar basis the recent outflows only make a minor dent in total sustainable investing assets, the reversal of the 10+ year positive trend is what has made many stakeholders in the industry take notice

U.S. Fund Flows: Sustainable vs. All U.S. Funds (USD Billion)



Source: Morningstar Direct, Manager Research. Data as of September 2023.

and ask – is this a bump in the road or the start of a wider negative trend? We believe the growth rate has come down to earth, but it certainly isn't a death knell.

Mark: In terms of the why: there was a convergence of three key factors, all negative, for sustainable investing funds: political backlash, pushback against perceived "greenwashing" by regulators and an unfavorable market environment affecting performance.

What is driving the political backlash against "ESG" and how may it play out in 2024?

Amy: The key question politicians have asked is the motivation and intent of ESG investing – with one camp alleging that this approach is taken on purely to help generate the most competitive risk-adjusted returns and the other claiming this approach is adverse for returns, and as such, in breach of fiduciary duty.

Mark: I think both camps are right if they were describing a specific set of ESG investing strategies, as some ESG strategies do prioritize "impact" over returns, whereas others purely consider ESG factors where financially material and relevant. For us, we lean on our Taxonomy to lay out four distinct approaches to utilizing ESG information in portfolios, with each having a different fiduciary treatment. The backlash has arisen because these types of approaches are often oversimplified to fit into one bucket, whereas, in reality, these approaches have very different objectives.

GTC's Sustainable & Impact Investing Taxonomy

Moving from risk mitigation to growth opportunities to measurable impact

Integrated	Mandated	Thematic	Concessionary High Impact
Explicit consideration of material ESG factors in the traditional investment decision-making process	Using ESG screens to avoid companies with poor ESG criteria and/or tilt toward companies with strong ESG characteristics	Dual goal to achieve measurable environmental or social impact and market-rate returns	Primary goal to achieve measurable environmental or social impact while willing to sacrifice returns to do so

Amy: Nonetheless, the political backlash has had a chilling effect on the industry, with 16 states passing laws in 2023 preventing state pools of capital from investing along these lines. According to Callan, the percentage of public plans citing that they incorporate ESG criteria into investment decisions fell from 63% in 2021 to 24% in 2022.[2] However, this dynamic has been relatively isolated to state pools of capital – we continue to see a high level of interest in these strategies from endowments, foundations and corporate entities that we do not believe will be impacted by the noise.

Mark: But for both of us, the key to navigating this period is to be precise and intentional with the what, why and how we are incorporating ESG information in investment portfolios. It helps us generate competitive risk-adjusted returns while helping our clients align with their organizational values. Being upfront and clear with asset owners is the key to building a durable approach in this space.

What led to a challenged performance by ESG strategies in 2023, and how should investors think about key trends to position towards in 2024?

Mark: We believe this question lumps too many types of strategies with highly different approaches into one camp. For example, a subset of strategies with a focus on clean energy were very negatively impacted by rising interest rates as clean energy investment requires large upfront borrowing costs and thus resulted in a challenging year of performance. Shifting sentiment around "stroke of pen" risk related to the potential for changing governmental energy policies is also a risk that is unlikely to be settled until the election.

Amy: I'd also flag that some broader sustainable or ESG-labeled strategies were negatively affected by an underweight to companies in the magnificent seven during a year in which this collection of stocks outperformed the broader market. This underweight may have been due to ESG tilts such as data privacy or labor rights concerns; however, it also may have simply been related to holding a more well-diversified portfolio versus an index that is at peak concentration levels. On the flip side, we did see positive performance and growth for sustainable bond funds as investors looked to lock in rates. In comparison to equities and commodities, sustainable bond funds "were the lone recipients of net new money for the third consecutive quarter," totaling nearly USD 690 million.[3]

Magnificent Seven 2023 Performance	
Company	2023 Gain
Apple	48.2%
Microsoft	56.8%
Alphabet	58.3%
Amazon	80.9%
Nvidia	238.9%
Meta Platforms	194.1%
Tesla	101.7%
S&P 500 Index	24.2%

Source: Bloomberg. Data as of 12/31/23. The companies identified are provided solely for illustrative purposes and should not be construed as a recommendation or solicitation for the purchase or sale of any security. It is not possible to invest directly in an index.

Mark: Looking ahead to 2024, we continue to see opportunities to play the climate transition from a thematic standpoint, but with a focus on end markets such as critical minerals that may prove more durable in a noisy political period of shifting incentives. We also are researching how the explosion in generative AI may impact corporations, as we believe winners and losers will be dictated by which companies integrate AI effectively and responsibly in business models, taking into account fast-moving regulation that is looking to improve data accuracy, ethical considerations and environmental sustainability.

Amy: On our side, we continue to focus purely on where we can build in the most relevant, financially material information through primary research. Areas of interest include the incorporation of ESG data sets in the valuation of intangibles and incorporating more nuanced and holistic environmental and gender equity data sets.

How has regulators' scrutiny of "greenwashing" affected the space and what do you expect for 2024?

Amy: We saw significant activity from the SEC in 2023, which brought fines against asset managers due to inconsistencies in how ESG information was applied to decision-making and documented. The SEC also passed the "names" rule in September, which increased the requirements and reporting needed to use words such as sustainable or ESG in fund titles. As a result, we've seen databases such as Morningstar "de-list" some strategies from their sustainability labels, whereas other asset managers have proactively sought to remove the names from their strategies.

Mark: I largely view this scrutiny on greenwashing and resulting regulation as a positive for the space. The wide variety of strategies launched with ESG or "sustainable" in the title created confusion over definitions, fiduciary fit and approach that we've spoken about already today. With tighter regulation, I expect a smaller group of strategies to remain in the market, which clearly define what, why and how they are incorporating ESG information as part of their approach. These are the types of strategies that we seek to include on our platform and upon which we've built our sustainability due diligence approach.

Changes to the SEC "Names" Rule

- Registered investment companies with names implying a specific investment focus must allocate a minimum of 80% of their asset value into those investments.
- This rule now extends to registered funds with names implying a concentration on investments or issuers with specific attributes, such as ESG.
- Terms utilized in a fund's name to indicate an investment focus must align with their plain English interpretations or recognized industry conventions.
- The rule does not directly apply to private funds but could signal the SEC's perspective on "best practices" for such funds.

Amy: For us, we have sought to be thoughtful in how we approach documentation and materiality. Our goal remains to seek competitive risk-adjusted returns while continuing to adhere to and understand the regulatory landscape as it evolves.

What does the future hold for the sustainable investing industry? How should investors interested in this space look to navigate what will continue to be a fast-evolving space?

Mark: Fast forwarding a year, I expect we'll be talking about an industry that has shrunk further in the sheer number of sustainable and ESG branded public markets strategies in the U.S. due to ever-increasing scrutiny, regulation and shifting investor preferences. However, I also expect pockets of growth. Specifically, I see increased opportunities for investors to express single-theme views, particularly those that incorporate risks and opportunities created by climate change across public and private markets beyond energy into topics such as agriculture, water, critical minerals and transportation.

Amy: We're at an important inflection point in the industry – increased scrutiny means increased interest and attention for better or for worse, which could result in some really fascinating datasets and product capability developments in the industry. However, ultimately the hope is that this period of scrutiny results in a more enduring, standardized industry fit for a larger proportion of institutional allocators' needs.

Mark: Over the long term, to ensure durability in approach in what will continue to be an evolving industry, investors should not lose focus on why they originally became interested in sustainable investing. Was it to simply ensure one is capturing material and relevant ESG information as part of a mosaic to achieve competitive risk-adjusted returns? Is it to produce "double bottom line returns" around a certain theme such as climate – seeking both financial returns AND measurable impact? Or is it to simply align your portfolio with your personal or organizational values? Identifying that intent and then ensuring a consistent and well-documented suite of strategies to achieve it is critical. That's our job - to work with our clients to design portfolios that achieve these goals in a thoughtful, consistent and thorough way, enabling the pursuit of both financial and, where relevant, impact goals.

Amy: GIM's aspiration is, and will always be, to generate alpha. Our framework for ESG investing, whether integrated or thematic, was designed around this principle.

1 Morningstar as of Q4 2023.

2 Callan. 2022 ESG Survey.

3 MorningStar. MorningStar. Global Sustainable Fund Flows: Q3 2023 in Review. October 25, 2023. https://www.morningstar.com/lp/global-esg-flows?utm_source=google&utm_medium=cpc&utm_campaign=%20&utm on December 19, 2023.